

Other Deductions, Penalties, and Loss Disallowance

Chapter 8

Common Loss Limitations and Disallowances

- ▶ Public policy limitations
- ▶ Political contributions
- ▶ Excessive compensation
- ▶ Hobby losses
- ▶ Rental of vacation homes
- ▶ Personal expenditures

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Public Policy Limitations

- ▶ Activities that violate public policy do not generate tax deductions
 - Penalties
 - Fines
 - Bribes and kickbacks
 - Non-deductible even when customary
 - Foreign Corrupt Practices Act

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Illegal Activities and Income Taxation

- ▶ Illegal business expenses
 - Deductible as if business were legal
 - Fines and bribes still nondeductible
- ▶ Trafficking in controlled substances (Drugs)
 - Only cost of goods sold is a deductible business expense

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Income and Deductions – Illegal Gambling Operation Example

Tony runs an illegal gambling operation in the back room of his meat packing firm.

- ▶ In 2012, Tony received \$750,000 in gross receipts from the gambling operation.
- ▶ The pro-rata portion of rent Tony paid for the space used for the gambling operation was \$40,000.
- ▶ Tony paid his employees \$250,000 to run the operation, and incurred \$20,000 in product costs (cards, chips, dice, etc.).

Tony's income from the gambling operation is \$440,000 (\$750,000 in gross receipts less \$250,000 in salaries, \$40,000 for rent, and \$20,000 for product costs).

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Income and Deductions – Illegal Drug Operation Example

Ted supplements his income by running an illegal drug procurement and distribution business.

- ▶ In 2012, Ted received \$750,000 in gross receipts from the illegal drug business.
- ▶ Ted paid \$40,000 in rent for the space used to store and package the drugs.
- ▶ Ted paid his employees and street pushers \$250,000 to run the operation, and incurred \$150,000 in product costs (costs of drugs sold) plus incidental expenses of \$20,000.

Ted's taxable income from the drug operation is \$600,000 (\$750,000 in gross receipts less \$150,000 cost of goods sold).

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Political and Lobbying Expenditures

- ▶ General Rule:
 - No business or personal deduction is allowed for political contributions or lobbying
- ▶ Deductions are allowed for lobbying:
 - To influence local legislation,
 - To monitor legislation, and
 - De minimis in-house expenses (limited to \$2,000)
 - If greater than \$2,000, none can be deducted

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Excessive Executive Compensation

- ▶ For publicly held corporations:
 - CEO and four highest compensated executives' salaries deductible up to \$1 million each
- ▶ Does not include:
 - Performance-based compensation and commissions
 - Payments to qualified retirement plans
 - Payments excludible from gross income

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Hobby Activity

- ▶ Activity not entered into for profit
 - Personal pleasure associated with activity
 - Examples:
 - Raising dogs
 - Sailboat racing
 - Gardening
- ▶ Sometimes difficult to determine if an activity is profit motivated or a hobby
 - Regulations provide nine factors to consider in making this determination

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Factors to Consider

- ▶ Manner activity is managed
- ▶ Time and effort expended
- ▶ Expertise of taxpayer and advisors
- ▶ Taxpayer's success in similar activities
- ▶ History of profit/loss in similar activities
- ▶ Amount of occasional profits generated
- ▶ Expectation that assets will increase in value
- ▶ Financial status of taxpayer
- ▶ Whether personal pleasure dictates involvement

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Presumptive Rule of Section 183

- ▶ If activity shows profit in 3 out of 5 years (2 out of 7 years for horses), presumption is that taxpayer has profit motive
 - Rebuttable presumption
 - Shifts burden of proof to IRS to show taxpayer did not have a profit motive
- ▶ Otherwise, taxpayer has burden to prove profit motive

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Hobby vs. For Profit Activities

- | | |
|--|---|
| <ul style="list-style-type: none">▶ <u>Profit Activity</u><ul style="list-style-type: none">◦ Deduct expenses above the line◦ At-risk and passive loss rules may apply | <ul style="list-style-type: none">▶ <u>Hobby Activity</u><ul style="list-style-type: none">◦ Income is included above the line◦ Expenses<ul style="list-style-type: none">• Allowed only to extent of income• Deducted below the line• Subject to the 2% floor<ul style="list-style-type: none">• Unless deductible without regard to profit motive (such as mortgage interest & taxes) |
|--|---|

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Hobby Expenses

► Order of deduction:

- **Tier 1:** otherwise deductible expenses
 - mortgage interest
 - property taxes
 - casualty losses
- **Tier 2:** Other non-depreciation expenses
- **Tier 3:** Cost Recovery (Depreciation)

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Hobby Deductions Example

Pat raises and sells toy poodles. This activity is motivated primarily by Pat's love of dogs, and has been classified as a hobby activity for income tax purposes. This year, the gross income from the activity was \$20,000. Pat incurred the following expenses:

Interest	\$6,000
Taxes	\$3,000
Vet Bills	\$6,000
Food & Treats	\$5,000
Advertising	\$2,000
Depreciation	<u>\$1,000</u>
Total Expenses	<u>\$23,000</u>



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Hobby Deductions Example (cont.)

Income: \$20,000

Deductions:

	<u>Amount</u>	<u>Order (Tier)</u>	<u>Amount</u>
Interest	\$6,000	1	\$6,000
Taxes	3,000	1	3,000
Vet Bills	6,000	2	6,000
Food & Treats	5,000	2	5,000
Advertising	2,000	2	0
Depreciation	1,000	3	0
Total	\$23,000		\$20,000

Deductions limited to income!

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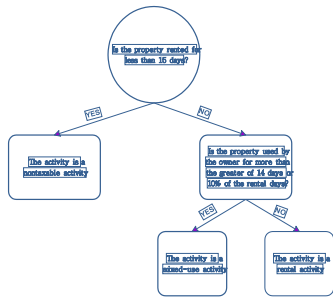
Classification of Rental Real Estate Activities

- ▶ Types of Rental Real Estate
 - Non-taxable rental use
 - Primarily rental use
 - Mixed use
- ▶ Personal Use Real Estate Tax Rules Differ
 - Personal residences
 - Second homes

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Rental Use Classification



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Non-Taxable Rental Activity

- ▶ Rental for less than 15 days
- ▶ Income is realized, but not recognized
- ▶ No expenses may be claimed
 - Mortgage interest and property taxes treated as personal expenses on Schedule A (Itemized Deductions)

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Primarily Rental Use Vacation Home

- ▶ Characteristics:
 - Rented for more than 14 days
 - Personal use is less than the greater of
 - 14 days
 - 10% of rental days
- ▶ Tax Consequences:
 - Income is recognized
 - All allocable expenses are deductible, even if it results in a loss
 - Ability to claim loss may be limited by passive activity rules

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Mixed Use Vacation Homes

- ▶ Characteristics:
 - Rented for more than 14 days
 - Personal use is greater than the greater of
 - 14 days
 - 10% of rental days
- ▶ Tax Consequences:
 - Income is recognized
 - Allocable expenses are deductible to extent of income
 - Tier rules from hobby loss expenses apply
 - 2% floor does not apply (as is the case with hobby losses)
 - Unused expenses can be carried forward

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Rental Vacation Homes

- ▶ Keegan spends relatively little time at his beach home, and rents the home out for 200 days during the year. Identify if the rental activity will be classified as a rental or mixed use activity.

Personal use	Rental Use	Mixed Use
7 days	X	
18 days	X	
25 days		X

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Rental Vacation Homes

- ▶ Reilly spends relatively little time at his mountain cabin, and rents it out for 100 days during the year. Identify if the rental activity will be classified as a rental or mixed use activity.

<u>Personal Use</u>	<u>Rental Use</u>	<u>Mixed Use</u>
7 days	X	
14 days	X	
18 days		X

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Rental Vacation Homes

- ▶ Expense Allocation (Personal v. Rental)
 - Mortgage interest and taxes
 - IRS requires allocation based on total days *used*
 - Courts have allowed allocation based on days in year
 - Other expenses allocated based on total days used

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Personal Expenditures

- ▶ Generally not deductible
- ▶ Some exceptions apply, usually associated with public policy concerns
 - Interest and taxes on personal residences and one additional home

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Limitations on Specific Deductions

- ▶ Bad debts
- ▶ Worthless securities
- ▶ Section 1244 stock
- ▶ Losses of individuals
- ▶ Research and experimental expenditures
- ▶ Net operating losses (NOLs)
- ▶ Depreciation

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Limitations on Bad Debts

- ▶ **Business Bad Debts**
 - Only deductible if accrual method of accounting is used
 - Generally required to use specific charge-off method in year the debt becomes partially or wholly worthless
 - Some businesses can use the reserve method
- ▶ **Personal Bad Debts**
 - Specific charge off method MUST be used
 - Allowed only when debt is wholly worthless
 - Always treated as short-term capital loss, regardless of the holding period
 - Related party debts are suspect, and are usually treated as gifts

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Classification of Bad Debts

- ▶ Determination of whether bad debt is business or personal is made at the time debt is created
- ▶ Individuals have non-business bad debts unless:
 - In the business of loaning money, or
 - Bad debt is associated with the individual's trade or business

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Worthless Securities

- ▶ Loss deduction allowed for securities that become worthless during the year
 - **Artificial Sale Date:** last day of the year in which the securities became worthless
 - For individuals (cash-basis taxpayers), this is December 31st
 - Causes holding period to be short-term unless the security was purchased prior to the last day of the preceding year

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Worthless Securities Example

- ▶ On December 1, 2011, Sally purchased stock for \$10,000. The stock became worthless on June 1, 2012.
 - Sally is treated as having sold the stock on December 31, 2012. The result is a long-term capital loss.

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Section 1244 Stock

- ▶ Stock may be classified as Section 1244 stock if
 - It is held by an original purchaser
 - The initial capitalization of the company was \$1 million or less
- ▶ Tax Treatment
 - If sold at a loss,
 - The first \$50,000 (\$100,000 for MFJ) each year is treated as an ordinary loss
 - Excess losses for the year follow normal capital loss rules
 - Section 1244 does not apply to gains

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Section 1244 Example

- ▶ In 2011, Kasey purchased a 20% interest in a newly organized company, Mishka Enterprises, Inc. for \$100,000. Unfortunately, the company did not succeed, and Kasey's interest became worthless in 2012. What are the tax consequences for Kasey?
 - The first \$50,000 of loss is treated as an ordinary loss.
 - Not subject to limitation
 - The remaining \$50,000 of loss is treated as a long-term capital loss.
 - Kasey's holding period was greater than 1 year
 - Assuming that Kasey had no other capital transactions for the year, he can deduct \$53,000 on his 2011 income tax return.

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Losses of Individuals

- ▶ Generally, personal losses are not deductible
 - Example: Loss on sale of personal residence is not deductible
- ▶ Individuals can deduct losses
 - Incurred in a trade or business,
 - Incurred in a transaction entered into for profit,
 - Losses caused by fire, storm, shipwreck, or other casualty or by theft.

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Research and Experimental Expenses

- ▶ Costs for the development of an experimental model, plant process, product, formula, or similar property and improvement of such existing property.
- ▶ Three alternatives are available for R&E expenditures
 - Expense in year paid or incurred,
 - Defer and amortize over period of 60 months or more, or
 - Capitalize (deductible when project abandoned or worthless).
- ▶ Credit of 20% of certain research and experiment expenditures available.

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Net Operating Losses (NOL)

- ▶ Business losses are above-the-line deductions and offset past or future income
 - Losses from trade or business operations, casualty and theft, or foreign government confiscations can create a NOL.
- ▶ Carryback/forward rule
 - NOL can be carried back 2 years; forward 20 – except for losses from 12/31/2007 – 1/1/2010 (5 years back)
 - Carryback rule extended to 3 years for small businesses if the loss results from
 - Casualty/theft
 - Presidentially declared disaster area
 - Farm losses qualify for 5-year carryback provision

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NOL Carryback Rule

- ▶ Losses must be carried back first, then forward
 - Can make irrevocable election to carry them forward
- ▶ Carry-back may impact
 - IRA deductions
 - Student loan interest deductions
 - Tuition and fees deduction
 - Savings bond exclusion (for education)
 - Itemized deductions subject to floors
 - Charitable deductions are not affected, since contribution base excludes NOL carrybacks
 - All other items dependent on AGI, including tax credits
- ▶ Carryback rule does not result in change to self-employment taxes

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Depreciation

- ▶ Allowed for assets used in
 - A trade or business
 - An activity for the production of income
- ▶ Represents return of capital
 - Basis is returned to the owner over the useful life of the asset
- ▶ Personal assets and land are not depreciated
 - Basis is returned to the owner when the property is sold

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Summary of Specific Deductions

Bad Debts	If business and accrual, ordinary loss If personal, specific write off and short-term capital loss
Worthless Securities	Assumed worthless at year-end of realization
Section 1244 Stock	\$100,000 ordinary loss for married filing jointly, excess is capital loss (\$50,000 for single filers)
Losses of Individuals	Not deductible except as casualty losses
Research and experimental expenditures	In year paid, amortized over 60 months, or capitalized
Net Operating Losses	Back 2 and forward 20 years, can elect forward only
Depreciation	Ratably written off

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Retirement Plan Penalties

- ▶ **Excess Contributions Penalty** (*Too Much*)
 - 6% excise tax for contributing too much
 - If corrected by due date of return, does not apply
- ▶ **Early Distribution Penalty** (*Too Early*)
 - 10% excise tax for taking early distribution
 - 25% for SIMPLE plan distributions within 2 years of entry
 - Exceptions apply
- ▶ **Late Distribution Penalty** (*Too Late*)
 - 50% excise tax for not taking enough
 - Must take distributions beginning at age 70 ½

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Early Distribution

Applies to Distribution from:	Exception to 10% Early Withdrawal Penalty
Both Qualified Plans & IRAs	Death
Both Qualified Plans & IRAs	Attainment of age 59½
Both Qualified Plans & IRAs	Disability
Both Qualified Plans & IRAs	Substantially equal periodic payments (Section 72(t))
Both Qualified Plans & IRAs	Medical expenses that exceeds 7.5% of AGI
Both Qualified Plans & IRAs	Tax levy
Only Qualified Plans	QDRO or state order under divorce*
Only Qualified Plans	Attainment of age 55 and separation from service
Only Qualified Plans	Public safety employee separated from service after age 50
Only IRAs	Higher education expenses
Only IRAs	First time home purchase (up to \$10,000)
Only IRAs	Health insurance for unemployed

*Where there is a distribution at divorce and the payee is under 59½, the use of a QDRO directed distribution will result in a taxable event but will not incur the 10% early withdrawal penalty. Under the same circumstances, except that the distribution is from an IRA, the result is both a taxable event and the application of the 10% early withdrawal penalty. However, the payee in any case can choose to rollover the distribution in which case, the rollover rules would apply or the payee can take substantially equal periodic payments under Section 72(t).

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Other Loss Disallowance

Temporarily Disallowed	Permanently Disallowed
Section 1031 Exchanges	Related Party Transactions
Wash Sales	Gifts Below Fair Market Value
	Loss on Sale of Personal Residence

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Wash Sale Rule

- ▶ Applies when a taxpayer
 - Sells an asset
 - Purchases a substantially similar asset within 30 days before or after the sale
- ▶ Tax Consequence
 - Loss is
 - Not recognized
 - Added to the basis of the replacement property

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Gifts When Fair Market Value is Below Donor's Basis

- ▶ Dual basis rule applies (covered later)

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