

# Chapter 5

## Deductions and Losses: In General

**Eugene Willis, William H. Hoffman, Jr.,  
David M. Maloney and William A. Raabe**

Copyright ©2004 South-Western/Thomson Learning

# Deductions

- Exclusive definition of deductions
  - Deductions allowed based on legislative grace and defined narrowly
  - Substantiation requirements
    - Taxpayer has burden of proof for substantiating all expenses deducted on return
    - Thus, adequate records of expenses must be maintained

# Deductions FOR and FROM AGI (slide 1 of 3)

- Deductions FOR AGI
  - Those listed in § 62
  - Can be claimed even if taxpayer does not itemize
  - Called “above the line” deductions

# Deductions FOR and FROM AGI (slide 2 of 3)

- Deductions FROM AGI :
  - Those not listed in § 62
  - In total must exceed standard deduction to provide any tax benefit
  - Called “below the line” or itemized deductions

# Deductions FOR and FROM AGI (slide 3 of 3)

- Comparison of deductions FOR and FROM AGI (2003 tax year)
  - Single taxpayer has gross income of \$45,000 and a \$5,000 deduction

	<u>For AGI</u>	<u>From AGI</u>
Gross income	\$45,000	\$45,000
Less: for AGI ded.	<u>5,000</u>	<u>0</u>
AGI	\$40,000	\$45,000
Less: from AGI ded.	4,750	5,000
Less: personal exempt.	<u>3,050</u>	<u>3,050</u>
Taxable income	\$32,200	\$36,950

# Deductions *for* AGI

(slide 1 of 2)

- Partial list includes:
  - Trade or business expenses
  - Reimbursed employee business expenses
  - Deductions from losses on sale or exchange of property
  - Deductions from rental and royalty property
  - Alimony
  - One-half of self-employment tax paid

# Deductions *for* AGI

(slide 2 of 3)

- Partial list includes:
  - 100% (in 2003) of health insurance premiums paid by a self-employed individual
  - Contributions to pension, profit sharing, annuity plans, IRAs, etc.
  - Penalty on premature withdrawals from time savings accounts or deposits
  - Moving expenses

# Deductions *for* AGI

(slide 3 of 3)

- Partial list includes:
  - Interest on student loans
  - Deduction for qualified tuition and related expenses under § 222
  - Deduction for up to \$250 for teachers' supplies for elementary and secondary school teachers

# Deductions *from* AGI

- Itemized deductions include:
  - Medical expenses (in excess of 7.5 percent of AGI)
  - Certain state and local taxes
  - Contributions to qualified charitable organizations
  - Personal casualty losses (in excess of 10 % of AGI and a \$100 floor per casualty)
  - Certain personal interest expense (e.g., mortgage interest on a personal residence)
  - Miscellaneous itemized deductions (in excess of 2% of AGI)

# Trade or Business Deductions

- In order for expenses to be deductible, they 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
  - Incurred in conduct of business

# 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

# Methods of Accounting

- 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
      - Exception to the economic performance test for recurring items

# Disallowance Possibilities

(slide 1 of 6)

- Contrary to public policy
  - Examples: penalties, fines, illegal bribes or kickbacks, two-thirds of treble damage payments for violation of anti-trust law

# Disallowance Possibilities

(slide 2 of 6)

- Legal expenses for business or production of income related activities may be deductible
  - E.g., Corporate officer's legal fees in defending against price-fixing charges
  - E.g., Landlord's legal fees associated with eviction of tenant

# Disallowance Possibilities

(slide 3 of 6)

- Illegal business expenses
  - Deductible as if business were legal
  - Fines, bribes, etc., still nondeductible
  - Trafficking in controlled substances: only cost of goods sold can reduce gross income

# Disallowance Possibilities

(slide 4 of 6)

- Political and lobbying expenditures
  - Generally, no business deduction is allowed for payments made for political purposes or for lobbying
  - Exceptions 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

# Disallowance Possibilities

(slide 5 of 6)

- Excessive executive compensation
  - For publicly held corporations: chief executive officer's 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

# Disallowance Possibilities

(slide 6 of 6)

- Investigation of business expenditures
  - Capitalize and elect to amortize over 60-month period, if new line of business and acquired
  - Nondeductible, if new line of business and not acquired
  - Deduct currently, if same line of business

# Hobby Losses (slide 1 of 8)

- Hobby defined
  - Activity not entered into for profit
    - Personal pleasure associated with activity
    - Examples: raising horses, fishing boat charter
  - Often it is difficult to determine if an activity is profit motivated or a hobby
    - Regulations provide nine factors to consider in making this determination

# Hobby Losses (slide 2 of 8)

- Profit activity
  - If activity is entered into for profit, taxpayer can deduct expenses FOR AGI even in excess of income from the activity
  - At-risk and passive loss rules may apply

# Hobby Losses (slide 3 of 8)

- Presumptive rule of § 183
  - If activity shows profit 3 out of 5 years (2 out of 7 years for horses), it is presumed that taxpayer has profit motive
    - Rebuttable presumption, shifts burden of proof to IRS
  - Otherwise, taxpayer has burden to prove profit motive

# Hobby Losses (slide 4 of 8)

<u>Year</u>	<u>Income (loss)</u>	<u>Hobby?</u>
1997	\$500	Yes
1998	(1,500)	Yes
1999	700	Yes
2000	(1,000)	Yes
2001	900	No, profit 3 of 5 years
2002	(500)	Yes, profit only 2 of 5 years
2003	1,200	No, profit 3 of 5 years

# Hobby Losses (slide 5 of 8)

- Hobby activity
  - Can only deduct expenses to extent of income from activity (i.e., cannot deduct hobby losses)

# Hobby Losses (slide 6 of 8)

- If an activity is a hobby:
  - Expenses are deductible FROM AGI
    - Treated as miscellaneous itemized deductions subject to the 2% of AGI limitation
    - Exception: expenses that are deductible without regard to profit motive, such as
      - Mortgage interest
      - Property taxes

# Hobby Losses (slide 7 of 8)

- Order in which hobby expenses are deductible:
  - First: Those otherwise deductible: e.g., home mortgage interest and property taxes
  - Then: Expenses that do not affect adjusted basis: e.g., maintenance, utilities
  - Then: Expenses that affect adjusted basis: e.g., Depreciation (or cost recovery)

# Hobby Losses (slide 8 of 8)

- Example of hobby expenses: Taxpayer sells horses raised as a hobby for \$15,500

	<u>Amount</u>	<u>Order</u>	<u>Amount</u>
Income	\$15,500		
Interest	6,000	1	\$ 6,000
Taxes	3,000	1	3,000
Vet Bills	2,000	2	2,000
Feed	4,000	2	4,000
Depreciation	1,000	3	Ltd. to 500
Total			15,500

# Rental Vacation Homes

(slide 1 of 9)

- May have both personal and rental use of a vacation home
- Rental expenses may be limited to rental income if primarily used for personal purposes
- Determination of vacation home treatment is dependent on personal use vs. rental use

# Rental Vacation Homes

(slide 2 of 9)

- Rental days
  - Less than 15 days: No gross income from rentals and no deductible rental expenses
    - Mortgage interest and property taxes treated as if on personal residence (generally deductible in full)
  - More than 14 days: Treatment depends on amount of personal use

# Rental Vacation Homes

(slide 3 of 9)

- 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
  - Can deduct all expenses allocated to rental use even if loss results
    - Rental loss subject to passive loss rules

# Rental Vacation Homes

(slide 4 of 9)

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

# Rental Vacation Homes

(slide 5 of 9)

- Example of personal use

Rental days: 200 (10% = 20)

<u>Personal use</u>	<u>Not Significant</u>	<u>Significant</u>
7 days	X	
18 days	X	
25 days		X

# Rental Vacation Homes

(slide 6 of 9)

- Example of personal use

Rental days: 100 (10% = 10)

<u>Personal Use</u>	<u>Not Significant</u>	<u>Significant</u>
7 days	X	
14 days	X	
18 days		X

# Rental Vacation Homes

(slide 7 of 9)

- 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

# Rental Vacation Homes

(slide 8 of 9)

- Tax treatment of income and expenses of a primarily rental vacation home
  - Rental income included in gross income
  - Rental expenses deductible FOR AGI
  - Rental income and expenses reported on Sch. E

# Rental Vacation Homes

(slide 9 of 9)

- Treatment of allocated *personal portion* of vacation home expenses
  - **Primarily rental use:** taxes deductible FROM AGI, mortgage interest nondeductible (personal interest)
  - **Personal/rental use:** mortgage interest and taxes deductible FROM AGI
  - Personal portion of other expenses (e.g., insurance, maintenance) nondeductible

# Expenditures Incurred for Taxpayer's Benefit or Obligation

- No deductions 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

# Personal Expenditures

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

# Capital Expenditures

- Amounts are capitalized
- Asset may be subject to depreciation (or cost recovery), amortization, or depletion

# Transactions Between Related Parties (slide 1 of 2)

- Section 267 disallows losses from direct or indirect sales or exchanges of property between related parties
  - Family and entity relationships apply
  - Constructive ownership rules apply
  - Loss disallowed may reduce gain on subsequent disposition to unrelated third party

# Transactions Between Related Parties (slide 2 of 2)

- Section 267 also requires the matching principle be applied for unpaid expenses and interest when different accounting methods used
  - Example: An accrual basis, closely held corporation, cannot deduct accrued, but unpaid, salary to cash basis related party employee/shareholder until it is actually paid

# Expenses and Interest Relating to Tax-Exempt Income

- Expenses relating to production of tax-exempt income are nondeductible
  - Example: interest expense on loan where funds used to acquire municipal bonds

**If you have any comments or suggestions concerning this PowerPoint Presentation for West's Federal Taxation, please contact:**

**Dr. Donald R. Trippeer, CPA  
donald.trippeer@colostate-pueblo.edu  
Colorado State University-Pueblo**