Chapter 5

Deductions and Losses: In General

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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 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

<table>
<thead>
<tr>
<th></th>
<th>For AGI</th>
<th>From AGI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$45,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Less: for AGI ded.</td>
<td>5,000</td>
<td>0</td>
</tr>
<tr>
<td>AGI</td>
<td>$40,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Less: from AGI ded.</td>
<td>4,750</td>
<td>5,000</td>
</tr>
<tr>
<td>Less: personal exempt.</td>
<td>3,050</td>
<td>3,050</td>
</tr>
<tr>
<td>Taxable income</td>
<td>$32,200</td>
<td>$36,950</td>
</tr>
</tbody>
</table>
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
• 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
• 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
<table>
<thead>
<tr>
<th>Year</th>
<th>Income (loss)</th>
<th>Hobby?</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>$500</td>
<td>Yes</td>
</tr>
<tr>
<td>1998</td>
<td>(1,500)</td>
<td>Yes</td>
</tr>
<tr>
<td>1999</td>
<td>700</td>
<td>Yes</td>
</tr>
<tr>
<td>2000</td>
<td>(1,000)</td>
<td>Yes</td>
</tr>
<tr>
<td>2001</td>
<td>900</td>
<td>No, profit 3 of 5 years</td>
</tr>
<tr>
<td>2002</td>
<td>(500)</td>
<td>Yes, profit only 2 of 5 years</td>
</tr>
<tr>
<td>2003</td>
<td>1,200</td>
<td>No, profit 3 of 5 years</td>
</tr>
</tbody>
</table>
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)
• Example of hobby expenses: Taxpayer sells horses raised as a hobby for $15,500

<table>
<thead>
<tr>
<th>Amount</th>
<th>Order</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td></td>
<td>$15,500</td>
</tr>
<tr>
<td>Interest</td>
<td>6,000</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 6,000</td>
</tr>
<tr>
<td>Taxes</td>
<td>3,000</td>
<td>1</td>
</tr>
<tr>
<td>Vet Bills</td>
<td>2,000</td>
<td>2</td>
</tr>
<tr>
<td>Feed</td>
<td>4,000</td>
<td>2</td>
</tr>
<tr>
<td>Depreciation</td>
<td>1,000</td>
<td>3</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>15,500</td>
</tr>
</tbody>
</table>
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)

<table>
<thead>
<tr>
<th>Personal use</th>
<th>Not Significant</th>
<th>Significant</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 days</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>18 days</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>25 days</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
## Rental Vacation Homes

*(slide 6 of 9)*

- Example of personal use

<table>
<thead>
<tr>
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<th>Significant</th>
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</thead>
<tbody>
<tr>
<td>7 days</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>14 days</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>18 days</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

Rental days: 100 (10% = 10)
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:

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