Chapter 6

Deductions and Losses: Certain Business Expenses and Losses

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

Business Bad Debts (slide 1 of 3)

- Specific charge-off method must be used
  - Exception: Reserve method is allowed for some financial institutions
- Deduct as <u>ordinary loss</u> in the year when debt is <u>partially or wholly</u> worthless
  - Cash basis taxpayer does not have bad debt deduction for unpaid receivables

Business Bad Debts (slide 2 of 3)

- Example:
  - Ted uses the accrual method of accounting
    - Ted sells inventory on account for $1,150
      - Buyer pays $150 down and makes no other payments
    - Ted has $1,000 bad debt deduction

Business Bad Debts (slide 3 of 3)

- Example:
  - Tara uses the cash method of accounting
    - Tara performs accounting services for $1,150
      - Client pays $150 down and makes no other payments
    - Tara has no bad debt deduction

Nonbusiness Bad Debts (slide 1 of 2)

- Specific charge-off method must be used
- Deduct as <u>short-term capital loss</u> in the year when amount of worthlessness is known with certainty
  - <u>No deduction</u> is allowed <u>for partial worthlessness</u> of a nonbusiness bad debt

Nonbusiness Bad Debts (slide 2 of 2)

- Related party (individuals) bad debts are generally suspect and may be treated as gifts

Classification of Bad Debts

- Individuals will generally have nonbusiness bad debts unless:
  - In the business of loaning money, or
  - Bad debt is associated with the individual's trade or business
- Determination is made either at the time the debt was created or when it became worthless

Worthless Securities (slide 1 of 2)

- 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 year in which the securities became worthless

Worthless Securities (slide 2 of 2)

- Example of worthless securities
  - On December 1, 2002, Sally purchased stock for $10,000. The stock became worthless on June 1, 2003. Sally's loss is treated as having occurred on December 31, 2003. The result is a long-term capital loss.

Section 1244 Stock

(slide 1 of 3)

- 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 MFJ taxpayers)
    - Loss in excess of per year limit is treated as capital loss

Section 1244 Stock
(slide 2 of 3)

- Section 1244 loss treatment is limited to stock owned by original purchaser
- Corporation must meet certain requirements to qualify
  - Major requirement is limit of $1 million of capital contributions
- Section 1244 does not apply to gains

Section 1244 Stock

(slide 3 of 3)

- Example of § 1244 loss
  - In 1994, Sam purchases from XYZ Corp. stock costing $150,000. (Total XYZ stock outstanding is $800,000.) In 2003, Sam sells the stock for $65,000.
  - Sam, a single taxpayer, has the following tax consequences:

    $50,000 ordinary loss

    $35,000 long-term capital loss

Losses of Individuals

- Only the following losses are deductible by individuals:
  - 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

Definition of Casualty & Theft (C & T)

- 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 not treated as casualties include losses from disease and insect damage

Definition of Theft

- Theft includes robbery, burglary, embezzlement, etc.
  - Does not include misplaced items

When Casualty & Theft Is Deductible

- Casualties: year in which loss is sustained
  - Exception: If declared "disaster area" by President, can elect to deduct loss in year prior to year of occurrence
- Thefts: year in which loss is discovered

Effect of Claim for Reimbursement

- 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

Amount of C&T Deduction

- Amount of loss and its deductibility depends on whether:
  - Loss is from nonpersonal (business or production of income) or personal property
  - Loss is partial or complete

Amount of Nonpersonal C&T Losses

- Theft or complete casualty (FMV after = 0)
  - Adjusted basis in property less insurance proceeds
- Partial casualty
  - Lesser of decline in value or adjusted basis in property, less insurance proceeds

C&T Examples

- Business and production of income losses (no insurance proceeds received)

Item	Adjusted Basis	FMV Before	FMV After	Loss
A	6,000	8,000	5,000	3,000
B	6,000	8,000	1,000	6,000
C	6,000	4,000	0	6,000

Nonpersonal C&T Losses

- Business, rental, and royalty properties
  - Deduction will be FOR AGI
- Employee business and investment properties
  - Deduction will be FROM AGI
    - Misc. itemized deduction subject to 2% of AGI limitation

Nonpersonal C&T Gains

- Depending on the property, gain can be ordinary or capital
- Amount of nonpersonal gains
  - Insurance proceeds less adjusted basis in property

Personal C&T Gains

- Net personal casualty gains and losses
  - If gains exceed losses, treat as gains and losses from the sale of capital assets
    - Short term or long term, depending on holding period
  - Personal casualty and theft gains and losses are not netted with the gains and losses on business and income-producing property

Personal C&T Losses

- Net personal casualty gains and losses
  - If losses exceed gains, C&T deduction will be FROM AGI (an itemized deduction)
- Amount of personal C&T losses
  - Lesser of decline in value or adjusted basis in property, less insurance proceeds
  - C&T Limitation
    - Each C&T occurrence is deductible to extent > $100, and aggregate of C&T losses for year must be > 10% AGI

Example of C&T Limitation
(slide 1 of 2)

- Karen (AGI = $40,000) has the following C&T (amounts are lesser of decline in value or adjusted basis):
    1. Car stolen ($6,000) with camera inside ($500)
    2. Earthquake damage: house ($2,000), furniture ($1,000)

Example of C&T Limitation
(slide 2 of 2)

- Example of C&T limitation (cont'd)

  Karen has no insurance coverage for either loss:

    1. \$6,000 + 500 = \$6,500 - 100 = \$6,400
    2. \$2,000 + 1,000 = \$3,000 - 100 = \$2,900

  Karen's deductible C&T loss is \$5,300 [\$6,400 + 2,900 - (10% \$40,000)]

Research and Experimental Expenditures (slide 1 of 2)

- Definition of research and experimental (R&E) expenditures
  - Costs for the development of an experimental model, plant process, product, formula, invention, or similar property and improvement of such existing property

Research and Experimental Expenditures (slide 2 of 2)

- 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 R&E expenditures available

Net Operating Losses
(slide 1 of 3)

- Carryover period
  - Must carryback to 2 prior years, then carryforward to 20 future years
    - May make an irrevocable election to just carryforward
    - When there are NOLs from two or more years, use on a FIFO basis
  - 3 year carryback is available for:
    - Individuals with NOL from casualty or thefts
    - Farming businesses and small businesses with NOLs from Presidentially declared disasters

Net Operating Losses
(slide 2 of 3)

- Example of NOL carryovers
  - Ken has a NOL for 2003
  - Ken must carryover his NOL in the following order:
    - Carryback to 2001 and 2002, then carryforward to 2004, 2005, ..., 2023
  - Ken can elect to just carryforward his NOL
    - Carryover would be to 2004, 2005, ..., 2023

Net Operating Losses
(slide 3 of 3)

- Effect of NOL in carryback year
  - Taxpayer must recompute taxable income and the income tax
  - All limitations and deductions based on AGI must be recomputed with the exception of charitable contribution deduction
  - All credits limited by or based on the tax liability must be recomputed

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