★ CHAPTER SEVEN ★

OVERVIEW OF DEDUCTIONS AND LOSSES

LEARNING OBJECTIVES

Upon completion of this chapter you will be able to:

- Recognize the general requirements for deducting expenses and losses
- Define the terms *ordinary*, *necessary*, and *reasonable* as they apply to business deductions
- Recognize tax accounting principles with respect to deductions and losses
- Explain the proper treatment of employee business expenses
- Describe the importance of properly classifying expenses as deductions *for* or *from* adjusted gross income
- Classify expenses as deductions *for* or *from* adjusted gross income
- Recognize statutory, administrative, and judicial limitations on deductions and losses
- Explain tax planning considerations for optimizing deductions

CHAPTER OUTLINE

As explained in Chapter 3, the income tax is imposed on taxable income, a quantity defined as the difference between gross income and allowable deductions.[1] The concept of gross income was explored in Chapters 5 and 6. This chapter and the following four chapters examine the subject of deductions.

There is little doubt that when it comes to taxation, the questions asked most frequently concern deductions. What is deductible? Can this expense be deducted? How much can I deduct? This is a familiar refrain around taxpaying time, and rightfully so, since any item that might be deductible reduces the tax that otherwise must be paid. Many of the questions concerning deductions are easily answered by merely referring to the basic criteria. On the other hand, many items representing potential deductions are subject to special rules. The purpose of this chapter is to introduce the general rules that are in fact used for determining the answer to that age-old question: Is it deductible?

DEDUCTION DEFINED

In the preceding chapters, the definition given for income was described as being ''all-inclusive'' (i.e., gross income includes *all* items of income except those specifically excluded by law). Given this concept of income, it might be assumed that a similarly broad meaning is given to the term deduction. Deductions, however, are defined narrowly. Deductions are only those *particular* expenses, losses, and other items for which a deduction is authorized.[2] The significance of this apparently meaningless definition is

1 § 63.

2 § 161.

found in the last word—"authorized." *Nothing is deductible unless it is allowed by the Code*. It is a well-established principle that before a deduction may be claimed the taxpayer must find some statutory provision permitting the deduction. The courts consistently have affirmed this principle, stating that a taxpayer has no constitutional right to a deduction. Rather, a taxpayer's right to a deduction depends solely on "legislative grace" (i.e., Congress has enacted a statute allowing the deduction).[3]

Although a taxpayer's deductions require statutory authorization, this does not mean that a particular deduction must be specifically mentioned in the Code. While several provisions are designed to grant the deduction for a specific item, such as § 163 for interest expense and § 164 for taxes, most deductions are allowed because they satisfy the conditions of some broadly defined category of deductions. For example, no specific deduction is allowed for the advertising expense of a restaurant owner, but the expense may be deductible if it meets the criteria required for deduction of *business expenses*.

The remainder of this chapter examines those provisions authorizing several broad categories of deductions: § 162 on trade or business expenses, § 212 on expenses of producing income, and § 165 on losses. In addition to these deduction-granting sections, several provisions that expressly deny or limit deductions for certain items are considered. The rules provided by these various provisions establish the basic framework for determining whether a deduction is allowed. Once the deductibility of an item is determined, an additional problem exists for individual taxpayers—the deduction must be classified as either a deduction *for* adjusted gross income or a deduction *from* adjusted gross income (itemized deduction). The classification process is also explained in this chapter.

DEDUCTIONS FOR EXPENSES: GENERAL REQUIREMENTS

Given that the taxpayer can deduct only those items that are authorized, what deductions does Congress in fact allow? The central theme found in the rules governing deductions is relatively straightforward: those expenses and losses incurred in business and profit-seeking activities are deductible while those incurred in purely personal activities are not. The allowance for business and profit-seeking expenses stems in part from the traditional notion that income is a *net* concept. From a conceptual perspective, income does not result until revenues exceed expenses. It generally follows from this principle that it would be unfair to tax the revenue from an activity but not allow deductions for the expenses that produced it.

In light of the Code's approach to deductions, many commentators have aptly stated that the costs of *earning* a living are deductible while the costs of living are not. Although this is a good rule of thumb, it is also an over-generalization. As will become clear, the Code allows deductions not only for the costs of producing income, but also for numerous personal expenses such as interest on home mortgages, property taxes, medical expenses, and charitable contributions. To complicate matters further, the line between personal and business expenses is often difficult to draw. For this reason, the various rules governing deductions must be examined closely.

GENERAL RULES: CODE §§ 162 AND 212

Two provisions in the Code provide the authority for the deduction of most expenses: § 162 concerning trade or business expenses and § 212 relating to expenses for the production of income. Numerous other provisions of the Code pertain to deductions. These other provisions, however, normally build on the basic rules contained in §§ 162 and 212. For this reason, the importance of these two provisions cannot be overstated.

3 *New Colonial Ice Co. v. Helvering*, 4 USTC ¶1292, 13 AFTR 1180, 292 U.S. 435 (USSC, 1934).

Section 162(a) on trade or business expenses reads, in part, as follows:

> In General.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—
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> **1)** a reasonable allowance for salaries or other compensation for personal services actually rendered;
> **2)** traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business;
> **3)** rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Although § 162(a) specifically enumerates three items that are deductible, the provision's primary importance lies in its general rule: ordinary and necessary expenses of carrying on a trade or business are deductible.

Section 212 contains a general rule very similar to that found in § 162. Section 212, in part, reads as follows:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
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> **1)** for the production or collection of income;
> **2)** for the management, conservation, or maintenance of property held for the production of income . . .

Production of income expenses are normally those related to investments, such as investment advisory fees and safe deposit box rentals.

An examination of the language of §§ 162 and 212 indicates that a deduction is allowed under either section if it meets *four* critical requirements. The expense must have all of the following properties:

1. It must be related to carrying on a trade or business or an income-producing activity.
2. It must be ordinary and necessary.
3. It must be reasonable.
4. It must be paid or incurred during the taxable year.

It should be emphasized, however, that satisfaction of these criteria does not ensure deductibility. Other provisions in the Code often operate to prohibit or limit a deduction otherwise granted by §§ 162 and 212. For example, an expense may be ordinary, necessary, and related to carrying on a business, but if it is also related to producing tax-exempt income, § 265 prohibits a deduction. This system of allowing, yet disallowing, deductions is a basic feature in the statutory scheme for determining deductibility.

RELATED TO CARRYING ON A BUSINESS OR AN INCOME-PRODUCING ACTIVITY

The Activity. Whether an expense is deductible depends in part on the type of activity in which it was incurred. A deduction is authorized by § 162 only if it is paid or incurred in an activity that constitutes a trade or business. Similarly, § 212 permits a deduction only if it is paid or incurred in an activity for the production or collection of income. The purpose of each of these requirements is to deny deductions for expenses incurred in an activity that is *primarily personal* in nature. For example, the costs incurred in pursuing what is merely a hobby, such as collecting antiques or racing automobiles, normally would be considered nondeductible personal expenditures. Of course, this assumes that such activities do not constitute a trade or business.

The Code does not provide any clues as to when an activity will be considered a trade or business or an income-producing activity rather than a personal activity. Over the years, however, one criterion has emerged from the many court cases involving the issue. To constitute a trade or business or an income-producing activity, the activity must be *entered into for profit*.[4] In other words, for the taxpayer's expenses to be deductible, they must be motivated by his or her hope for a profit. For this reason, taxpayers who collect antiques or race automobiles can deduct all of the related expenses if they are able to demonstrate that they did so with the hope of producing income. In such case, they would be considered to be in a trade or business. If the required profit motive is lacking, however, expenses of the activity generally are not deductible except to the extent the activity has income.

As may be apparent, the critical question in this area is what inspired the taxpayer's activities. The factors to be used in evaluating the taxpayer's motivation, along with the special provisions governing activities that are not engaged in for profit—the so-called hobby loss rules—are considered in detail later in this chapter.

A profit motive is the only requirement necessary to establish existence of an *income-producing* activity. However, the courts have imposed an additional requirement before an activity qualifies as a *trade or business*. Business status requires both a profit motive and a sufficient degree of taxpayer involvement in the activity to distinguish the activity from a passive investment. No clear guidelines have emerged indicating when a taxpayer's activities rise to the level of carrying on a business. The courts, however, generally have permitted business treatment where the taxpayer has devoted a major portion of time to the activities or the activities have been regular or continuous.[5]

Example 1. C owns six rental units, including several condominiums and townhouses. He manages his rental properties entirely by himself. His managing activities include seeking new tenants, supplying furnishings, cleaning and preparing the units for occupancy, advertising, and bookkeeping. In this case, C's involvement with the rental activities is sufficiently continuous and systematic to constitute a business.[6] If the rental activities were of a more limited nature, they might not qualify as a trade or business. The determination ultimately depends on the facts of the particular situation.[7]

Example 2. H owns various stocks and bonds. Her managerial activities related to these securities consist primarily of maintaining records and collecting dividends and interest. She rarely trades in the market. These activities are those normally associated with a passive investor, and accordingly would not constitute a trade or business under § 162 (they would be considered an income-producing activity under § 212).[8] On the other hand, if H had a substantial volume of transactions, made personal investigations of the corporations in which she was interested in purchasing, and devoted virtually every day to such work, her activities could constitute a trade or business.[9] Again, however, the answer depends on the facts.

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4 *Doggett v. Burrett*, 3 USTC ¶1090, 12 AFTR 505, 65 F.2d 192 (CA-D.C., 1933).

5 *Grier v. U.S.*, 55-1 USTC ¶9184, 46 AFTR 1536, 218 F.2d. 603 (CA-2, 1955).

6 *Edwin R. Curphey*, 73 T.C. 766 (1980).

7 *Ibid.*

8 *Higgins v. Comm.*, 41-1 USTC ¶9233, 25 AFTR 1160, 312 U.S. 212 (UCSC, 1941).

9 *Samuel B. Levin v. U.S.*, 79-1 USTC ¶9331, 43 AFTR2d 79-1057, 597 F.2d 760 (Ct. Cls., 1979). But see *Joseph Moller v. U.S.*, 83-2 USTC ¶9698, 52 AFTR2d 83-633 (CA-FC, 1983) where, for purposes of the home office deduction, the court held that the taxpayer's management of his substantial investment portfolio could not be a trade or business regardless of how continuous, regular, and extensive the activities were. But see Chapter 16 and discussion of traders in securities and § 475(f)

Distinguishing between §§ 162 and 212. Prior to enactment of § 212, many investment-related expenses were not deductible because the activities did not constitute a business. The enactment of § 212 in 1942, allowing for the deduction of expenses related to production or collection of income, enabled the deduction of investment-oriented expenses. This expansion of the deduction concept to include so-called nonbusiness or investment-related expenses eliminates the need for an activity to constitute a business before a deduction is allowed. As a result, the issue of deductibility (*assuming* the other requirements are met) is effectively reduced to a single important question: Is the expense related to an activity engaged in for profit?

It may appear that the addition of § 212 completely removed the need for determining whether the activity resulting in the expense constitutes a business or is merely for the production of income. However, the distinction between business and production of income expenses remains important. For example, the classification of the expense as a deduction for or from adjusted gross income may turn on whether the expense is a trade or business expense or a production of income expense. Production of income expenses (other than those related to rents or royalties) are usually miscellaneous itemized deductions that can be deducted only to the extent they *exceed* two percent of adjusted gross income. In contrast, most business expenses are deductions for adjusted gross income and are deductible in full.

Example 3. Refer to *Example 2*. In the first situation, where H is considered a passive investor, her investment related expenses (e.g., subscriptions to stock advisory services and investment newsletters) would be miscellaneous itemized deductions and deductible only to the extent they exceed 2% of adjusted gross income. In the second situation, however, the same type of expenses would be deductions for adjusted gross income since H's trading activities qualify as a trade or business.

Another reason for ascertaining whether the activity constitutes a business relates to the use of the phrase ''trade or business'' in other Code Sections. The phrase ''trade or business'' appears in at least 60 different Code Sections, and the interpretation given to this phrase often controls the tax treatment. For example, whether an activity is an active business or a passive investment affects the tax consequences related to losses (deductible or limited), bad debts (short-term capital loss vs. ordinary loss), property sales (capital gain or loss vs. ordinary gain or loss), expenses for offices in the home (deductible vs. nondeductible), and limited expensing of depreciable property (allowed vs. disallowed).[10]

The Relationship. Before an expense is deductible under §§ 162 or 212, it must have a certain relationship to the trade or business or income-producing activity. The Regulations require that business expenses be directly connected with or pertain to the taxpayer's trade or business.[11] Similarly, production of income expenses must bear a reasonable and proximate relationship to the income-producing activity.[12] Whether an expenditure is directly related to the taxpayer's trade or business or income-producing activity usually depends on the facts. For example, the required relationship for business expenses normally exists where the expense is primarily motivated by business concerns or arises as a result of business, rather than personal, needs.[13]

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10 See §§ 165, 166, 1221, 280A, and 179.

11 Reg. § 1.162-1(a).

12 Reg. § 1.212-1(d).

13 *U.S. v. Gilmore*, 63-1 USTC ¶9285, 11 AFTR2d 758, 372 U.S. 39 (USSC, 1963).

Example 4. While driving from one business to another, T struck a pedestrian with his car. He paid and deducted legal fees and damages in connection with the accident that were disallowed by the IRS. The Court found that the expenses were not directly related to, nor did they proximately result from, the taxpayer's business. The accident was merely incidental to the transportation and was related only remotely to the business.[14]

Whether a particular item is deductible often hinges on whether the expense was incurred for business or personal purposes. Consider the case of a law enforcement officer who is required to keep in top shape to retain his employment. Is the cost of a health club membership incurred for business or personal purposes? Similarly, can a disc jockey who obtains dentures to improve his speech deduct the cost as a business expense? Unfortunately, many expenses—like these—straddle the business-personal fence and the final determination is difficult. In both of the cases above, the Court denied the taxpayers' deductions on the theory that such expenses were inherently personal.

Another common question concerns expenses paid or incurred prior to the time that income is earned. In the case of § 212 expenses, it is not essential that the activity produce income currently. For example, expenses may be deductible under § 212 even though there is little likelihood that the property will be sold at a profit or will ever produce income.[15] Deductions are allowed as long as the transaction was entered into for profit.

Example 5. B purchased a vacant lot three years ago as an investment. During the current year she paid $200 to have it mowed. Although the property is not currently producing income, the expense is deductible since it is for the conservation or maintenance of property held for the production of income.

ORDINARY AND NECESSARY EXPENSES

The second test for deductibility is whether the expense is ordinary and necessary. An expense is *ordinary* if it is normally incurred in the type of business in which the taxpayer is involved.[16] This is not to say that the expense is habitual or recurring.[17] In fact, the expense may be incurred only once in the taxpayer's lifetime and be considered ordinary. The test is whether other taxpayers in similar businesses or income-producing activities would customarily incur the same expense.

Example 6. P has been in the newspaper business for 35 years. Until this year, his paper had never been sued for libel. To protect the reputation of the newspaper, P incurred substantial legal costs related to the libel suit. Although the taxpayer has never incurred legal expenses of this nature before, the expenses are ordinary since it is common in the newspaper business to incur legal expenses to defend against such attacks.[18]

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[14] *Julian D. Freedman v. Comm.*, 62-1 USTC ¶9400, 9 AFTR2d 1235, 301 F.2d. 359 (CA-5, 1962); but see *Harold Dancer*, 73 T.C. 1103 (1980), where the Tax Court allowed the deduction when the taxpayer was traveling between two locations of the *same* business. Note how the subtle change in facts substantially alters the result!

[15] Reg. § 1.212-1(b).

[16] *Deputy v. DuPont*, 40-1 USTC ¶9161, 23 AFTR 808, 308 U.S. 488 (USSC, 1940).

[17] *Dunn and McCarthy, Inc. v. Comm.*, 43-2 USTC ¶9688, 31 AFTR 1043, 139 F.2d 242 (CA-2, 1943).

[18] *Welch v. Helvering*, 3 USTC ¶1164, 12 AFTR 1456, 290 U.S. 111 (USSC, 1933).

It is interesting to note that the "ordinary" criterion normally becomes an issue in circumstances that are, in fact, unusual. For example, in *Goedel*,[19] a stock dealer paid premiums for insurance on the life of the President of the United States, fearing that his death would disrupt the stock market and his business. The Court denied the deduction on the grounds that the payment was not ordinary but unusual or extraordinary.

A deductible expense must be not only ordinary, but also *necessary*. An expense is necessary if it is appropriate, helpful, or capable of making a contribution to the taxpayer's profit-seeking activities.[20] The necessary criterion, however, is rarely applied to deny a deduction. The courts have refrained from such a practice since to do so would require overriding the judgment of the taxpayer.[21] The courts apparently feel that it would be unfair to judge *currently* whether a previous expenditure was necessary at the time it was incurred.

It should be emphasized that not all necessary expenses are ordinary expenses. Some expenses may be appropriate and helpful to the taxpayer's business but may not be normally incurred in that particular business. In such case, no deduction is allowed.

> **Example 7.** W was an officer in his father's corporation. The corporation B unable to pay its debts, was adjudged bankrupt. After the corporation was discharged from its debts, W decided to resume his father's business on a fresh basis. To reestablish relations with old customers and to solidify his credit standing, W paid as much of the old debts as he could. The Supreme Court held that the expenses were necessary in the sense that they were appropriate and helpful in the development of W's business. However, the Court ruled that the payments were not ordinary because people do not usually pay the debts of another.[22]

REASONABLE EXPENSES

The third requirement for a deduction is that the expense be reasonable in amount. An examination of § 162(a) reveals that the term "reasonable" is used only in conjunction with compensation paid for services (e.g., a reasonable allowance for salaries). The courts have held, however, that reasonableness is implied in the phrase "ordinary and necessary."[23] In practice, the reasonableness standard is most often applied in situations involving salary payments made by a closely held corporation to a shareholder who also is an employee. In these situations, if the compensation paid exceeds that ordinarily paid for similar services—that which is reasonable—the excessive payment may represent a nondeductible dividend distribution.[24] Dividend treatment of the excess occurs if the amount of the excessive payment received by each employee closely relates to the number of shares of stock owned.[25] The distinction between reasonable compensation and dividend is critical because characterization of the payment as a dividend results in double taxation (i.e., it is taxable to the shareholder-employee and not deductible by the corporation).

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19 39 B.T.A. 1 (1939).

20 *Supra*, Footnote 18. See also *Comm. v. Heininger*, 44-1 USTC ¶9109, 31 AFTR 783, 320 U.S. 467 (USSC, 1943).

21 *Supra*, Footnote 18.

22 *Supra*, Footnote 18.

23 *Comm. v. Lincoln Electric Co.*, 49-2 USTC ¶9388, 38 AFTR 411, 176 F.2d 815 (CA-6, 1949).

24 Reg. § 1.162-7(b)(1).

25 Reg. § 1.162-8.

Example 8. B and C own 70 and 30% of XYZ Corporation, respectively. Employees in positions similar to that of B earn $60,000 annually while those in positions similar to C's earn $20,000. During the year, the corporation pays B a salary of $130,000 and C a salary of $50,000. The excessive payment of $100,000 [($130,000 + $50,000) − ($60,000 + $20,000)] is received by B and C in direct proportion to their percentage ownership of stock (i.e., B's salary increased by $70,000 or 70% of the excessive payment). Because the payments are in excess of that normally paid to employees in similar positions and the excessive payment received by each is closely related to his stockholdings, the excessive payment may be treated as a nondeductible dividend.

Some of the factors used by the IRS when considering the reasonableness of compensation are:[26]

1. Duties performed (i.e., amount and character of responsibility)
2. Volume and complexity of business handled (i.e., time required)
3. Individual's ability and expertise
4. Number of available persons capable of performing the duties of the position
5. Corporation's dividend policies and history

PAID OR INCURRED DURING THE TAXABLE YEAR

Sections 162 and 212 both indicate that an expense is allowable as a deduction only if it is "paid or incurred during the taxable year." This phrase is used throughout the Code in sections concerning deductions. Use of both terms, "paid" and "incurred," is necessary because the year in which deductions are allowable depends on the method of accounting used by the taxpayer.[27] The term *paid* refers to taxpayers using the cash basis method of accounting while the term *incurred* refers to taxpayers using the accrual basis method of accounting. Accordingly, the year in which a deduction is allowed usually depends on whether the cash or accrual basis method of accounting is used. Each of these methods is discussed in detail in a later section.

EMPLOYEE BUSINESS EXPENSES

The definition of *trade or business* also includes the performance of services as an employee. In other words, an employee is considered to be in the business of being an employee. [28] As a result, the ordinary and necessary expenses incurred by an employee in connection with his or her employment are deductible under § 162 as business expenses. Examples of deductible expenses typically incurred by employees include union dues, dues to trade and professional societies, subscriptions to professional journals, small tools and supplies, medical exams required by the employer, and work clothes and uniforms as well as their maintenance (where required as a condition of employment and not suitable for everyday use).[29] Expenses such as travel, entertainment, and education may also be deducted as employee business expenses under certain conditions explained in Chapter 8.

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[26] Internal Revenue Manual 4233, § 232.

[27] § 461(a).

[28] See *Lloyd U. Noland, Jr. v. Comm.* 59-2 USTC ¶9600, 4 AFTR 2d 5031, 269 F2d 108, (CA-4, 1959) holding that "every person who works for compensation is engaged in the business of earning his pay, and that expense which is essential to the continuance of his employment is deductible. . ."

[29] Rev. Rul. 70-474, 1970 C.B. 35.

As explained later in this chapter, employee business expenses—other than those that are reimbursed—are considered miscellaneous itemized deductions and thus are deductible only to the extent they exceed 2 percent of A.G.I.

ACCOUNTING FOR DEDUCTIONS

Identifying the taxable year in which a taxpayer can claim a deduction is extremely important for a number of reasons. No doubt the most important of these is the time value of money. Taxpayers normally want to claim their deductions and obtain the accompanying tax savings as soon as possible. In contrast, the government is concerned about zealous taxpayers who, in its view, prematurely deduct their expenses. When an expense is deductible generally depends on whether the taxpayer uses the cash or accrual method of accounting. However, the natural friction between taxpayers and the government over when an expense should be deducted has led to a somewhat confusingly intricate set of rules filled with exceptions. Interestingly, the effects of the various exceptions often make the accrual method look like the cash method and vice versa.

CASH METHOD OF ACCOUNTING

General Rule. For those taxpayers eligible to use the cash method (as discussed in Chapter 5), expenses are deductible in the taxable year when the expenses are actually paid.[30] However, there are numerous exceptions to this rule that are designed to restrict the flexibility a cash basis taxpayer would otherwise have in reporting deductions. Without these restrictions, a cash basis taxpayer could choose the year of deductibility simply by appropriately timing the cash payment. Before examining these restrictions, it is important to understand when the taxpayer is considered to have paid the expense.

Time of Payment. Determining when a cash basis taxpayer has paid an expense usually is not difficult. A cash basis taxpayer "pays" the expense when cash, check, property, or service is transferred. Neither a promise to pay nor a note evidencing such promise is considered payment. Consequently, when a cash basis taxpayer buys on credit, no deduction is allowed until the debts are paid. However, if the taxpayer borrows cash and then pays the expense, the expense is deductible when paid. For this reason, a taxpayer who charges expenses to a credit card is deemed to have borrowed cash and made payment when the charge is made. Thus, the deduction is claimed when the charge is actually made and not when the bank makes payment or when the taxpayer pays the bill.[31] If the taxpayer uses a "pay-by-phone" account, the expense is deductible in the year the financial institution paid the amount as reported on a monthly statement sent to the taxpayer.[32] When the taxpayer pays by mail, payment is usually considered made when the mailing occurs (i.e., dropping it in the post-office box).[33]

Restrictions on Use of Cash Method. Under the general rule, a cash basis taxpayer deducts expenses when paid. Without restrictions, however, aggressive taxpayers could liberally interpret this provision to authorize not only deductions for routine items, but also deductions for capital expenditures and other expenses that benefit future periods (e.g., supplies, prepaid insurance, prepaid rent, and prepaid interest). To preclude such an approach, numerous limitations have been imposed.

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30 Reg. § 1.446-1(a)(1).

31 Rev. Rul. 78-39, 1978-1 C.B. 73.

32 Rev. Rul. 80-335, 1980-2 C.B. 170.

33 See Rev. Rul. 73-99, 1973-1 C.B. 412 for clarification of this general rule.

Inventories. One of the more fundamental restrictions applying to cash basis taxpayers concerns inventories. For example, if no limitation existed, a cash basis owner of a department store could easily reduce or eliminate taxable income by increasing purchases of inventory near year-end and deducting their cost. To prevent this possibility, the Regulations require taxpayers to use the accrual method for computing sales and costs of goods sold if inventories are an income-producing factor.[34] In such cases, inventory costs must be capitalized, and accounts receivable and accounts payable (with respect to cost of goods sold) must be created. The taxpayer could continue to use the cash method for other transactions, however. It is also important to note that there are two relief provisions for small business owners that allow them to elect out of the accrual method and the requirement to account for inventories. As discussed in Chapter 10, taxpayers with average gross receipts of no more than $1 million, and certain taxpayers with average annual gross receipts of more than $1 million and up to $10 million may use the cash method of accounting even when inventory is an income producing factor.[35]

Capital Expenditures. Provisions of both the Code and the Regulations limit the potential for deducting capital expenditures. As discussed later in this chapter, Code § 263 specifically denies the deduction for a capital expenditure; such costs as those for equipment, vehicles, and buildings normally are recovered through depreciation, as discussed in Chapter 9. Special rules exist requiring taxpayers to capitalize certain costs as part of their inventory under the uniform capitalization rules of § 263A. The "unicap" rules are discussed in Chapter 10.

The Regulations—at least broadly—deal with other expenditures that are not capital expenditures per se but that do benefit future periods. According to the Regulations, any expenditure resulting "in the creation of an asset having a useful life which extends *substantially beyond the close of the taxable year* may not be deductible when made, or may be deductible only in part."[36] In this regard, the courts agree that "substantially beyond" means a useful life of more than one year.[37] Perhaps the simplest example of this rule as so interpreted concerns payments for supplies. Assuming the supplies would be exhausted before the close of the following tax year, a deduction should be allowable when payment is made.

Prepaid Expenses in General. One of the most troublesome issues related to both the cash and accrual methods of accounting concerns prepaid expenses. If prepayments are made for regularly recurring expenses and the payments result in the creation of an asset having a life extending substantially beyond the taxable year of payment, the treatment historically has not always been clear. Unfortunately, the *one-year rule* described above was not necessarily applied to all expenses uniformly.

12-Month Rule. The problems with prepaid expenses became acutely apparent in *U.S. Freightways Corporation*.[38] Here an accrual basis calendar-year trucking company claimed a deduction for permits, licenses and fees paid in order for its trucks to operate legally in certain locations. In 1993, the company paid $4,308,460 for licenses, many of which expired in 1994 rather than 1993. Similarly, in 1993, the company paid premiums of $1,090,602 for liability and property insurance for the 1-year period from July 1, 1993, to June 30, 1994. Relying on the one-year rule, the corporation expensed all of the prepayments. However, the government denied the deduction, asserting that the 12-month

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[34] Reg. § 1.446-1(c)(2).

[35] Rev. Proc. 2000-22, Rev. Proc. 2001-10, and Rev. Proc. 2002-28. See full discussion of inventory in Chapter 10.

[36] Reg. § 1.446-1(a)(1).

[37] *Martin J. Zaninovich*, 69 T.C. 605, rev'd in 80-1 USTC ¶9342, 45 AFTR2d 80-1442, 616 F.2d 429 (CA-9, 1980).

[38] 2001-2 USTC 50,731, 88 AFTR2d 2001-6703, 270 F3d 1137 (CA-7, 2001)).

rule existed solely for cash basis taxpayers and did not apply to accrual basis taxpayers. The Seventh Circuit disagreed and extended the rule to accrual basis taxpayers.

To address the confusion resulting from *U.S. Freightways* and similar cases, the government issued Regulations in early in 2004 to address the capitalization of intangibles.[39] Among these lengthy provisions is the government's own 12-month rule. Under these Regulations, taxpayers—both cash and accrual—are entitled to claim an immediate deduction for prepaid expenses (e.g. prepaid insurance) if the rights or benefits do not extend beyond the earlier of

- 12 months after the first date on which the taxpayer realizes the benefit or
- The end of the taxable year following the year in which payment was made

This rule generally is consistent with prior law that enables cash basis taxpayer to claim deductions for prepaid expenses for supplies, service and other non-capital expenditures. It should be emphasized that the rule applies to both cash and accrual taxpayers. However, as discussed below, accrual taxpayers must meet the all events and economic performance tests before a deduction can be claimed. Specific items are discussed below.

Prepaid Insurance and Prepaid Rent. Prepayments of insurance and rent follow the 12-month rule. If the 12-month rule does not apply, the prepayment must be amortized over the term for which the insurance is provided or the term of the lease.[40]

> **Example 9.** On December 1, 2008, Blue Inc., a cash basis taxpayer, paid a $12,000 insurance premium to obtain a property insurance policy with a one-year term that begins on February 1, 2009. Although the policy is only for one year, the payment does not meet the 12-month rule since the benefit attributable to the $12,000 payment extends beyond the end of the taxable year following the taxable year in which the payment was made. The corporation must capitalize the payment and amortize it over the policy period. Thus the corporation's deduction is $0 in 2008, $11,000 in 2009 and $1,000 in 2010.

> **Example 10.** Same facts as above except the policy has a term beginning on December 15, 2008. The 12-month rule applies since the benefit does not extend more than 12 months beyond December 15, 2008 (the date when the benefit is first realized by the corporation) nor beyond the close of the tax year following the year in which the payment was made (December 31, 2009). Thus the corporation may deduct the entire $12,000 prepayment in the year paid, 2008.

> **Example 11.** WRK Corporation, a cash basis taxpayer, leases space at a monthly rate of $2,000. In December of 2008, the corporation prepays its rent for the first six months of 2008 in the amount of $12,000. The corporation may deduct the entire $12,000 in 2009 since the benefits received for the prepayment do not extend beyond 12 months. (Note as discussed below accrual basis taxpayers would be required to amortize this expense over the term because the economic performance test delays deduction until the property is used.)

Other Prepayments. Perhaps the Service's current view of the proper treatment of most prepayments is best captured in a ruling concerning prepaid feed. In this ruling, the taxpayer purchased a substantial amount of feed prior to the year in which it would be used.[41] The purchase was made in advance because the price was low due to a depressed market.

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[39] Reg. § 1.263-(a)(4).

[40] See Reg. 1.263(a)-4(f)(8), Examples 1, 2 and 10.

[41] Rev. Rul. 79-229, 1979-2 C.B. 210. See also, *Kenneth Van Raden*, 71 T.C. 1083 (1979), aff'd in 81-2 USTC ¶9547, 48 AFTR2d 81-5607, 650 F.2d 1046 (CA-9, 1981).

The IRS granted a deduction for the prepayment because there was a business purpose for the advanced payment, the payment was not merely a deposit, and it did not materially distort income. Based on this ruling and related cases, prepayments normally should be deductible if the asset will be consumed by the close of the following year, there is a business purpose for the expenditure, and there is no material distortion of income.

Prepaid Interest. The Code expressly denies the deduction of prepaid interest. Prepaid interest must be capitalized and deducted ratably over the period of the loan.[42] The same is true for any costs associated with obtaining the loan. The sole exception is for "points" paid for a debt incurred by the taxpayer to purchase his or her *principal* residence. In this regard, the IRS has ruled that points incurred to refinance a home must be amortized over the term of the loan.[43] However, an Appeals Court case allowed a taxpayer to deduct the amount of points paid on refinancing a home. The proceeds were used to pay off a three-year, temporary loan that was made to allow the borrower time to secure permanent financing for the home.[44] The court stated that, since the temporary loan was merely an integrated step in securing permanent financing for the taxpayer's residence, the points were deductible currently.

> **Example 12.** K desires to obtain financing for the purchase of a new house costing \$100,000. The bank agrees to make her a loan of 80% of the purchase price, or \$80,000 (80% of \$100,000) for thirty years at a cost of two points (two percentage "points" of the loan obtained). Thus, she must pay \$1,600 (2% of \$80,000) to obtain the loan. Assuming it is established business practice in her area to charge points in consideration of the loan, the \$1,600 in points (prepaid interest) is deductible. However, if the house is not the principal residence of the taxpayer, then the prepaid interest must be deducted ratably over the 30-year loan period.

ACCRUAL METHOD OF ACCOUNTING

An accrual basis taxpayer deducts expenses when they are incurred. For this purpose, an expense is considered incurred when the all events test is satisfied and economic performance has occurred.[45]

All Events Test. Two requirements must be met under the all-events test: (1) all events establishing the existence of a liability must have occurred (i.e., the liability is fixed); and (2) the amount of the liability can be determined with reasonable accuracy. Therefore, before the liability may be accrued and deducted it must be fixed and determinable.

> **Example 13.** In *Hughes Properties, Inc*., an accrual basis corporation owned a gambling casino in Reno, Nevada that operated progressive slot machines that paid a large jackpot about every four months.[46] The increasing amount of the jackpot was maintained and shown by a meter. Under state gaming regulations, the jackpot amount could not be turned back until the amount had been paid to a winner. In addition, the corporation had to maintain a cash reserve sufficient to pay all the guaranteed amounts. At the end of each taxable year, the corporation accrued and deducted the liability for the jackpot as accrued at year-end. The IRS challenged the accrual,

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[42] § 461(g).

[43] Rev. Rul. 87-22, 1987-1 C.B. 146. See also Rev. Proc. 94-27, 1994-1 I.R.B. 15.

[44] *James R. Huntsman*, 90-2 USTC ¶50,340, 66 AFTR2d 90-5020, 905 F.2d 1182 (CA-8, 1990). In an *Action on Decision* issued on February 11, 1991, the IRS ruled that although it will not appeal the *Huntsman* decision, it will not follow this decision outside the Eighth Circuit.

[45] § 461(h).

[46] *Hughes Properties, Inc.*, 86-1 USTC ¶9440, 58 AFTR2d 86-5015, 106 S. Ct. 2092 (USSC, 1986).

alleging that the all events test had not been met, and that the amount should be deducted only when paid. It argued that payment of the jackpot was not fixed but contingent, since it was possible that the winning combination may never be pulled. Moreover, the Service pointed out the potential for tax avoidance: the corporation was accruing deductions for payments that may be paid far in the future, and thus—given the time value of money—overstated the amount of the deduction. The Supreme Court rejected these arguments, stating that the probability of payment was not a remote and speculative possibility. The Court noted that not only was the liability fixed under state law, but it also was not in the interest of the taxpayer to set unreasonably high odds, since customers would refuse to play and would gamble elsewhere.

The all events test often operates to deny deductions for certain estimated expenditures properly accruable for financial accounting purposes. For example, the estimated cost of product guarantees, warranties, and contingent liabilities normally may not be deducted—presumably because the liability for such items has not been fixed or no reasonable estimate of the amount can be made.[47] However, the courts have authorized deductions for estimates where the obligation was certain and there was a reasonable basis (e.g., industry experience) for determining the amount of the liability.

Economic Performance Test. The condition requiring *economic performance* was introduced in 1984 due to Congressional fear that the all events test did not prohibit so-called premature accruals. Prior to 1984, the courts—with increasing frequency—had permitted taxpayers to accrue and deduct the cost of estimated expenditures required to perform certain activities *prior* to the period when the activities were actually performed. For example, in one case, a strip-mining operator deducted the estimated cost of backfilling land that he had mined for coal.[48] The court allowed the deduction for the estimated expenses in the current year even though the back filling was not started and completed until the following year. According to the court, the liability satisfied the all-events test since the taxpayer was required by law to backfill the land and a reasonable estimate of the cost of the work could be made. A similar decision involved a taxpayer that was a self-insurer of its liabilities arising from claims under state and Federal worker's compensation laws.[49] Under these laws, the taxpayer was obligated to pay a claimant's medical bills, disability payments, and death benefits. In this situation, the taxpayer was allowed to accrue and deduct the estimated expenses for its obligations even though actual payments would extend over many years. In Congress' view, allowing the deduction in these and similar cases prior to the time when the taxpayer actually performed the services, provided the goods, or paid the expenses, overstated the true cost of the expense, because the time value of money was ignored. Perhaps more importantly, Congress recognized that allowing deductions for accruals in this manner had become the foundation for many tax shelter arrangements. Accordingly, the economic performance test was designed to defer the taxpayer's deduction until the activities giving rise to the liability are performed.

The time at which economic performance is deemed to occur—and hence the period in which the deduction may be claimed—depends on the nature of the item producing the liability. A taxpayer's liabilities commonly arise in three ways, as summarized below.

1. *Liability of taxpayer to provide property and services.* When the taxpayer's liability results from an obligation to provide goods or services to a third party (e.g., perform repairs), economic performance occurs when the taxpayer provides the goods or services to the third party.

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47 *Bell Electric Co.*, 45 T.C. 158 (1965).

48 *Paul Harrold v. Comm.*, 52-1 USTC ¶9107, 41 AFTR 442, 192 F.2d 1002 (CA-4, 1951).

49 *Crescent Wharf & Warehouse Co. v. Comm.*, 75-2 USTC ¶9571, 36 AFTR2d 75-5246, 518 F.2d 772 (CA-5, 1975).

2. *Liability for property or services provided to the taxpayer*. When the taxpayer's liability arises from an obligation to pay for services, goods, or the use of property provided to (or to be provided to) the taxpayer (e.g., consulting, supplies, and rent), economic performance occurs when the taxpayer receives the services or goods or uses the property. Note that in this case, economic performance occurs when the taxpayer *receives* the consideration bargained for, while in the situation above it occurs when the taxpayer *provides* the consideration. Under a special rule, a taxpayer may treat services or property as being provided when the taxpayer makes *payment* to the person providing the services or property *if* the taxpayer can reasonably expect the person to provide the services or property within 3½ months after the date of payment.[50]

3. *Liabilities for which payment represents economic performance*. There are a number of liabilities for which economic performance is deemed to occur only when the taxpayer actually makes payment. This rule for so-called "payment liabilities" effectively places the taxpayer on the cash basis for these liabilities. These include the following:

- Refunds and rebates
- Awards, prizes, and jackpots
- Premiums on insurance
- Provision of work to the taxpayer under warranty or service contracts
- Taxes
- Liabilities arising under a worker's compensation act or out of any tort, breach of contract, or violation of law, including amounts paid in settlement of such claims

Example 14. In 2008 C, an accrual basis corporation, contracted with P, a partnership, to drill 50 gas wells over a five-year period for $500,000. Absent the economic performance test, C could accrue and deduct the $500,000 fee in 2008 because the obligation is fixed and determinable. However, because economic performance has not occurred (i.e., the services have not been received by C), no deduction is permitted in 2008. Rather, C may deduct the expense when the wells are drilled.

Example 15. Same facts as above. Although P is obligated to perform services for C for $500,000 over the five-year period (i.e., the obligation is fixed and determinable), P cannot prematurely accrue the cost of providing these services because economic performance has not occurred. Deduction is permitted only as the wells are drilled.

Example 16. C Corporation, a calendar year, accrual method taxpayer, owns several casinos across the country. Each contains progressive slot machines. These machines provide a guaranteed jackpot that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 2008, the guaranteed jackpot amount on one of C's slot machines reaches the maximum predetermined amount of $100,000. On February 1, 2009, the $100,000 jackpot is won by B. Although the all-events test is met in 2008 when the amount of the liability becomes fixed (i.e., guaranteed) and determinable, economic performance does not occur for prizes until payment is actually made. As a result, C is not allowed to accrue the deduction in 2008 but must wait and claim the expense when it pays the jackpot in 2009. (Note this rule reverses the decision in *Hughes Properties, Inc*. However, the deduction may still be allowed under the recurring item exception discussed below.)

[50] § 1.461-4(d)(6)(ii).

Note that even though payment of an expense may make it ripe for accrual, other rules may require deferral of the deduction.

Example 17. On December 10, 2008, T Inc., an accrual basis calendar year taxpayer, paid a painting contractor $15,000 to paint the interior of its office building. T anticipated that the painting would be completed by February 15 of 2009. Since the painting services are to be provided within 3 ½ months after the date of payment, economic performance is deemed to have occurred when the payment is made and T may deduct the $15,000 expense in 2008.

Example 18. Kidco Products Corporation, a calendar year E accrual method taxpayer, manufactures car seats for children. On July 1, 2008 it purchased an insurance policy from INS Inc. for $360,000 under which INS must satisfy any liability arising during the next three years for any claims attributable to defects in the manufacturing. Although economic performance occurs when Kidco pays the premium, it has created an asset with a life that extends substantially beyond 2008. Under cash-basis principles, such expenses cannot be deducted currently but must be amortized. Consequently, Kidco should amortize the insurance premium over the term of the policy, deducting $60,000 ($360,000/36 × 6 months) in 2008 and the remaining $300,000 over the next 30 months.

Example 19. WNDE Corporation leases space at a monthly rate of $2,000. In December of 2008, the corporation prepays its rent for the first six months of 2009 in the amount of $12,000. If WNDE is a cash basis taxpayer, it could deduct the $12,000 in 2008 under the 12-month rule *(See Example 10 above)*. However, if WNDE uses the accrual method, economic performance for the rent does not occur until the corporation uses the property and, therefore, it cannot use the 12 month rule but must deduct the rental expense over the period it uses the property, 2009.

Economic Performance and Recurring Item Exception. To prohibit the disruption of normal business and accounting practices, certain recurring expenses are exempted from the economic performance rules. The expense may be accrued and deducted under the recurring item exception if all of the following conditions are met.[51]

1. The all-events test is satisfied.
2. Economic performance does in fact occur within eight and one-half months after the close of the taxable year or the filing of the return if earlier.
3. The item is recurring in nature, and the taxpayer consistently treats such items as incurred in the taxable year.
4. The item is immaterial or accrual in the earlier year results in a better match against income than accruing the item when economic performance occurs.

The recurring item exception does not apply to liabilities arising under a worker's compensation act or out of any tort, breach of contract, or violation of law.

Example 20. M Corporation, a calendar year, accrual method taxpayer, manufactures and sells automobile mufflers. Under the terms of an agreement with D Corporation, one of its distributors, D is entitled to a discount on future purchases (i.e., a rebate) from M based on the amount of purchases made by D from M during any calendar year. During 2008, purchases by D entitled it to future rebates of $20,000. M paid

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[51] § 461(h)(3).

$12,000 of the rebate in January 2009 and the remaining $8,000 in October 2009. M filed its 2008 tax return on March 15, 2009. Although the all events test has been met in 2008 (i.e., the fact of the liability is fixed and the amount can be determined with reasonable accuracy), no deduction is allowed until economic performance occurs. Normally, economic performance for rebates is deemed to occur when the rebate is paid. Therefore, the expense would usually be deductible by M in 2009. However, under the recurring item exception M should be able to accrue $12,000 of the $20,000 in 2008 because all of the conditions are met: (1) the all events test is met, (2) economic performance occurs in a timely manner (i.e., the January payment occurs before the earlier of the filing of the tax return or 8½ months after the close of the year), (3) the item is recurring, and (4) accrual in the earlier year results in a better match against income. The remaining $8,000 is not eligible for the recurring item exception because economic performance (payment of the $8,000 liability) did not occur until October, which is beyond both the filing of the return and the 8½-month window.

Real Property Taxes. The addition of the economic performance test and the recurring item exception posed a problem for a great number of taxpayers who incur real property taxes.

Example 21. Oldco Corporation uses the accrual method and reports on the calendar year. It owns a warehouse in a state where the lien date (i.e., the date on which the corporation technically becomes liable) for real property taxes for 2008 is January 1, 2009. Payment is due in two installments, 40 percent due on June 1 and the remaining 60 percent due on December 1. Shortly after the close of 2008, the corporation received its bill for its 2008 taxes of $100,000, paying $40,000 on June 1 and $60,000 on December 1. For financial accounting purposes, the corporation accrues the entire $100,000 expense in 2008. For tax purposes, however, economic performance for taxes does not occur until payment is made. Therefore, accrual normally is not allowed until the payment is made (2009) unless the recurring item exception applies. In this case, the recurring item exception would apply. However, the corporation could deduct only the portion paid by the earlier of the filing of its tax return or September 15 (8½ months after the close of the taxable year). If the corporation delayed filing its return until the extended due date, September 15, it could accrue and deduct on its 2008 tax return the $40,000 paid on June 1. However, if it filed its return by March 15, none of the taxes could be accrued under the recurring item exception.

Recognizing the problem illustrated *Example 18* above, Code § 461(c) was created. Under this provision, taxpayers can elect to accrue real property taxes ratably over the period to which the taxes relate. Note that if the taxpayer makes the election, the treatment for tax purposes is consistent with that for financial accounting.

Example 22. Same facts as *Example 21*. If the corporation makes the election under § 461(c), it may accrue and deduct the entire $100,000 in 2008 because all of the taxes related to such period.

RELATIONSHIP TO FINANCIAL ACCOUNTING

As may be apparent from the discussion above, the rules for accruing expenses for tax accounting purposes do not necessarily produce the same result as those for financial accounting. Differences often occur, particularly in the treatment of estimated expenses. As noted in Chapter 5, such differences are justified given the differing goals of financial and tax accounting. Financial accounting principles adopt a conservative approach in measuring income to ensure that income is not overstated and investors are not misled. Accordingly, financial accounting embraces the matching principle that encourages the accrual of estimated expenditures. In contrast, the objective of the income tax system is to ensure that taxable income is objectively measured so as to minimize controversy. Consistent with this view, the tax law allows a deduction only when a liability is actually fixed and economic performance has occurred. Estimates of future expenses are not sufficient to warrant a deduction for tax purposes (unless the recurring item exception should apply). Note, however, that these different accounting techniques produce differences only in *when* the expense is taken into account. The total amount of expense to be accounted for is not affected. Common examples of these so-called timing differences include:

- *Depreciation.* As discussed in Chapter 9, depreciation for tax purposes differs substantially from that for financial accounting purposes. Although the total amount of depreciation is often the same in both cases, the amount expensed in any one period may differ significantly.
- *Bad debts.* For tax purposes, bad debts normally may be deducted only in the year they actually become worthless. In contrast, financial accounting permits use of the reserve method, which allows an estimate of future bad debts related to current year sales to be charged against current year income. The tax treatment of bad debts is discussed fully in Chapter 10.
- *Vacation pay.* For financial accounting purposes, vacation pay accrues as it is earned by the employees. For tax purposes, however, vacation pay may be accrued and deducted only if it is paid within 2½ months following the close of the taxable year.
- *Warranty costs.* For financial accounting purposes, warranty costs are normally estimated and matched against current year sales. For tax purposes, no deduction is allowed until the warranty work is actually performed (unless the recurring item exception applies).

Timing differences should be distinguished from permanent differences. As seen throughout this text, there are a number of situations in which an expense for financial accounting purposes is not allowed as a deduction for tax purposes. For example, fines and penalties are expenses that must be taken into account in determining financial accounting income, as are expenses related to tax-exempt income. However, tax deductions for such costs are not allowed. Similarly, expenses for business meals and entertainment may be fully expensed for financial accounting but only 50 percent of such costs can be deducted for tax purposes.

The rules governing the accrual of deductions are summarized in Exhibit 7-1.

EXHIBIT 7-1
Requirements for Accrual of Deduction

Requirements

- All events test is met.
  All events have occurred that fix the fact of the liability.
  The amount of the liability can be determined with reasonable accuracy.
- Economic performance has occurred as follows:

Event Producing Liability	*Time When Economic Performance Occurs*	*Example*
Taxpayer obligated to provide goods or services to a third party	When the taxpayer provides the property or services	Taxpayer to perform repairs, warranty work
Goods or services provided or to be provided to the taxpayer	When taxpayer actually receives the goods or services	Taxpayer buys supplies, contracts for consulting
Property provided or to be provided to the taxpayer	When taxpayer uses the property	Taxpayer rents property
Obligations to pay refunds, rebates, awards, prizes, insurance, warranty or service contracts, taxes	When taxpayer makes payment	Refunds, rebates, etc.
Claims under worker's compensation, tort, breach of contract	When taxpayer makes payment	Taxpayer incurs product liability
Real property taxes	When taxpayer makes payment unless he or she elects special accrual rule	Real estate taxes

DEDUCTIONS FOR LOSSES

The general rules concerning deduction of losses are contained in § 165. This provision permits a deduction for any loss sustained that is not compensated for by insurance. The deductions for losses of an individual taxpayer, however, are limited to

1. Losses incurred in a trade or business
2. Losses incurred in a transaction entered into for profit
3. Losses of property not connected with a trade or business if such losses arise by fire, storm, shipwreck, theft, or some other type of casualty

Note that personal losses—other than those attributable to a casualty—are not deductible. For example, the sale of a personal residence at a loss is not deductible.

Before a loss can be deducted, it must be evidenced by a closed and completed transaction. Mere decline in values or unrealized losses cannot be deducted. Normally, for the loss to qualify as a deduction, the property must be sold, abandoned, or scrapped, or become completely worthless. The amount of deductible loss for all taxpayers cannot exceed the taxpayer's basis in the property. Special rules related to various types of losses are discussed in Chapter 10.

CLASSIFICATION OF EXPENSES

Once the deductibility of an item is established, the tax formula for individuals requires that the deduction be classified as either a deduction *for* adjusted gross income or a deduction *from* adjusted gross income (itemized deduction).[52] In short, the deduction process requires that two questions be asked. First, is the expense deductible? Second, is the deduction for or from adjusted gross income (A.G.I.)? Additional aspects of the first question are considered later in this chapter. At this point, however, it is appropriate to consider the problem of classification.

The classification process arose with the introduction of the standard deduction in 1944. The standard deduction was introduced to simplify filing for the majority of individuals by eliminating the necessity of itemizing primarily personal deductions such as medical expenses and charitable contributions. In addition, the administrative burden of checking such deductions was eliminated. Although these objectives were satisfied by providing a blanket deduction in lieu of itemizing actual expenses, a new problem arose. The standard deduction created the need to classify deductions as either deductions that would be deductible in any event (deductions for A.G.I.), or deductions that would be deductible only if they exceeded the prescribed amount of the standard deduction (deductions from A.G.I.).

IMPORTANCE OF CLASSIFICATION

The classification problem is significant for several reasons. First, itemized deductions may be deducted only to the extent they exceed the standard deduction. For this reason, a taxpayer whose itemized deductions do not exceed the standard deduction would lose a deduction if a deduction for A.G.I. is improperly classified as a deduction from A.G.I. This would occur because deductions for A.G.I. are deductible without limitation.

A second reason for properly classifying deductions concerns the treatment of miscellaneous itemized deductions. As part of the tax overhaul in 1986, Congress limited the deduction of miscellaneous itemized deductions—defined below—to the amount that exceeds 2 percent of A.G.I. This new limitation is extremely important. Under prior law, taxpayers who itemized deductions could misclassify a deduction for A.G.I. as an itemized deduction with little or no effect, since the expense would be deductible either one place or the other. Under the current scheme, however, misclassification of a deduction for A.G.I. as a miscellaneous itemized deduction would subject the expense to the 2 percent floor, possibly making it wholly or partially nondeductible.

A third reason for properly classifying deductions concerns A.G.I. itself. Limitations on deductions such as medical expenses and charitable contributions are expressed in terms of the taxpayer's A.G.I. For example, miscellaneous itemized deductions are deductible only to the extent they exceed 2 percent of A.G.I., medical expenses are deductible only to the extent they exceed 7.5 percent of A.G.I., and charitable contributions are deductible only to the extent of various limitations (50, 30, or 20 percent) based on A.G.I.

As discussed in Chapter 3, Congress has created two relatively new limitations that are based on A.G.I. First, the amount of itemized deductions (other than for medical expenses, gambling losses, investment interest and casualty and theft losses) must be

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52 § 62.

reduced under the deduction cutback rule by 1 percent of a taxpayer's A.G.I. in excess of $159,950 (2008). In addition, the deduction for personal exemptions is phased out as the taxpayer's A.G.I. exceeds a threshold amount (e.g., in 2008 $239,950 for joint returns and $159,950 for a single taxpayer). Thus, the misclassification of a deduction for A.G.I. as an itemized deduction would result in a higher A.G.I. and could result in a lower deduction for itemized deductions and personal exemptions.

Adjusted gross income for Federal income tax purposes also serves as the tax base or the starting point for computing taxable income for many state income taxes. Several states do not allow the taxpayer to itemize deductions. Consequently, misclassification could result in an incorrect state tax liability.

Still another reason for properly classifying expenses concerns the self-employment tax. Under the social security and Medicare programs, self-employed individuals are required to make an annual contribution based on their net earnings from self-employment. Net earnings from self-employment include gross income from the taxpayer's trade or business less allowable trade or business deductions attributable to the income. Failure to properly classify a deduction as a deduction for A.G.I. attributable to self-employment income results in a higher self-employment tax.

DEDUCTIONS FOR A.G.I.

The deductions for A.G.I. are specifically identified in Code § 62. It should be emphasized, however, that § 62 merely classifies expenses; it does *not* authorize any deductions. Deductions *for* A.G.I. are:

1. Trade or business deductions except those expenses incurred in the business of being an employee (e.g., expenses of a sole proprietorship or self-employment normally reported on Schedule C of Form 1040)
2. Three categories of employee business deductions:
   - **a.** Expenses that are reimbursed by an employee's employer (and included in the employee's income);
   - **b.** Expenses incurred by a qualified performing artist (see below); and
   - **c.** Expenses incurred by an official of a state or local government who is compensated on a fee basis
3. Losses from sale or exchange of property
4. Deductions attributable to rents or royalties
5. Educator expenses (K–12 teachers)
6. Deductions for reservists, performing artists, fee-basis government officials
7. Deductions for certain tuition and fees
8. Student loan interest expense
9. Deduction for certain legal expenses
10. Deductions for contributions to Individual Retirement Accounts or Keogh retirement plans
11. Alimony deductions
12. Deductions for penalties imposed for premature withdrawal of funds from a savings arrangement
13. Deduction for 50 percent of self-employment tax paid by self-employed persons

14. Deduction for contributions to Medical Savings Accounts (MSAs) and Health Savings Accounts (HSAs)
15. Moving expenses
16. Deduction for 100 percent of self-employed health insurance premiums
17. Certain other deductions

All of the above are deductible for A.G.I., while all other deductions are from A.G.I. (i.e., itemized deductions).

ITEMIZED DEDUCTIONS

As seen above, only relatively few expenses are deductible for A.G.I. The predominant expenses in this category are the deductions incurred by taxpayers who are self-employed (i.e., those carrying on as a sole proprietor). All other expenses are deductible from A.G.I. as itemized deductions.

Itemized deductions fall into two basic categories: those that are *miscellaneous itemized deductions* and those that are not. The distinction is significant because miscellaneous itemized deductions are deductible only to the extent they exceed two percent of A.G.I. Miscellaneous itemized deductions are all itemized deductions *other than* the following:

1. Interest
2. Taxes
3. Casualty and theft losses
4. Medical expenses
5. Charitable contributions
6. Gambling losses to the extent of gambling gains
7. Deduction where annuity payments cease before investment is recovered
8. Certain other deductions

The miscellaneous itemized deductions category is comprised primarily of *unreimbursed* employee business expenses, investment expenses, and deductions related to taxes such as tax preparation fees. Examples of these (assuming they are not reimbursed by the employer) include:

1. Employee travel away from home (including meals and lodging)
2. Employee transportation expenses
3. Outside salesperson's expenses [except that "statutory employees" (e.g., full-time life insurance salespersons, certain agent or commission drivers, and traveling salespersons) are allowed to report their income and expenses on a separate Schedule C and avoid the two percent of A.G.I. limitation]
4. Employee entertainment expenses
5. Employee home office expenses
6. Union dues
7. Professional dues and memberships
8. Subscriptions to business journals

9. Job-seeking expenses (in the same business) or employment-seeking expenses

10. Education expenses

11. Investment expenses, including expenses for an investment newsletter, investment advice, and rentals of safety deposit boxes

12. Tax preparation fees or other tax-related advice including that received from accountants or attorneys, tax seminars, and books about taxes

With respect to item 12 above, expenses related to tax preparation and resolving tax controversies normally are reported as miscellaneous itemized deductions. However, the IRS allows taxpayers who own a business, farm, or rental real estate or have royalty income to allocate a portion of the total cost of preparing their tax return to the cost of preparing Schedule C (trade or business income), Schedule E (rental and royalty income), or Schedule F (farm income) and deduct these costs "for" A.G.I.[53] The same holds true for expenses incurred in resolving tax controversies, including expenses relating to IRS audits or business or rental activities.

SELF-EMPLOYED VERSUS EMPLOYEE

Under the current scheme of deductions for and from A.G.I., an important—and perhaps inequitable—distinction is made based on whether an individual is an employee or self-employed. As seen above, employees generally deduct all unreimbursed business expenses as itemized deductions. In contrast, self-employed taxpayers (i.e., sole proprietors or partners) deduct business expenses for A.G.I. At first glance, the difference appears trivial, particularly for those taxpayers who itemize their deductions. Recall, however, that an employee's business expenses are treated as miscellaneous itemized deductions and thus are deductible only to the extent that these and all other miscellaneous itemized deductions collectively exceed 2 percent of the taxpayer's A.G.I. Due to this distinction, deductibility often depends on the employment status of the taxpayer.

> **Example 23.** T is an accountant. During the year she earns $30,000 and pays dues of $100 to be a member of the local CPA society. These were her only items of income and expense. If T practices as a self-employed sole proprietor (e.g., she has a small firm or partnership), the dues are fully deductible for A.G.I. However, if T is an employee, none of the expense is deductible since it does not exceed the 2% floor of $600 (2% × $30,000). If T's employer had reimbursed her for the expense and included the reimbursement in her income, the expense would have been completely deductible, totally offsetting the amount that T must include in income. If T is employed, but at the same time does some accounting work on her own, part-time, the treatment is unclear.

The logic for the distinction based on employment status is fragile at best. According to the committee reports, Congress believed that it was generally appropriate to disallow deductions for employee business expenses because employers reimburse employees for those expenses that are most necessary for employment. In addition, Congress felt that the treatment would simplify the system by relieving taxpayers of the burden of record keeping and at the same time relieving the IRS of the burden of auditing such deductions.

53 Rev. Rul. 92-29, 1992-1 C.B.20.

Reimbursed Expenses. As emphasized above, an employee's business expenses are generally deductible as itemized deductions unless a reimbursement is received. Where the employee is fully reimbursed and the reimbursement is included in income, the deduction is fully deductible for A.G.I. If only a portion of the expense is reimbursed and included in income, that portion is deductible for A.G.I. and the remainder is a miscellaneous itemized deduction.

Example 24. Professor K is employed by State University in the finance department. The department has a policy of reimbursing up to $50 for each faculty member's costs of subscribing to finance journals. During the year, K spent $75 on subscriptions and received a $50 reimbursement. K's tentative A.G.I. is $40,000 (including the $50 reimbursement). He may deduct $50 for A.G.I., thereby leaving K with A.G.I. of $39,950. The remaining $25 is a miscellaneous itemized deduction that may or may not be deductible depending on whether the sum of this amount plus all other miscellaneous itemized deductions exceeds the 2% floor of $799 ($39,950 × 2%).

The discussion to this point assumes that all employee reimbursements are included by the employer in the employee's income. This is usually not the case, however. As discussed in Chapter 8, the employee may omit both the reimbursement and the expense from the return if, as is generally true, the reimbursement equals such expense and an adequate accounting is made to the employer. In fact, the IRS does not require the employer to file an information return under such circumstances.[54] As a result, an employee expense reimbursement generally is not included in income, and the related expense is not deductible either as a deduction for A.G.I. or as an itemized deduction.

Whether a reimbursement is or is not included in the income of the employee, the effect on A.G.I. is the same. That is, there is no effect on A.G.I. The transaction is a "wash" economically for the employee and is, therefore, a "wash" on the employee's tax return. This concept is demonstrated below.

Example 25. Dr. R is employed by General Hospital. The hospital reimburses employees for the cost of subscribing to medical journals. During the year, Dr. R spent $100 on subscriptions and, after an adequate accounting, received a $100 reimbursement. If the reimbursement is included in Dr. R's income, she is allowed an offsetting deduction for A.G.I. If the reimbursement is not included in her income, she does not take any deduction with respect to the subscription cost.

	Reimbursement Included in Income	*Reimbursement Not Included in Income*
Gross income	$100	$-0-
Deduction for A.G.I.	(100)	(-0-)
A.G.I.	$ -0-	$-0-

Expenses of Performing Artists. Most employee business expenses were relegated to second-class status in 1986 as they became subject to the 2 percent limitation. However, one group of employees, the struggling performing artists, escaped this restriction. These actors, actresses, musicians, dancers, and the like are technically employees but exhibit many attributes of the self-employed. They often work for several employers for little income yet incur relatively large unreimbursed expenses as they

54 Reg. § 1.6041-3(i).

seek their fortunes. For these reasons, "qualified performing artists" are permitted to deduct their business expenses *for* A.G.I. To qualify, the individual must perform services in the performing arts as an employee for at least two employers during the taxable year, earning at least $200 from each. In addition, the individual's A.G.I. before business deductions cannot exceed $16,000. Lastly, the artist's business deductions must exceed 10 percent of his or her gross service income, otherwise they too are considered miscellaneous itemized deductions.

> **Example 26.** Z is an actress. This year she worked in two Broadway productions for two different employers, earning $7,000 from each for a total of $14,000. Her expenses, including the fee to her agent, were $2,000. She may deduct all of her expenses for A.G.I.

Self-Employed or Employee? The above discussion illustrates the importance of determining whether an individual is self-employed or is treated as an employee. However, whether an individual is self-employed or is an employee is often difficult to determine. An employee is a person who performs services for another individual subject to that individual's direction and control.[55] In the employer-employee relationship, the right to control extends not only to the result to be accomplished but also to the methods of accomplishment. Accordingly, an employee is subject to the will and control of the employer as to both what will be done and how it will be done. In the case of the self-employed person, the individual is subject to the control of another only as to the end result, and not as to the means of accomplishment. Generally, physicians, lawyers, dentists, veterinarians, contractors, and subcontractors are not employees. An insurance agent or salesperson may be an employee or self-employed, depending on the facts. The courts have developed numerous tests for differentiating between employees and self-employed persons. Each of the following situations would suggest that an employer-employee relationship exists.[56]

1. Complying with written or oral instructions (an independent contractor need not be trained or attend training sessions)
2. Regular written or oral reports on the work's status
3. Continuous relationship—more than sporadic services over a lengthy period
4. Lack of control over the place of work
5. No risk of profit or loss; no income fluctuations
6. Regular payment—hourly, weekly, etc. (an independent contractor might work on a job basis)
7. Specified number of hours required to work (an independent contractor is master of his or her own time)
8. Unable to delegate work—hiring assistants not permitted
9. Not independent—does not work for numerous firms or make services available to general public

[55] Reg. § 31.3401(c)-1(a).

[56] Rev. Rul. 87-41, 1987-1 C.B. 296. This Revenue Ruling actually contains 20 questions.

LIMITATIONS ON DEDUCTIONS

Some provisions of the Code specifically prohibit or limit the deduction of certain expenses and losses despite their apparent relationship to the taxpayer's business or profit-seeking activities. These provisions operate to disallow or limit the deduction for various expenses unless such expenses are specifically authorized by the Code. As a practical matter, these provisions have been enacted to prohibit abuses identified in specific areas. Several of the more fundamental limitations are considered in this chapter.

HOBBY EXPENSES AND LOSSES

As previously discussed, a taxpayer must establish that he or she pursues an activity with the objective of making a profit before the expense is deductible as a business or production of income expense. When the profit motive is absent, the deduction is governed by § 183 on activities not engaged in for profit (i.e., hobbies). Section 183 generally provides that hobby expenses of an individual taxpayer or S corporation are deductible only to the extent of the gross income from the hobby. Thus, the tax treatment of hobby expenses substantially differs from profit-seeking expenses if the expenses of the activity exceed the income, resulting in a net loss. If the loss is treated as arising from a profit-motivated activity, then the taxpayer ordinarily may use it to reduce income from other sources.[57] Conversely, if the activity is considered a hobby, no loss is deductible. Note, however, that hobby expenses may be deducted to offset any hobby income.

Profit Motive. The problem of determining the existence of a profit motive usually arises in situations where the activity has elements of both a personal and a profit-seeking nature (e.g., auto racing, antique hunting, coin collecting, horse breeding, weekend farming). In some instances, these activities may represent a profitable business venture. Where losses are consistently reported, however, the business motivation is suspect. In these cases all the facts and circumstances must be examined to determine the presence of the profit motive. The courts have held that the taxpayer simply is required to pursue the activity with a bona fide intent of making a profit. The taxpayer, however, need not show a profit. Moreover, the taxpayer's expectation of profit need not be considered reasonable.[58] The Regulations set out nine factors to be used in ascertaining the existence of a profit motive.[59] Some of the questions posed by these factors are:

1. Was the activity carried on in a businesslike manner? Were books and records kept? Did the taxpayer change his or her methods or adopt new techniques with the intent to earn a profit?
2. Did the taxpayer attempt to acquire knowledge about the business or consult experts?
3. Did the taxpayer or family members devote much time or effort to the activity? Did they leave another occupation to have more time for the activity?
4. Have there been years of income as well as years of loss? Did the losses occur only in the start-up years?

57 The limitations imposed on losses from passive activities should not be applicable in this situation since the taxpayer materially participates in the activity. See discussion in Chapter 12 and § 469.

58 Reg. § 1.183-2(a).

59 Reg. § 1.183-2(b).

5. Does the taxpayer have only incidental income from other sources? Is the taxpayer's wealth insufficient to maintain him or her if future profits are not derived?

6. Does the taxpayer derive little personal or recreational pleasure from the activity?

An affirmative answer to several of these questions suggests a profit motive exists.

Presumptive Rule. The burden of proof in the courts is normally borne by the taxpayer. Section 183, however, shifts the burden of proof to the IRS in hobby cases where the taxpayer shows profits in any three of five consecutive years (two of seven years for activities related to horses).[60] The rule creates a presumption that the taxpayer has a profit motive unless the IRS can show otherwise. An election is available to the taxpayer to postpone IRS challenges until five (or seven) years have elapsed from the date the activity commenced. Making the election allows the taxpayer sufficient time to have three profitable years and thus shift the burden of proof to the IRS. This election must be filed within three years of the due date of the return for the taxable year in which the taxpayer first engages in the activity, but not later than 60 days after the taxpayer has received notice that the IRS proposes to disallow the deduction of expenses related to the hobby. The election automatically extends the statute of limitations for each of these years, thus enabling a later challenge by the IRS. It should be emphasized that this presumptive rule only shifts the burden of proof. Profits in three of the five (or two of seven) years do not absolve the taxpayer from attack.

Example 27. T enjoys raising, breeding, and showing dogs. In the past, she occasionally sold a dog or puppy. In 2007 T decided to pursue these activities seriously. During the year, she incurred a loss of $4,000. T also had a loss of $2,000 in 2008. If T made no election for any of these years (i.e., within three years of the start of the activity), the IRS may assert that T's activities constitute a hobby. In this case, the burden of proof is on T to show a profit motive, since she has not shown a profit in at least three years. If T made an election, then the IRS is barred from assessing a deficiency until five years have elapsed. Five years need to elapse to determine whether T will have profits in three of the five years and, if so, shift the burden of proof to the IRS in any litigation that may occur. If an election is made, however, the period for assessing deficiencies for all years is extended until two years after the due date of the return for the last taxable year in the five-year period.[61] In T's case, an election would enable the IRS to assess a deficiency for 2007 and subsequent years up until April 15, 2014, assuming T is a calendar year taxpayer. If an election were not made, the statute of limitations would normally bar assessments three years after the return is due (e.g., assessments for 2007 would be barred after April 15, 2011).

Deduction Limitation. If the activity is considered a hobby, the related expenses are deductible to the extent of the activity's gross income as reduced by *otherwise allowable deductions*.[62] Otherwise allowable deductions are those expenses relating to the hobby that are deductible under other sections of the Code regardless of the activity in which they are incurred. For example, property taxes are deductible under § 164 without regard to whether the activity in which they are incurred is a hobby or a business. Similarly, interest

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60 § 183(d).

61 § 183(d)(4).

62 § 183(b). On classification of the deductions, see Rev. Rul. 75-14, 1975-1 C.B. 90 and Senate Finance Committee Report on H.R. 3838, S. Rep. No. 99-313 (5/29/86), p. 80, 99th Cong., 2nd. Sess.

on debt secured by the taxpayer's principal or secondary residence is deductible regardless of the character of the activity. Consequently, any expense otherwise allowable is deducted *first* in determining the gross income limitation. Any other expenses are deductible to the extent of any remaining gross income (i.e., other operating expenses are taken next, with any depreciation deductions, taken last). Otherwise allowable deductions are fully deductible as itemized deductions, while other deductible expenses are considered miscellaneous itemized deductions and are deductible only to the extent they exceed 2 percent of A.G.I. (including the hobby income).

Example 28. R, an actor, enjoys raising, breeding, and racing horses as a hobby. His A.G.I. excluding the hobby activities is $68,000. He has a small farm on which he raises the horses. During the current year, R won one race and received income of $2,000. He paid $2,300 in expenses as follows: $800 property taxes related to the farm and $1,500 feed for horses. R calculated depreciation with respect to the farm assets at $6,500. As a result, R has a net loss from the activity of $6,800 ($2,000 – $2,300 – $6,500). If the activity is *not* considered a hobby but rather a trade or business, R would report the loss on Schedule C and assuming it is not a passive loss, he could use it to offset his other income. However, if the activity is considered a hobby and R itemizes deductions, he would compute his deductions as follows:

Gross income	$2,000	
Otherwise allowable deductions:		
Taxes	(800)	$ 800
Gross income limitation	$ 1,200	
Feed expense:		
$1,500 limited to remaining gross income		1,200
Total		$2,000

Note that because depreciation is taken last, there is no deduction for this item.

R would include $2,000 in gross income, increasing his A.G.I. to $70,000. Of the $2,000 in deductible expenses, the property taxes of $800 are deductible in full as an itemized deduction. The remaining $1,200 is considered a miscellaneous itemized deduction. In this case, none of the $1,200 is deductible since this amount does not exceed the 2% floor of $1,400 (2% of $70,000). No deduction is allowed for the remaining feed expense of $300 ($1,500 – $1,200) due to the gross income limitation.

Example 29. Assume the same facts as in *Example 25* except that R's expense for property taxes is $2,400 instead of $800. In this case, because the entire $2,400 is deductible as an otherwise allowable deduction and exceeds the gross income from the hobby, none of the feed expense is deductible. Thus, R would include $2,000 in gross income and the $2,400 of property taxes would be fully deductible from A.G.I.

PERSONAL LIVING EXPENSES

Just as the Code specifically authorizes deductions for the costs of pursuing income—business and income-producing expenses—it denies deductions for personal expenses. Section 262 prohibits the deduction of any personal, living, or family expenses. Only those personal expenditures expressly allowed by some other provision in the Code are deductible. Some of the personal expenditures permitted by other provisions are medical expenses, contributions, qualified residence interest, and taxes. Normally, these expenses are classified as itemized deductions. These deductions and their underlying rationale are discussed in Chapter 11.

The disallowance of personal expenditures by § 262 complements the general criteria allowing a deduction. Recall that the general rules of §§ 162 and 212 permit deductions for ordinary and necessary expenses *only where a profit motive exists*. As previously seen in the discussion of hobbies, however, determining whether an expense arose from a personal or profit motive can be difficult. Some of the items specifically disallowed by § 262 are:

1. Expenses of maintaining a household (e.g., rent, utilities)
2. Losses on sales of property held for personal purposes
3. Amounts paid as damages for breach of promise to marry, attorney's fees, and other costs of suits to recover such damages
4. Premiums paid for life insurance by the insured
5. Costs of insuring a personal residence

Legal Expenses. Legal expenses related to divorce actions and the division of income-producing properties are often a source of conflict. Prior to clarification by the Supreme Court, several decisions held that divorce expenses incurred primarily to protect the taxpayer's income-producing property or his or her business were deductible.[63] The Supreme Court, however, has ruled that deductibility depends on whether the expense arises in connection with the taxpayer's profit-seeking activities. That is, the *origin* of the expense determines deductibility.[64] Under this rule, if the spouse's claim arises from the marital relationship—a personal matter—then no deduction is allowed. Division of income-producing property would only be incidental to or a consequence of the marital relationship.

Example 30. R pays legal fees to defend an action by his wife to prevent distributions of income from a trust to him. Because the wife's action arose from the marital relationship, the legal expenses are nondeductible personal expenditures.[65]

Legal expenses related to a divorce action may be deductible where the expense is for advice concerning the tax consequences of the divorce.[66] The portion of the legal expense allocable to counsel on the tax consequences of a property settlement, the right to claim children as dependents, and the creation of a trust for payment of alimony are deductible.

Contingent Attorney Fees. Over the years, there has been a great deal of controversy regarding the treatment of contingent attorney fees incurred in securing a damages award. To illustrate, assume a taxpayer receives an award of fully taxable punitive damages of $10 million and the attorney is to receive a contingent fee of 40 percent of that amount or $4 million. In this situation, the taxpayer typically asserted that the fees represent a splitting of the income and, therefore, he or she should be taxed only on the net amount

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63 *F.C. Bowers v. Comm.*, 57-1 USTC ¶9605, 51 AFTR 207, 243 F.2d 904 (CA-6, 1957).

64 *Supra*, Footnote 13, Also, compare *Comm. v. Tellier*, 66-1 USTC ¶9319, 17 AFTR2d 633, 383 U.S. 687 (USSC, 1966) with *Boris Nodiak v. Comm.*, 66-1 USTC ¶9262, 17 AFTR2d 396, 356 F.2d 911 (CA-2, 1966).

65 *H.N. Shilling, Jr.*, 33 TCM 1097, T.C. Memo 1974-246.

66 Rev Rul. 72-545, 1972-2 C.B. 179.

received or $6 million. Conversely, the government argued that the full $10 million is included in gross income and the $4 million of attorney fees were a miscellaneous itemized deduction subject to the two percent limitation and the one percent cutback. But more importantly, since the attorney fees were classified as miscellaneous itemized deductions, they were not allowed in computing the alternative minimum tax (AMT). As a result, an AMT often resulted. In effect, the taxpayer paid tax on $10 million when he or she had only received $6 million.

Congress addressed this problem in 2004. Attorney's fees and court costs incurred for certain legal actions are deductible for A.G.I. This rule applies to most legal actions, but not necessarily all.[67] Apparently, certain types of tort actions, such as defamation, would not fall within the statute unless they occur within the employment context. By classifying these expenses as deductions for A.G.I., the AMT problem is eliminated since the AMT limitations generally apply only to certain itemized deductions.[68]

CAPITAL EXPENDITURES

A capital expenditure is ordinarily defined as an expenditure providing benefits that extend beyond the close of the taxable year. It is a well-established rule in case law that a business expense, though ordinary and necessary, is not deductible in the year paid or incurred if it can be considered a capital expenditure.[69] Normally, however, a capital expenditure may be deducted ratably over the period for which it provides benefits. For example, the Code authorizes deductions for depreciation or cost recovery, amortization, and depletion where the asset has a determinable useful life.[70] Capital expenditures creating assets that do not have a determinable life, however, generally cannot be deducted. For example, land is considered as having an indeterminable life and thus cannot be depreciated or amortized. The same is true for stocks and bonds. Expenditures for these types of assets are recovered (i.e., deducted) only when there is a disposition of the asset through sale (e.g., cost offset against sales price), exchange, abandonment, or other disposition.

As a general rule, assets with a useful life of one year or less need not be capitalized. For example, the taxpayer can write off short-lived assets with small costs such as supplies (e.g., stationery, pens, pencils, calculators), books (e.g., the Internal Revenue Code), and small tools (e.g., screwdrivers, rakes, and shovels).

Goodwill. Like land, goodwill is an example of an asset that does not have a determinable useful life. Because of this indeterminate life, acquired goodwill historically has been treated as a capitalized asset that could not be depreciated. The only way a taxpayer could receive a current tax benefit from acquired goodwill was to identify components separate and apart from goodwill that had an ascertainable value and limited useful life (e.g., client files and subscription lists). If a taxpayer was successful in

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[67] § 62 (a)(19) extends the deduction for actions in connection with unlawful discrimination claims, certain claims against the federal government, and private causes of action under the Medicare Secondary Payer law. Unlawful discrimination actions include those that claim violations of the Civil Rights Acts of 1964 and 1991, the Congressional Accountability Act of 1995, the National Labor Relations Act, the Family and Medical Leave Act of 1993, the Fair Housing Act, the Americans with Disabilities Act of 1990, and various whistle-blower statutes.

[68] The Jobs Act does apply to cases settled prior to October 23, 2004. The Supreme Court settled the issue for these cases, reversing pro-taxpayer decisions in the Sixth and Ninth Circuits, indicating that there had been an invalid assignment of income and, therefore the legal expenses were miscellaneous itemized deductions. See *Comm. v. John W. Banks II and Comm. v. Sigitas J. Banaitis*, (combined) 2005-1 USTC ¶50,595, AFTR 2d 2005-659, (USSC, 2005), rev'g *Banks II*, 92 2003-6298, 2003-2 USTC ¶50,675,AFTR 2d, 345 F3d 373 (CA-6, 2003), and rev'g *Banaitis*, 92 AFTR 2d 2003-5834, 2003-2 USTC ¶50,638; 340 F3d 1074 (CA-9, 2003).

[69] *Supra*, footnote 18.

[70] §§ 167, 168, 169, 178, 184, 188, and 611 are examples.

establishing the requisite valuation and limited life for a goodwill component, the taxpayer could depreciate the cost of the intangible asset over its useful life using the straight-line method (known as amortization). However, in practice, taxpayers often faced challenges by the IRS, and many attempts to depreciate goodwill components were unsuccessful.

Congress enacted Code § 197 to reduce the uncertainty surrounding the depreciation of goodwill and its identifiable components. Effective August 10, 1994, the cost of acquiring intangible assets (including acquired goodwill) may, at the election of the taxpayer, be amortized over a 15-year period. If the election is not made, the cost of acquiring goodwill and related intangibles must be capitalized and no amortization will be allowed.

> **Example 31.** B has decided to purchase a newspaper business in a small town for $100,000. It can be determined that $80,000 of the purchase price is allocable to the assets of the business and $20,000 is attributable to goodwill (subscription lists and other intangibles). B may be able to recover all $100,000 of the cost through deductions for depreciation and amortization.

Capital Expenditures vs. Repairs. The general rule of case law disallowing deductions for capital expenditures has been codified for expenditures relating to property. Code § 263 provides that deductions are not allowed for any expenditures for new buildings or for permanent improvements or betterments made to increase the value of property.[71] Additionally, expenditures substantially prolonging the property's useful life, adapting the property to a new or different use, or materially adding to the value of the property are not deductible.[72] Conversely, the cost of incidental repairs that do not materially increase the value of the property nor appreciably prolong its life, but maintain it in a normal operating state, may be deducted in the current year.[73] For example, costs of painting, inside and outside, and papering are usually considered repairs.[74] However, if the painting is done in conjunction with a general reconditioning or overhaul of the property, it is treated as a capital expenditure.[75]

> **Example 32.** L operates his own limousine business. Expenses for a tune-up such as the costs of spark plugs, points, and labor would be deductible as routine repairs and maintenance since such costs do not significantly prolong the car's life. In contrast, if L had the transmission replaced at a cost of $600, allowing him to drive it for another few years, the expense must be capitalized.

Acquisition Costs. As a general rule, costs related to the acquisition of property must be capitalized. For example, freight paid to acquire new equipment or commissions paid to acquire land must be capitalized. In addition, Code § 164 requires that state and local general sales taxes related to the purchase of property be capitalized. The costs of demolition or removal of an old building prior to using the land in another fashion must be capitalized as part of the cost of the land.[76] Costs of defending or perfecting the title to property, such as legal fees, are normally capitalized.[77] Similarly, legal fees incurred for

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71 § 263(a).

72 Reg. § 1.263(a)-1(b).

73 Reg. § 1.162-4.

74 *Louis Allen*, 2 BTA 1313 (1925).

75 *Joseph M. Jones*, 57-1 USTC ¶9517, 50 AFTR 2040, 242 F.2d 616 (CA-5, 1957).

76 § 280B.

77 Reg. § 1.263(a)-2.

the recovery of property must be capitalized unless the recovered property is investment property or money that must be included in income if received.[78]

INDOPCO and the Long-Term Benefit Theory. Interestingly, one of the most important and widely debated tax developments to occur in recent years concerns the capital expenditure area. The controversy stems from a Supreme Court decision involving the treatment of costs incurred by a target company as part of a friendly takeover. In 1977, Unilever approached one of its suppliers, INDOPCO, about the possibility of a takeover to which INDOPCO agreed. During the acquisition process, INDOPCO paid an investment banking company, Morgan Stanley, about $2.2 million for advice and a fairness opinion and another $500,000 to its own legal counsel for services related to the takeover. The IRS ultimately denied deduction of the expenses (as well as amortization) on the grounds that the expenses were capital in nature. In 1992, the Supreme Court concurred with the IRS, believing that INDOPCO would receive long-term benefits from the acquisition, including the opportunity for synergy with Unilever and the future availability of Unilever's financial and business resources.[79]

The effect of the INDOPCO decision would not be so great if it were confined to costs incurred as part of a friendly takeover. However, the IRS has used the broad language of the court to capitalize any expense to which it can associate any long-term benefit. In this regard, it is important to understand that the Supreme Court indicated that the long-term benefits need not be associated with any specific identifiable asset. As long as the expenditure leads to the permanent betterment of the business as a whole, capitalization may be in order. For example, the IRS has used this approach to deny a deduction for the costs of removing asbestos insulation from equipment if the removal is part of a general plan of rehabilitation, despite the fact that the expense did not extend the life of the asset.[80] Instead, the taxpayer was required to capitalize the expenditure on the grounds that the firm would derive long-term benefits from safer working conditions and reduced risk of liability. In another ruling concerning advertising costs, the IRS, while allowing a current deduction, warned that in certain instances advertising could produce long-term benefits, in which case such expenses must be capitalized.[81] In short, the INDOPCO decision has increased the tension between taxpayers and the IRS in the capital expenditure arena.

Over time, the intensity of the controversy and the level of uncertainty produced by INDOPCO escalated to an intolerable level. In response to the criticism, the IRS issued final regulations in 2004 to reign in the scope of INDOPCO and its "long-term-benefit" theory.[82] The regulations are quite extensive. There are over 50 pages and more than 80 examples all aimed at resolving whether a particular cost related to an intangible should be capitalized. Although a full discussion of these regulations is beyond the scope of this text, they are required reading whenever a taxpayer incurs an expense related to an intangible. Specifically, the regulations address amounts paid to

- *Acquire* an intangible (e.g., purchase a customer list, lease, patent, copyright, franchise, trademark, trade name, assembled workforce, or goodwill; most of these must be amortized over 15 years under § 197)
- *Create* an intangible (e.g., costs for prepaid items such as prepaid rents and insurance, membership privileges such as membership in a trade association, rights from governmental agencies such as the exclusive rights obtained from the

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78 Reg. § 1.212-1(k).

79 *INDOPCO, Inc. v. Comm.*, 92-1 USTC ¶50,113, 69 AFTR2d 92-694, 503 U.S. 79 (USSC, 1992).

80 *Norwest Corporation*, 108 T.C. No. 15 (1997).

81 Rev. Rul. 92-80, 1992-2 C.B. 57.

82 Reg. § 1.263(a)-4 and -5.

local government by a cable television company to serve a particular region, contract rights and contract terminations such as the rights to renew or renegotiate, licenses, and covenants not to compete)

- *Create* or enhance a separate and distinct intangible
- *Facilitate* the acquisition or creation of an intangible (e.g., legal expenses for negotiating commercial property lease, drafting agreements)
- *Facilitate* the acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions (e.g., legal expenses to issue debt, payments to investment banker and outside legal counsel for evaluating alternative investments, performing due diligence, structuring the transaction, preparing SEC filings, and obtaining necessary regulatory approvals, hostile takeover defenses).

These regulations should bring to a close a period of great uncertainty that was not envisioned when the Supreme Court decided the INDOPCO case in 1992.

Environmental Remediation Costs. Under Code § 198 which took effect on August 5, 1997, a taxpayer may elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred. To qualify for this special treatment, the expense must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. Prior to the enactment of this provision, the IRS took the view that costs incurred to clean-up the environment were controlled by the long-term benefit theory of INDOPCO and, therefore, were capital expenditures for which no deduction was allowed. The effect of § 198, then, is to override the IRS's reliance on the long-term benefit theory to deny deductions with respect to environmental remediation costs.

Elections to Capitalize or Deduct. Various provisions of the Code permit a taxpayer to treat capital expenditures as deductible expenses, as deferred expenses, or as capital expenditures. For example, at the election of the taxpayer, expenses for research and experimentation may be deducted currently, treated as deferred expenses and amortized over at least 60 months, or capitalized and included in the basis of the resulting property.[83]

BUSINESS INVESTIGATION EXPENSES AND START-UP COSTS

Another group of expenses that arguably may be considered capital expenditures are those incurred when seeking and establishing a new business, such as costs of investigation and start-up. Business investigation expenses are those costs of seeking and reviewing prospective businesses prior to reaching a decision to acquire or enter any business. Such expenses include the costs of analysis of potential markets, products, labor supply, and transportation facilities. Start-up or pre-opening expenses are costs that are incurred after a decision to acquire a particular business and prior to its actual operations. Examples of these expenses are advertising, employee training, lining up distributors, suppliers, or potential customers, and the costs of professional services such as attorney and accounting fees.

For many years, the deductibility of expenses of business investigation and start-up turned solely on whether the taxpayer was "carrying on" a business at the time the expenditures were incurred. Notwithstanding some modifications, the basic rule still remains: when the taxpayer is in the same or similar business as the one he or she is

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83 § 174. See §§ 175 and 180 for other examples.

starting or investigating, the costs of investigation and start-up are wholly deductible in the year paid or incurred.[84] The deduction is allowed regardless of whether the taxpayer undertakes the business.[85] However, this rule often forces taxpayers to litigate to determine whether a business exists at the time the expenses are incurred. Prior to the enactment of § 195, if the taxpayer could not establish existence of a business, the expenditures normally were treated as capital expenditures with indeterminable lives.[86] As a result, the taxpayer could only recover the expenditure if and when he or she disposed of or abandoned the business.

In 1980 Congress realized that the basic rule not only was a source of controversy but also discouraged formation of new businesses. For this reason, special provisions permitting deduction of these expenses under certain conditions were enacted.[87] Before examining these provisions, it should be emphasized that the traditional rule continues to be valid. Thus, if a taxpayer can establish that the investigation and start-up costs are related to a similar existing business of the taxpayer, a deduction is allowed.

> **Example 33.** S owns and operates an ice cream shop on the north side of the city. A new shopping mall is opening on the south side of the city, and the developers have approached her about locating a second ice cream shop in their mall. During 2008 S pays a consulting firm $1,000 for a survey of the potential market on the south side. Because S is in the ice cream business when the expense is incurred, the entire $1,000 is deductible regardless of whether she undertakes the new business.

Amortization Provision. Section 195 sets out the treatment for the start-up and investigation expenses of taxpayers who are *not* considered in a similar business when the expenses are incurred *and* who actually enter the new business. Eligible taxpayers may elect to deduct up to $5,000 of business investigation and start-up expenses in the tax year in which the business begins. If the §195 expenses exceed $5,000, the excess must be amortized over the 180-month period (15 years) beginning with the month in which the business begins.[88] If the expenses exceed $50,000, the $5,000 allowance is reduced one dollar for each dollar in excess of $50,000. Expenses for research and development, interest payments, and taxes are not considered start-up expenditures.[89] Consequently, these costs are not subject to §195 and may be deducted under normal rules.

> **Example 34.** J, a calendar year, cash basis taxpayer, recently graduated and received $10,000 from his wealthy uncle as a graduation gift. J paid an accountant $1,200 in September to review the financial situation of a small restaurant he desired to purchase. In December, J purchased the restaurant and began actively participating in its management. J may deduct $1,200 for the current year.

> **Example 35.** S, a famous bodybuilder, has decided to build his first health spa. While the facility is being constructed, a temporary office is set up in a trailer next to the site. The office is nicely decorated and contains a small replica of the facility. S hired a staff who will manage the facility but at this time are calling prospective customers. Elaborate brochures have been printed. All of these costs, including the salaries paid to the staff, the printing of the brochures, and the costs of operating the trailer such as

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84 *The Colorado Springs National Bank v. U.S.*, 74-2 USTC ¶9809, 34 AFTR2d 74-6166, 505 F.2d 1185 (CA-10, 1974).

85 *York v. Comm.*, 58-2 USTC ¶9952, 2 AFTR2d 6178, 261 F.2d 421 (CA-4, 1958).

86 *Morton Frank*, 20 T.C. 511 (1953).

87 § 195(a).

88 § 195 expenses incurred prior to October 23, 2004 are amortized over 60 months.

89 § 195(c)(1).

depreciation and utilities, are start-up costs. Assuming the total start-up costs were less than $50,000, the taxpayer could expense the first $5,000 and amortize the balance over 180 months.

Example 36. Same facts as above except S incorporated and the corporation incurred $23,000 of start-up and investigation expenses. The corporation was formed in July of this year and adopted the calendar year. In this case, the corporation could deduct $5,000 immediately and amortize the remaining balance of $18,000 over 15 years (180 months) beginning in July. This would result in amortization of $100/month for 180 months. The deduction for start-up and investigation expenses for 2007 would be $5,600 computed as follows:

First-year allowance	$5,000
Amortization ($18,000/180 = $100/month × 6 months)	600
Total deduction in first year	$5,600

In 2008, the corporation would continue to amortize the remaining expenses, resulting in a deduction of $1,200 ($100/month × 12).

Example 37. In March, 2008 LMN, LLC was formed and incurred start-up and investigation expenses of $52,000. LMN's immediate expensing allowance of $5,000 must be reduced one dollar for each dollar of § 195 expense exceeding $50,000. In this case, the allowance is reduced by $2,000 ($52,000 − $50,000) to $3,000. Thus LMN may deduct $3,000 plus amortization of the remaining $49,000, resulting in a deduction of $5,720 computed below.

First-year allowance [$5,000 − ($52,000 − $50,000 = $2,000)]		$3,000
Amortization:		
Total expense	$52,000	
First-year allowance	(3,000)	
Amortizable balance	$49,000	
Amortization ($49,000/180 = $272/month × 10 months)		2,720
Total § 195 expense deduction in first year		$5,720

Note that if LMN had incurred $55,000 or more of § 195 expenses, the $5,000 immediate write-off would be reduced to zero and all $55,000 of the expenses would be amortized over 180 months.

As suggested above, the taxpayer must enter the business to qualify for amortization. Whether the individual is considered as having entered the business normally depends on the facts in each case.

If the taxpayer (who is not in a similar, existing business) does not enter into the new business, the investigation and start-up expenses generally are not deductible. The Tax Court, however, has held that a taxpayer may deduct costs as a loss suffered from a transaction entered into for profit if the activities are sufficient to be considered a "transaction."[90] The IRS has interpreted this rule to mean that those expenditures related to a *general search* for a particular business or investment are not deductible.[91] Expenses are considered general when they are related to whether to enter the transaction and which transaction to enter. Once the taxpayer has focused on the acquisition of a *specific* business or investment, expenses related to an unsuccessful acquisition attempt are deductible as a loss on a transaction entered into for profit.

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90 *Harris W. Seed*, 52 T.C. 880 (1969).

91 Rev. Rul. 77-254, 1977-2 C.B. 63.

Example 38. L, a retired army officer, is interested in going into the radio business. He places advertisements in the major trade journals soliciting information about businesses that may be acquired. Upon reviewing the responses to his ads, L selects two radio stations for possible acquisition. He hires an accountant to audit the books of each station and advise him on the feasibility of purchase. He travels to the cities where each station is located and discusses the possible acquisition with the owners. Finally, L decides to purchase station FMAM. To this end, he hires an attorney to draft the purchase agreement. Due to a price dispute, however, the acquisition attempt collapses. The expenses for advertising, auditing, and travel are not deductible since they are related to the taxpayer's general search. The legal expenses are deductible as a loss, however, since they occurred in the taxpayer's attempt to acquire a specific business.

Job-Seeking Expenses. The tax treatment of job-seeking expenses of an employee is similar to that for expenses for business investigation. If the taxpayer is seeking a job in the same business in which he or she is presently employed, the related expenses are deductible as miscellaneous itemized deductions subject to the 2 percent floor.[92] The deduction is allowed even if a new job is not obtained. No deduction or amortization is permitted, however, if the job sought is considered a new trade or business or the taxpayer's first job.

Example 39. B, currently employed as a biology teacher, incurs travel expenses and employment agency fees to obtain a new job as a computer operator. The expenses are not deductible because they are not incurred in seeking a job in the profession in which she was currently engaged. Moreover, the expenses are not deductible even though B obtained the new job. However, the expenses would be deductible if she had obtained a new job in her present occupation.

PUBLIC POLICY RESTRICTIONS

Although an expense may be entirely appropriate and helpful, and may contribute to the taxpayer's profit-seeking activities, it is not considered necessary if the allowance of a deduction would frustrate sharply defined public policy. The courts established this longstanding rule on the theory that to allow a deduction for expenses such as fines and penalties would encourage violations by diluting the penalty.[93] Historically, however, the IRS and the courts were free to restrict deductions of any type of expense where, in their view, it appeared that the expenses were contrary to public policy—even if the policy had not been clearly enunciated by some governmental body. As a result, taxpayers were often forced to go to court to determine if their expense violated public policy.

Recognizing the difficulties in applying the public policy doctrine, Congress enacted provisions specifically designed to limit its use.[94] The rules identified and disallowed certain types of expenditures that would be considered contrary to public policy. Under these provisions no deduction is allowed for fines, penalties, and illegal payments.

Fines and Penalties. A deduction is not allowed for any fine or similar penalty paid to a government for the violation of any law.[95]

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[92] Rev. Rul. 75-120, 1975-1 C.B. 55, as clarified by Rev. Rul. 77-16, 1977-1 C.B. 37.

[93] *Hoover Motor Express Co., Inc. v. U.S.*, 58-1 USTC ¶9367, 1 AFTR2d 1157, 356 U.S. 38 (USSC, 1958).

[94] S. Rep. No. 91-552, 91st Cong., 1st Sess. 273-75 (1969). Note, however, that the Tax Court continues to utilize the doctrine despite Congress's attempt to restrict its use—see *R. Mazzei*, 61 T.C. 497 (1974).

[95] § 162(f).

Example 40. S is a salesperson for an office supply company. While calling on customers this year, he received parking tickets of $100. None of the cost is deductible because the violations were against the law.

Example 41. Upon audit of T's tax return, it was determined that he failed to report $10,000 of tip income from his job as a maitre d', resulting in additional tax of $3,000. T was also required to pay the negligence penalty for intentional disregard of the rules. The penalty—20% of the tax due—is not deductible.

Example 42. This year the Federal Drug Administration fined C Inc., a drug manufacturing company, $5,000,000 for failure to maintain adequate quality control. The fine is not deductible because the practices were in violation of Federal law.

Fines include those amounts paid in settlement of the taxpayer's actual or potential liability.[96] In addition, no deduction is allowed for two-thirds of treble damage payments made due to a violation of antitrust laws.[97] Thus, one-third of this antitrust "fine" is deductible.

Illegal Kickbacks, Bribes, and Other Payments. The Code also disallows the deduction for four categories of illegal payments:[98]

1. Kickbacks or bribes to U.S. government officials and employees if illegal
2. Payments to governmental officials or employees of *foreign* countries if such payments would be considered illegal under the U.S. Foreign Corrupt Practices Act

Example 43. R travels all over the world, looking for unique items for his gift shop. Occasionally when going through customs in foreign countries, he is forced to "bribe" the customs official to do the necessary paperwork and get him through customs as quickly as possible. These so-called grease payments to employees of foreign countries are deductible unless they violate the Foreign Corrupt Practices Act. In general, such payments are not considered to be illegal.

3. Kickbacks, bribes, or other illegal payments to any other person if illegal under generally enforced U.S. or state laws that provide a criminal penalty or loss of license or privilege to engage in business
4. Kickbacks, rebates, and bribes, although legal, made by any provider of items or services under Medicare and Medicaid programs

Those kickbacks and bribes not specified above would still be deductible if they were ordinary and necessary. The payment, however, may not be necessary and thus will be disallowed if it controverts public policy.

Kickbacks generally include payments for referral of clients, patients, and customers. However, under certain circumstances, trade discounts or rebates may be considered kickbacks.

Example 44. M, a life insurance salesperson, paid rebates or discounts to purchasers of policies. Since such practice is normally illegal under state law, the rebate is not deductible.[99]

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96 § 162(g).

97 Reg. § 1.162-21(b).

98 § 162(c).

99 *James Alex*, 70 T.C. 322 (1978).

Expenses of Illegal Business. The expenses related to an illegal business are deductible.[100] Similar to the principle governing taxation of income from whatever source (including income illegally obtained), the tax law is not concerned with the lawfulness of the activity in which the deductions arise. No deduction is allowed, however, if the expense itself constitutes an illegal payment as discussed above. In addition, Code § 280E prohibits the deduction of any expenses related to the trafficking in controlled substances (i.e., drugs).

LOBBYING AND POLITICAL CONTRIBUTIONS

Although expenses for lobbying and political contributions may be closely related to the taxpayer's business, Congress has traditionally limited their deduction. These restrictions usually are supported on the grounds that it is not in the public's best interest for government to subsidize efforts to influence legislative matters.

Lobbying. Prior to 1962, no deduction was permitted for any type of lobbying expense. In 1962, however, Congress altered its position slightly with the addition of § 162(e), which carved out a narrow exception for certain lobbying expenses. This provision allowed a deduction for the expenses of appearing before or providing information to governmental units on legislative matters of *direct interest* to the taxpayer's business. Similarly, a deduction was permitted for expenses of providing information to a trade organization of which the taxpayer was a member where the legislative matter was of direct interest to the taxpayer and the organization. The portion of dues paid to such an organization attributable to the organization's allowable lobbying activities was also deductible. Beginning in 1994, however, these rules for deducting lobbying expenses are even more restrictive. Lobbying expenditures are now deductible only if incurred for the purpose of influencing legislation at the *local* level. Therefore, the expense of influencing national and state legislation (including the costs of hiring lobbyists to represent the taxpayer in these matters) is not deductible. This prohibition is extended to the costs of any direct communication with executive branch officials in an attempt to influence official actions or positions of such official.

The taxpayer must have a direct interest in the local legislation before lobbying expenses may be deducted. Although the definitional boundaries of the term "direct" are vague, a taxpayer is considered as having satisfied the test if it is reasonable to expect that the local legislative matter affects or will affect the taxpayer's business. However, a taxpayer does not have a direct interest in the nomination, appointment, or operation of any local legislative body.[101]

The deduction for lobbying *does not* extend to expenses incurred to influence the general public on legislative matters, elections, or referendums.[102] Expenses related to the following types of lobbying are not deductible:

1. Advertising in magazines and newspapers concerning legislation of direct interest to the taxpayer.[103] However, expenses for "goodwill" advertising presenting views on economic, financial, social, or similar subjects of a general nature, or encouraging behavior such as contributing to the Red Cross, are deductible.[104]

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[100] See *Max Cohen v. Comm.*, 49-2 USTC ¶9358, 176 F.2d 394 (CA-10, 1949) and *Neil Sullivan v. Comm.*, 58-1 USTC ¶9368, AFTR2d 1158, 356 U.S. 27 (USSC, 1958).

[101] Reg. § 1.162-20(b).

[102] § 162(e)(2).

[103] Rev. Rul. 78-112, 1978-1 C.B. 42.

[104] Reg. § 1.162-20(a)(2).

2. Preparing and distributing to a corporation's shareholders pamphlets focusing on certain legislation affecting the corporation and urging the shareholders to contact their representatives in Congress.[105]

Example 45. T owns a restaurant in Austin, Texas. Legislation has been introduced by the City Council to impose a sales tax on food and drink sold in Austin, to be used for funding a dome stadium. T places an ad in the local newspaper stating reasons why the legislation should not be passed. He goes to the City Council and testifies on the proposed legislation before several committees. He pays dues to the Austin Association of Restaurant Owners organization, which estimates that 60% of its activities are devoted to lobbying for local legislation related to restaurant owners. T may deduct the cost of travel and 60% of his dues since the local legislation is of direct interest to him. He may not deduct the ad since it is intended to influence the general public.

Political Contributions. No deduction is permitted for any contributions, gifts, or any other amounts paid to a political party, action committee, or group or candidate related to a candidate's campaign.[106] This rule also applies to indirect payments, such as the payments for advertising in a convention program and admission to a dinner, hall, or similar affair where any of the proceeds benefit a political party or candidate.[107]

EXPENSES AND INTEREST RELATING TO TAX-EXEMPT INCOME

Section 265 sets forth several rules generally disallowing deductions for expenses relating to tax-exempt income. These provisions prohibit taxpayers from taking advantage of the tax law to secure a double tax benefit: tax-exempt income and deductions for the expenses that help to produce it. The best known rule prohibits the deduction for any *interest* expense or nonbusiness (§ 212) expense related to tax-exempt *interest* income.[108] Without this rule, taxpayers in high tax brackets could borrow at a higher rate of interest than could be earned and still have a profit on the transaction.

Example 46. D, an investor in the 25% tax bracket with substantial investment income, borrows funds at 9% and invests them in tax-exempt bonds yielding 7%. If the interest expense were deductible, the after-tax cost of borrowing would be 6.75% [(100% − 25% = 75%) × 9%]. Since the interest income is nontaxable, the after-tax yield on the bond remains 7%, or .25 percentage points higher than the effective cost of borrowing. Section 265, however, denies the deduction for the interest expense, thus eliminating the feasibility of this arrangement. It should be noted, however, that business (§ 162) expenses (other than interest) related to tax-exempt interest income may be deductible.

If the income that is exempt is not interest, none of the related expenses are deductible.[109]

Example 47. A company operating a baseball team paid premiums on a disability insurance policy providing that the company would receive proceeds under the policy if a player were injured. Because the proceeds would not be taxable, the premiums are not deductible even though the expenditure would apparently qualify as a business

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105 Rev. Rul. 74-407, 1974-2 C.B. 45, as amplified by Rev. Rul. 78-111, 1978-1 C.B. 41.

106 § 162(e).

107 § 276.

108 § 265(2).

109 § 265(1).

expense.[110] Note, however, that such expenses would enter into the calculation of net income for financial accounting purposes.

As a practical matter, it would appear difficult to determine whether borrowed funds (and the interest expense) are related to carrying taxable or tax-exempt securities. For example, an individual holding tax-exempt bonds may take out a mortgage to buy a residence instead of selling the bonds to finance the purchase price. In such case, it could be inferred that the borrowed funds were used to finance the bond purchase. Generally, the IRS will allow the deduction in this and similar cases unless the facts indicate that the primary purpose of the borrowing is to carry the tax-exempt obligations.[111] The facts must establish a *sufficiently direct relationship* between the borrowing and the investment producing tax exempt income before a deduction is denied.

Example 48. K owns common stock with a basis of $70,000 and tax-exempt bonds of $30,000. She borrows $100,000 to finance an investment in an oil and gas limited partnership. The IRS will disallow a deduction for a portion of the interest on the $100,000 debt because it is presumed that the $100,000 is incurred to finance all of K's portfolio including the tax-exempt securities.[112]

Example 49. R has a margin account with her broker. This account is devoted solely to the purchase of taxable investments and tax-exempt bonds. During the year, she buys several taxable and tax-exempt securities on margin. A portion of the interest expense on this margin account is disallowed because the borrowings are considered partially related to financing of the investment in tax-exempt securities.[113]

Business Life Insurance. Absent a special rule, premiums paid on insurance policies covering officers and employees of a business might be deductible as ordinary and necessary business expenses. However, to ensure that the taxpayer is not allowed to deduct expenses related to tax-exempt income (i.e., life insurance proceeds), a special provision exists. Under § 264, the taxpayer is not allowed any deduction for life insurance premiums paid on policies covering the life of any officer, employee, or any other person who may have a financial interest in the taxpayer's trade or business, if the taxpayer is the *beneficiary* of the policy. Thus, premiums paid by a business on a key-person life insurance policy where the company is beneficiary are not deductible. Note that this differs from the financial accounting treatment, where the premiums would be considered routine operating costs that should be expensed in determining net income. In contrast, payments made by a business on group-term life insurance policies where the employees are beneficiaries are deductible.

RELATED TAXPAYER TRANSACTIONS

Without restrictions, related taxpayers (such as husbands and wives, shareholders and their corporations) could enter into arrangements creating deductions for expenses and losses, and not affect their economic position. For example, a husband and wife could create a deduction simply by having one spouse sell property to the other at a loss. In this case, the loss is artificial because the property remains within the family and their financial situation is unaffected. Although the form of ownership has been altered, there is no

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110 Rev. Rul. 66-262, 1966-2 C.B. 105.

111 Rev. Proc. 72-18, 1972-1 C.B. 740, as clarified by Rev. Proc. 74-8, 1974-1 C.B. 419, and amplified by Rev. Rul. 80-55, 1980-2 C.B. 849.

112 *Ibid.*

113 *B.P. McDonough v. Comm.*, 78-2 USTC ¶9490, 42 AFTR2d 78-5172, 577 F.2d 234 (CA-4, 1978).

substance to the transaction. To guard against the potential abuses inherent in transactions between related taxpayers, Congress designed specific safeguards contained in § 267.

Related Taxpayers. The transactions that are subject to restriction are only those between persons who are considered "related" as defined in the Code. Related taxpayers are:[114]

1. Certain family members: brothers and sisters (including half-blood), spouse, ancestors (i.e., parents and grandparents), and lineal descendants (i.e., children and grandchildren)
2. Taxpayer and his or her corporation: an individual and a corporation if the individual owns either directly or *indirectly* more than 50 percent of the corporation's stock[115]
3. Personal service corporation and an employee-owner: a corporation whose principal activity is the performance of personal services that are performed by the employee-owners (i.e., an employee who owns either directly or indirectly *any* stock of the corporation)
4. Certain other relationships involving regular corporations, S corporations, partnerships, estates, trusts, and individuals

In determining whether a taxpayer and a corporation are related, the taxpayer's direct and indirect ownership must be taken into account for the 50 percent test. A taxpayer's indirect stock ownership is any stock that is considered owned or "constructively" owned but not actually owned by the taxpayer. Section 267 provides a set of constructive ownership rules, also referred to as *attribution rules*, indicating the circumstances when the taxpayer is considered as owning the stock of another. Under the constructive ownership rules, a taxpayer is considered owning indirectly[116]

1. Stock owned directly or indirectly by his or her family as defined above
2. His or her proportionate share of any stock owned by a corporation, partnership, estate, or trust in which he or she has ownership (or of which he or she is a beneficiary in the case of an estate or trust)
3. Stock owned indirectly or directly by his or her partner in a partnership

In using these rules, the following limitations apply: (1) stock attributed from one family member to another *cannot* be reattributed to members of his or her family, and (2) stock attributed from a partner to the taxpayer *cannot* be reattributed to a member of his or her family or to another partner.[117]

Example 50. H and W are husband and wife. HB is H's brother. H, W, and HB own 30, 45, and 25% of X Corporation, respectively. H is considered as owning 100% of X Corporation, 30% directly and 70% indirectly (25% through HB and 45% through W, both by application of attribution rule 1 above). W is considered as owning 75% of X Corporation, 45% directly and 30% indirectly through H by application of attribution rule 1 (note that HB's stock cannot be attributed to H and reattributed to W).

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[114] § 267(b).

[115] A partner and a partnership in which the partner owns more than a 50 percent interest are treated in the same manner. See § 707(b).

[116] § 267(c).

[117] § 267(c)(5).

HB is considered as owning 55% of X Corporation, 25% directly and 30% indirectly through H by application of attribution rule 1 and the reattribution limitation.

Losses. The taxpayer is not allowed to deduct the loss from a sale or exchange of property directly or indirectly to a related taxpayer (as defined above).[118] However, any loss disallowed on the sale may be used to offset any gain on a subsequent sale of the property by a related taxpayer to an unrelated third party.[119]

Example 51. A father owns land that he purchased as an investment for $20,000. He sells the land to his daughter for $15,000, producing a $5,000 loss. The $5,000 loss may not be deducted because the transaction is between related taxpayers. If the daughter subsequently sells the property for $22,000, she will then realize a $7,000 gain ($22,000 sales price − $15,000 basis). However, the gain may be reduced by the $5,000 loss previously disallowed, resulting in a recognized gain of $2,000 ($7,000 realized gain − $5,000 previously disallowed loss). If the daughter had sold the property for only $19,000, the realized gain of $4,000 ($19,000 − $15,000) would have been eliminated by the previous loss of $5,000. The $5,000 loss previously disallowed is used only to the extent of the $4,000 gain. The remaining portion of the disallowed loss ($1,000) cannot be used. Had the father originally sold the property for $19,000 to an outsider as his daughter subsequently did, the father would have recognized a $1,000 loss ($19,000 sales price − $20,000 basis). Note that the effect of the disallowance rule does not increase the basis of the property to the related taxpayer by the amount of loss disallowed.

The results of these transactions are summarized below.

Original sale between related parties	
Sales price	$ 15,000
Adjusted basis	(20,000)
Disallowed loss	($ 5,000)

	1	2
Subsequent sale		
Sales price	$ 22,000	$ 19,000
Adjusted basis	(15,000)	(15,000)
Realized gain (loss)	$ 7,000	$ 4,000
Usage of disallowed loss	(5,000)	(4,000)
Recognized gain	$ 2,000	$ 0

Example 52. S owns 100% of V Corporation. She sells stock with a basis of $100 to her good friend T for $75, creating a $25 loss for S. T, in turn, sells the stock to V Corporation for $75, thus recouping the amount he paid S with no gain or loss. The $25 loss suffered by S, however, is not deductible because the sale was made *indirectly* through T to her wholly owned corporation.

Unpaid Expenses and Interest. Prior to enactment of § 267, another tax avoidance device used by related taxpayers involved the use of different accounting methods by each taxpayer. In the typical scheme, a taxpayer's corporation would adopt the accrual basis method of accounting while the taxpayer reported on a cash basis. The taxpayer could lend money, lease property, provide services, etc., to the corporation and charge the

118 § 267(a)(1).

119 § 267(d).

corporation for whatever was provided. As an accrual basis taxpayer, the corporation would accrue the expense and create a deduction. The cash basis individual, however, would report no income until the corporation's payment of the expense was actually received. As a result, the corporation could accrue large deductions without ever having to make a disbursement and, moreover, without the taxpayer recognizing any offsetting income. The Code now prohibits this practice between "related taxpayers" as defined above. Code § 267 provides that an accrual basis taxpayer can deduct an accrued expense payable to a related cash basis taxpayer *only* in the period in which the payment is included in the recipient's income.[120] This rule effectively places all accrual basis taxpayers on the cash method of accounting for purposes of deducting such expenses.

Example 53. B, an individual, owns 100% of X Corporation, which manufactures electric razors. B uses the cash method of accounting while the corporation uses the accrual basis. Both are calendar year taxpayers. On December 27, 2008 the corporation accrues a $10,000 bonus for B. However, due to insufficient cash flow, X Corporation was not able to pay the bonus until January 10, 2009. The corporation may not deduct the accrued bonus in 2008. Rather, it must deduct the bonus in 2009, the year in which B includes the payment in his income.

Example 54. Assume the same facts as above, except that B owns only a 20% interest in X. In addition, X is a large law firm in which B is employed. The results are the same as above because B and X are still related parties: a personal service corporation and an employee-owner.

PAYMENT OF ANOTHER TAXPAYER'S OBLIGATION

As a general rule, a taxpayer is not permitted to deduct the payment of a deductible expense of another taxpayer. A deduction is allowed only for those expenditures satisfying the taxpayer's obligation or arising from such an obligation.

Example 55. As part of Q's rental contract for his personal apartment, he pays 1% of his landlord's property taxes. No deduction is allowed because the property taxes are the obligation of the landlord.

Example 56. P is majority stockholder of R Corporation. During the year, the corporation had financial difficulty and was unable to make an interest payment on an outstanding debt. To protect the goodwill of the corporation, P paid the interest. The payment is not deductible, and P will be treated as having made a contribution to the capital of the corporation for interest paid.

An exception to the general rule is provided with respect to payment of medical expenses of a dependent. To qualify as a dependent for this purpose, the person needs only to meet the relationship, support, and citizen tests.[121] If the taxpayer pays the medical expenses of a person who qualifies as a dependent under the modified tests, the expenses are treated as if they were the taxpayer's expenses and are deductible subject to limitations applicable to the taxpayer.

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[120] § 267(a)(2).

[121] § 213(a)(1).

SUBSTANTIATION

The Code requires that taxpayers maintain records sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown on the tax return.[122] As a practical matter, record keeping requirements depend on the nature of the item. With respect to most deductions, taxpayers may rely on the "*Cohan* rule."[123] In *Cohan*, George M. Cohan, the famous playwright, spent substantial sums for travel and entertainment. The Board of Tax Appeals (predecessor to the Tax Court) denied any deduction for the expenses because the taxpayer had no records supporting the items. On appeal, however, the Second Circuit Court of Appeals reversed this decision, indicating that "absolute certainty in such matters is usually impossible and is not necessary."[124] Thus, the Appeals Court remanded the case to make some allowance for the expenditures. From this decision, the "*Cohan* rule" developed, providing that a reasonable estimation of the deduction is sufficient where the actual amount is not substantiated. In 1962, however, Congress eliminated the use of the *Cohan* rule for travel and entertainment expenses and established rigorous substantiation requirements for these types of deductions. Substantiation for other expenses, however, is still governed by the *Cohan* rule. Despite the existence of the *Cohan* rule, records should be kept documenting deductible expenditures since estimates of the expenditures may be substantially less than actually paid or incurred.

TAX PLANNING CONSIDERATIONS

MAXIMIZING DEDUCTIONS

Perhaps the most important step in minimizing the tax liability is maximizing deductions. Maximizing deductions obviously requires the taxpayer to identify and claim all the deductions to which he or she is entitled. Many taxpayers, however, often overlook deductions that they are allowed because they fail to grasp and apply the fundamental rules discussed in this chapter. To secure a deduction, the taxpayer needs only to show that the expense paid or incurred during the year is ordinary, necessary, and related to a profit-seeking activity. Notwithstanding the special rules of limitation that apply to certain deductions, most deductions are allowed because the *taxpayer* is able to recognize and establish the link between the expenditure and the profit-seeking activity. The taxpayer is in the best position to recognize that an expenditure relates to his or her trade or business, not the tax practitioner. Practitioners typically lack sufficient insight into the taxpayer's activities to identify potential deductions. Thus, it is up to the taxpayer to recognize and establish the relationship between an expenditure and the profit-seeking activity. Failure to do so results in the taxpayer's paying a tax liability higher than what he or she is required to pay.

The taxpayer should maximize not only the absolute dollar amount of deductions, but also the value of the deduction. A deduction's value is equal to the product of the amount of the deduction and the taxpayer's marginal tax rate. Because the taxpayer's marginal rate fluctuates over time, the value of a deduction varies depending on the period in which the deduction is claimed. When feasible, deductions should normally be accelerated or deferred to years when the taxpayer is in a higher tax bracket. In timing deductions, however, the time value of money also must be considered. For example, in periods of

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[122] Reg. § 1.6001-1(a).

[123] *Cohan v. Comm.*, 2 USTC ¶489, 8 AFTR 10552, 39 F.2d 540 (CA-2, 1930).

[124] *Ibid.*

inflation, the deferral of a deduction to a high-bracket year may not always be advantageous, since a deduction in the future is not worth as much as one currently.

An individual taxpayer's timing of itemized deductions is particularly important in light of the standard deduction and the floor on miscellaneous itemized deductions. Many taxpayers lose deductions because their deductions do not exceed the standard deduction in any one year. These deductions need not be lost, however, if the taxpayer alternates the years in which he or she itemizes or uses the standard deduction. For example, in those years where the taxpayer itemizes, all tax deductible expenditures from the prior year should be deferred while expenditures of the following year should be accelerated. By so doing, the taxpayer bunches itemized deductions in the current year to exceed the standard deduction. In the following year, the taxpayer would use the standard deduction. Itemized deductions are considered in detail in Chapter 11.

Maximizing deductions also requires shifting of deductions to the taxpayer who would derive the greatest benefit. For example, if two sisters are co-obligors on a note, good tax planning dictates that the sister in the higher tax bracket pay the deductible interest expense. In this case, either sister may pay and claim a deduction.

TIMING OF DEDUCTIONS

In the previous section, the importance of maximizing the absolute amount of deductions was emphasized. However, because of the time value of money it is equally important to consider the timing of deductions.

> **Example 57.** R, who pays Federal, state, and local taxes equal to 50% of his income, makes a cash expenditure of $10,000. If the $10,000 is deductible immediately, R will realize a tax benefit of $5,000 ($10,000 × 50%). Moreover, because the tax savings were realized immediately, the present value of the benefit is not diminished. On the other hand, if R is not able to deduct the $10,000 for another five years, the benefit of the deduction is substantially reduced. Specifically, assuming the annual interest rate is 10%, the present value of the $5,000 tax savings decreases to $3,105 ($5,000 × [1 ÷ (1 + 0.10)5]), a decrease of almost 38%.

As the above example illustrates, accelerating a deduction from the future to the present can substantially increase its value. Awareness of the provisions permitting acceleration of deductions allows taxpayers to arrange their affairs so as to reap the greatest rewards. For example, a taxpayer may choose an investment that the tax law allows him or her to deduct immediately rather than an investment that must be capitalized and deducted through depreciation over the asset's life.

EXPENSES RELATING TO TAX-EXEMPT INCOME

Although expenses related to tax-exempt income are not deductible, expenses related to tax-deferred income are deductible.[125] For example, income earned on contributions to Individual Retirement Accounts is not taxable until the earnings are distributed (usually at retirement). If the taxpayer borrows amounts to contribute to his or her Individual Retirement Account, interest paid on the borrowed amounts may be deductible (if the general rules for deductibility are met) because the income to which it relates is only tax-deferred, not tax-exempt.

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[125] *Hawaiian Trust Co., Ltd. v. U.S.*, 61-1 USTC ¶9481, 7 AFTR2d 1553, 291 F.2d 761 (CA-9, 1961). See also Letter Rul. 8527082 (April 2, 1985).

"POINTS" ON MORTGAGES

"Points" paid to secure a mortgage to acquire or improve a principal residence normally are deductible in the year paid or incurred. In some cases, however, the points are not paid out of independent funds of the taxpayer but are withheld from the mortgage proceeds. For example, where a lender is charging two points on a $50,000 loan, or $1,000 (2% of $50,000), the $1,000 is withheld by the lender as payment while the remaining $49,000 ($50,000 − $1,000) is advanced to the borrower. The Tax Court has ruled that in these situations, the taxpayer has not prepaid the interest (as represented by the points) and thus must amortize the points over the term of the loan.[126] To avoid this result and obtain a current deduction, the taxpayer should pay the points out of separate funds rather than having them withheld by the lender. This requirement will be met if the cash paid by the borrower up to and at the closing (including down payments, escrow deposits, earnest money, and amounts paid at closing) is at least equal to the amount deducted for points.[127] In this regard, the IRS has ruled that points paid by the seller on behalf of a borrower will be treated as paid directly from the funds deposited by the borrower.[128] Thus, the borrower will be entitled to a deduction. However, in determining the basis of the residence, the borrower must subtract the amount of seller paid points from the purchase price.

HOBBIES

Several studies suggest that the factor on which the hobby/business issue often turns is the manner in which the taxpayer carries on the activity.[129] For business treatment, it is imperative that the taxpayer have complete and detailed financial and nonfinancial records. Moreover, such records should be used in decision making and in constructing a profit plan. The activity should resemble a business in every respect. For example, the taxpayer should maintain a separate checking account for the activity, advertise where appropriate, obtain written advice from experts and follow it, and acquire some expertise about the operation.

Although the taxpayer is not required to actually show profits, profits in *three* of *five* consecutive years create a substantial advantage for the taxpayer. Where the profit requirement is satisfied, it is presumed that the activity is not a hobby and the IRS has the burden of proving otherwise. For this reason, the cash basis taxpayer might take steps that could convert a loss year into a profitable year. For example, in some situations it may be possible to accelerate receipts and defer payment of expenses. However, the taxpayer should be cautioned that arranging transactions so nominal profits occur has been viewed negatively by the courts.

PROBLEM MATERIALS

DISCUSSION QUESTIONS

7-1 *General Requirements for Deductions*. Explain the general requirements that must be satisfied before a taxpayer may claim a deduction for an expense or a loss.

[126] *Roger A. Schubel*, 77 T.C. 701 (1982).

[127] Rev. Proc. 92-12, 1992-3, I.R.B. 27.

[128] Rev. Proc. 94-27, 1994 I.R.B. 15, 6.

[129] See, for example, Burns and Groomer, "Effects of Section 183 on the Business Hobby Controversy, " *Taxes* (March 1980) pp. 195–206.

7-2 *Deduction Defined.* Consider the following:

a. It is often said that income can be meaningfully defined while deductions can be defined only procedurally. Explain.

b. The courts are fond of referring to deductions as matters of "legislative grace." Explain.

c. Although deductions may only be defined procedurally, construct a definition for a deduction similar to the "all inclusive" definition for income.

d. Will satisfaction of the requirements of your definition ensure deductibility? Explain.

7-3 *Business versus Personal Expenditures.* Consider the following:

a. If the taxpayer derives personal pleasure from an otherwise deductible expense, will the expense be denied? Explain.

b. Name some of the purely personal expenses that are deductible, and indicate whether they are deductions for or from A.G.I.

7-4 *Business versus Investment Expenses.* Two Code sections govern the deductibility of ordinary and necessary expenses related to profit-motivated activities. Explain why two provisions exist and the distinction between them.

7-5 *An Employee's Business.* Is an employee considered as being in trade or business? Explain the significance of your answer.

7-6 *Year Allowable.* The year in which a deduction is allowed depends on whether the taxpayer is a cash basis or accrual basis taxpayer. Discuss.

7-7 *Classification of Expenses.* F is a self-employed registered nurse and works occasionally for a nursing home. G is a registered nurse employed by a nursing home. Their income, exemptions, credits, etc. are identical. Explain why a deductible expense, although paid in the same amount by both, may cause F and G to have differing tax liabilities.

7-8 *Above- and Below-the-Line Deductions.* At a tax seminar, F was reminded to ensure that he properly classified his deductions as either above- or below-the-line. After the seminar, F came home and scrutinized his Form 1040 to determine what the instructor meant and why it was important. Despite his careful examination of the form, F could not figure out what the instructor was talking about or why it was important. Help F out by explaining the meaning of this classification scheme.

7-9 *Performing Artists.* V hopes to become a movie star someday. Currently, she accepts bit parts in various movies, waiting for her break. What special tax treatment may be available for V?

7-10 *Classification of Deductions.* J and K are both single, and each earns $30,000 of income and has $2,000 of deductible expenses for the current year. J's deductions are for A.G.I. while K's deductions are itemized deductions.

a. Given these facts, and assuming that the situation of J and K is identical in every other respect, will their tax liabilities differ? Explain.

b. Same as (a) except their deductions are $5,000.

7-11 *Constructive Distributions.* D owns all of the stock of DX Inc., which manufactures record jackets. Over the years, the corporation has been very successful. This year, D placed his 16- and 14-year-old sons on the payroll, paying them each $10,000 annually. The boys worked on the assembly line a couple of hours each week. Explain D's strategy and the risks it involves.

7-12 *Disguised Distributions.* E owns all of the stock of EZ Inc., which operates a nursery. During the past several years, the company has operated at a deficit and E finally sold all of his stock to C. C drew a very low salary before he could turn things around. Now the business is highly profitable, and C is paying himself handsomely. As C's tax adviser, what counsel if any should be given to C?

7-13 *Income and Expenses of Illegal Business.* B is a bookie in a state where gambling is illegal. During the year, he earned $70,000 accepting bets. His expenses included those for rent, phone, and utilities. In addition, he paid off a state legislator who was a customer and who obviously knew of his activity.

- **a.** Discuss the tax treatment of B's income and expenses.
- **b.** Same as (a) except B was a drug dealer.

7-14 *Permanent and Timing Differences.* Financial accounting and tax accounting often differ in the manner in that certain expenses are treated. Identify several expenditures that, because of their treatment, produce permanent or timing differences.

7-15 *Capital Expenditures.* Can a cash basis taxpayer successfully reduce taxable income by purchasing supplies near year-end and deducting their cost?

7-16 *Independent Contractor versus Employee.* Briefly discuss the difference between an independent contractor (self-employed person) and an employee and why the distinction is important.

7-17 *Hobby Expenses.* Discuss the factors used in determining whether an activity is a hobby and the tax consequences resulting from its being deemed a hobby.

7-18 *Public Policy Doctrine.* A taxpayer operates a restaurant and failed to remit the sales tax for August to the city as of the required date. As a result, he must pay an additional assessment of 0.25 percent of the amount due. Comment on the deductibility of this payment.

7-19 *Constructive Ownership Rules.* Explain the concept of constructive ownership and the reason for its existence.

7-20 *Expenses Relating to Tax-Exempt Income.* Discuss what types of expenses relating to tax exempt income may be deductible.

7-21 *Substantiation.* Explain the Cohan rule.

PROBLEMS

7-22 *General Requirements for Deduction.* For each of the following expenses identify and discuss the general requirement(s) (ordinary, necessary, related to business, etc.) upon which deductibility depends.

- **a.** A police officer who is required to carry a gun at all times lives in New York. The most convenient and direct route to work is through New Jersey. The laws of New Jersey, however, prohibit the carrying of a gun in the car. As a result, he must take an indirect route to the police station to avoid New Jersey. The indirect route causes him to drive ten miles more than he would otherwise. The cost of the additional mileage is $500. (**Note:** commuting expense from one's home to the first job site generally is a nondeductible personal expense.)
- **b.** The current president of a nationwide union spends $10,000 for costs related to reelection.
- **c.** The taxpayer operates a lumber business. He is extremely religious and consequently is deeply concerned over the business community's social and moral responsibility to society. For this reason, he hires a minister to give him and his employees moral and spiritual advice. The minister has no business background although he does offer solutions to business problems.

d. The taxpayer operates a laundry in New York City. He was recently visited by two "insurance agents" who wished to sell him a special bomb policy (i.e., if the taxpayer paid the insurance "premiums," his business would not be bombed). The taxpayer paid the premiums of $500 each month.

7-23 *Accrual Basis Deductions.* In each of the following situations assume the taxpayer uses the accrual method of accounting and indicate the amount of the deduction allowed.

a. R sells and services gas furnaces. As part of his sales package, he agrees to turn on and cut off the buyer's furnace for five years. He normally charges $80 for such service, which costs him about $50 in labor and materials. Based on 2008 sales, R sets up a reserve for the costs of the services to be performed, which he estimates will be $9,000 over the next five years.

b. At the end of 2008, XYZ, a regular corporation, agreed to rent office space from ABC Leasing Corp. Pursuant to the contract, XYZ paid $10,000 on December 1, 2008 for rent for all of 2009.

c. RST Villas, a condominium project in a Vermont ski resort, reached an agreement with MPP Pop-Ins providing that MPP would provide maid services in 2009 for $20,000. RST transferred its note payable for $20,000 at the end of 2009 to MPP on December 1, 2008.

7-24 *Economic Performance.* KKO Printing, a calendar year, accrual method taxpayer, leases a number of copying machines. In conjunction with the lease, it typically purchases a one-year maintenance contract covering service on the machines. On July 20, 2008, KKO paid $6,000 for a one-year service contract that runs from July 1, 2008 through June 30, 2009. Ignoring the recurring item exception, when may KKO deduct the expense?

7-25 *Recurring Items.* M Corporation is an accrual basis taxpayer and uses the calendar year for both financial accounting and tax purposes. The corporation manufactures car stereo equipment and provides a one-year warranty. Based on an analysis of its sales for 2008, it estimates that its warranty expense for equipment sold in 2008 will be $500,000. For financial accounting purposes, M plans to accrue the expense in 2008. The corporation is in the process of finishing its 2008 tax return, which it plans on filing by the extended due date, September 15, 2009. According to the company's latest figures, as of August 31, it had incurred $200,000 in parts and labor costs in honoring warranties on 2008 sales. How should the corporation treat the $500,000 estimated warranty cost on its 2008 tax return?

7-26 *Accrual of Real Property Taxes.* M Corporation owns a chain of hamburger restaurants located all across the country. In one state where the company has several outlets, it paid real property taxes of $12,000 for the period October 1, 2007 through September 30, 2008 on January 10, 2009. M is an accrual basis taxpayer and uses a calendar year-end for reporting.

a. When is the corporation entitled to a deduction for the real estate taxes assuming it has not made an election under § 461(c) and the recurring item exception does not apply?

b. Same as (a) except the corporation makes an election under § 461(c).

7-27 *Accrual versus Cash Method of Accounting.* D operates a hardware store. For 2008, D's first year of operation, D reported the following items of revenue and expense:

Cash receipts	$140,000
Purchase of goods on credit	90,000
Payments on payables	82,000

By year-end, D had unsold goods on hand with a value of $25,000.

a. Using the cash method of accounting, compute D's taxable income for the year.
b. Using the accrual method of accounting, compute D's taxable income for the year.
c. Which method of accounting is required for tax purposes? Why?

7-28 *Prepaid Interest.* In each of the following cases, indicate the amount of the deduction for the current year. In each case, assume the taxpayer is a calendar year, cash basis taxpayer.

a. On December 31, P, wishing to reduce his current year's tax liability, prepaid $3,000 of interest on his home mortgage for the first three months of the following taxable year.
b. On December 1 of this year, T obtained a $100,000 loan to purchase her residence. The loan was secured by the residence. She paid two points to obtain the loan bearing a 6 percent interest rate.
c. Same as (b) except the loan was used to purchase a duplex, which she will rent to others. The loan was secured by the duplex.

7-29 *Prepaid Rent.* This year F, a cash basis taxpayer, secured a ten-year lease on a warehouse to be used in his business. Under the lease agreement he pays $12,000 on September 1 of each year for the following twelve months' rental.

a. Assuming F pays $12,000 on September 1 for the next 12 months' rental, how much, if any, may he deduct? How would your answer change if F were an accrual basis taxpayer?
b. In order to secure the lease, F also was required to pay an additional $12,000 as a security deposit. How much, if any, may he deduct?

7-30 *Prepaid Expenses.* D, a cash basis taxpayer, operates a successful travel agency. One of her more significant costs is a special computer form on which airline tickets are printed as well as stationery on which itineraries are printed. Typically, D buys about a three-month supply of these forms for $2,000. Knowing that she will be in a lower tax bracket next year. D would like to accelerate her deductions to the current year.

a. Assuming that D pays $12,000 on December 15 for forms that she expects to exhaust before the close of next year, how much can she deduct?
b. Same as above except D purchases the larger volume of forms because D's supplier began offering special discounts for purchases in excess of $3,000.

7-31 *Expenses Producing Future Benefits.* B took over as chief executive officer of Pentar Inc., which specializes in the manufacture of cameras. As part of his strategy to increase the corporation's share of the market, he ran a special advertising blitz just prior to Christmas that cost more than $1,000,000. The marketing staff estimates that these expenditures could very well increase the company's share of the market by 10 percent over the next three years. Speculate on the treatment of the promotion expenses.

7-32 *Capital Expenditure or Repair.* This year, Dandy Development Corporation purchased an apartment complex with 100 units. At the time of purchase, it had a 40 percent vacancy rate. As part of a major renovation, Dandy replaced all of the carpeting and painted all of the vacant units. Discuss the treatment of the expenditures.

7-33 *Identifying Capital Expenditures.* K, a sole proprietor, made the following payments during the year. Indicate whether each is a capital expenditure.

a. Sales tax on the purchase of a new automobile
b. Mechanical pencil for K
c. Mops and buckets for maintenance of building
d. Freight paid on delivery of new machinery
e. Painting of K's office

f. Paving of dirt parking lot with concrete
g. Commissions to leasing agent to find new office space
h. Rewiring of building to accommodate new equipment

7-34 *Hobby Expenses—Effect on A.G.I.* C is a successful attorney and stock car racing enthusiast. This year she decided to quit watching the races and start participating. She purchased a car and entered several local races. During the year, she had the following receipts and disbursements related to the racing activities:

Race winnings	$3,000
Property taxes	2,800
Fuel, supplies, maintenance	1,000

Her A.G.I. exclusive of any items related to the racing activities is $100,000.

a. Indicate the tax consequences assuming the activity is not considered to be a hobby.
b. Assuming the activity is treated as a hobby, what are the tax consequences?
c. Assuming the activity is deemed a hobby and property taxes are $4,000, what are the tax consequences?
d. What is the critical factor in determining whether an activity is a hobby or a business?
e. What circumstances suggest the activity is a business rather than a hobby?

7-35 *Hobby-Presumptive Rule.* In 2006 R, a major league baseball player, purchased a small farm in North Carolina. He grows several crops and maintains a small herd of cattle on the farm. During 2006 his farming activities resulted in a $2,000 loss, which he claimed on his 2006 tax return, filed April 15, 2007. In 2007 his 2006 return was audited, and the IRS pro posed an adjustment disallowing the loss from the farming activity, asserting that the activity was merely a hobby.

a. Assuming R litigates, who has the burden of proof as to the character of the activity?
b. Can R shift the burden of proof at this point in time?
c. Assume R filed the appropriate election for 2006 and reported losses of $3,000 in 2007 and profits of $14,000 in 2008, $5,000 in 2009, and $6,000 in 2010. What effect do the reported profits have?

7-36 *Hobby Losses and Statute of Limitations.* Assume the same facts as in *Problem 7-35*. When does the statute of limitations bar assessment of deficiencies with respect to the 2006 tax return?

7-37 *Investigation Expenses.* H currently operates several optical shops in Portland. During the year he traveled to Seattle and San Francisco to discuss with several doctors the possibility of locating optical shops adjacent to their practices. He incurred travel costs to Seattle of $175 and to San Francisco of $200. The physicians in Seattle agreed to an arrangement and H incurred $500 in legal fees drawing up the agreement. The physicians in San Francisco, however, would not agree, and H did not pursue the matter further.

In the following year, H decided to enter the ice cream business. He sent letters of inquiry to two major franchisers of ice cream stores and subsequently traveled to the headquarters of each. He paid $400 for travel to Phoenix for discussions with X Corporation and $500 for travel to Los Angeles for discussions with Y Corporation. He also paid an accountant $1,200 to evaluate the financial aspects of each franchise ($600 for each evaluation). H decided to acquire a franchise from Y Corporation. He paid an attorney $800 to review the franchising agreement.

a. Discuss the tax treatment of H's expenses associated with the attempt to expand his optical shop business.

b. Discuss the tax treatment of the expenses incurred in connection with the ice cream business, assuming H acquires the Y franchise and begins business.

c. Same as (b). Discuss the treatment of these costs if H abandons the transaction after being informed that there is no franchise available in his city.

7-38 *Investigation Expenses.* P incurred significant expenses to investigate the possibility of opening a Dowell's Hamburgers franchise in Tokyo, Japan. Her expenditures included hiring a local firm to perform a feasibility study, travel, and accounting and legal expenses. Her 2008 expenditures total $25,000. With respect to this amount:

a. Assuming this was P's first attempt at opening a business of her own, how much may she deduct in 2008 if she decides not to acquire the franchise?

b. Assuming this was P's first attempt at opening a business of her own, how much may she deduct in 2008 if she decides to acquire the franchise?

c. Assuming P was already in the fast-food business (she owns a Dowell's franchise in Toledo, Ohio), how much may she deduct in 2008 to acquire the franchise?

7-39 *Capital Expenditures.* Consider the following:

a. A corporate taxpayer reimbursed employees for amounts they had loaned to the corporation's former president, who was losing money at the racetrack. Comment on the deductibility of these payments as well as those expenditures discussed in *Example 7* of this chapter (relating to payments of debts previously discharged by bankruptcy) in light of the rules concerning capital expenditures.

b. How are expenditures such as land and investment securities recovered?

c. How are the costs of expenditures for goodwill recovered?

d. Distinguish between a capital expenditure and a repair.

7-40 *Classification of Deductions.* M works as the captain of a boat. His income for the year is $20,000. During the year, he purchased a special uniform for $100. Indicate the amount of the deduction and whether it is for or from A.G.I. for the following situations:

a. M's boat is a 50-foot yacht, and he operates his business as a sole proprietorship (i.e., he is self-employed).

b. M is an employee for Yachts of Fun Inc.

c. M is an employee for Yachts, which reimbursed him $70 of the cost (included in his income on Form W-2).

7-41 *Computing Employee's Deductions.* T is employed as a supervisor in the tax department of a public accounting firm in Manhattan. She recently took the job after working on the tax staff at a commercial tax preparation firm. She lives in a condominium on the upper east side. Every day she takes the subway to and from work. She loves living in New York. T's total income for the year consisted of compensation of $80,000 and alimony of $2,100. During the year, she incurred the following expenses:

AICPA dues	$ 400
New York State Society of CPAs dues	315
State of New York CPA license	345
Subscriptions to tax journals	225
Continuing education course on new tax law	600
New business suits	700
Cleaning of suits	389
Legal fee for preparation of will ($230 related to tax planning)	1,500
Legal fee to collect alimony	250
Job hunting expenses (resumes and employment agency fee)	150
Subway expenses	456
Safe deposit box (holds investment documents)	90
Annual fee on brokerage account	130
Qualified residence interest	6,000

T's employer reimbursed her $100 for the AICPA dues (included in her income).

a. Compute T's taxable income.

b. Assuming T expects her expenses to be about the same for the next several years, what advice can you offer?

7-42 *Computing Employee's Deductions.* Z, a single taxpayer, is employed as a nurse at a local hospital. Z's records reflect the following items of revenue and expense for 2008:

Gross wages	$20,000
Expenses:	
Employee travel expenses, not reimbursed	1,100
Cost of commuting to and from work, reimbursed (included in gross wages)	520
Charitable contributions	700
Interest and taxes on personal residence	3,900
Nurse's uniform, reimbursed (included in gross wages)	250

a. What is Z's A.G.I.?

b. What is Z's total of itemized deductions?

7-43 *Interest.* Mr. E operates a replacement window business as a sole proprietorship. He uses the cash method of accounting. On November 1, 2008 he secured a loan in order to purchase a new warehouse to be used in his business. Information regarding the loan and purchase of the warehouse is shown below. All of the costs indicated were paid during the year.

Term	20 years
Loan origination fee	$ 2,000
Points	6,000
One year's interest paid in advance	20,000
Legal fees for recording mortgage lien	500

What amount may E deduct in 2008?

7-44 *Insurance*. Hawk Harris owns and operates the Waterfield Mudhens, a franchise in an indoor soccer league. Both Hawk and the corporation are cash basis, calendar year taxpayers. During 2008 the corporation purchased the following policies:

Policy Description	*Cost*	*Date Paid*
Two-year fire and theft effective 12/1/08	$2,400	12/15/05
One-year life insurance policy on Jose Greatfoot, star forward; the corporation is beneficiary; effective 11/1/08	1,000	11/1/05
One-year group-term life insurance policy covering entire team and staff; effective 1/1/08	9,000	1/15/05

One-year policy for payments of overhead costs should the team strike and attendance fall; effective 11/1/08	3,600	9/1/05

In addition to the policies purchased above, the corporation is unable to get insurance on certain business risks. Therefore, the corporation has set up a reserve—a separate account—to which it contributes $5,000 on February 1 of each year.

How much may the corporation deduct for 2008?

7-45 *Life Insurance.* The Great Cookie Corporation is owned equally by F and G. Under the articles of incorporation, the corporation is required to purchase the stock of each shareholder upon his or her death to ensure that it does not pass to some undesirable third party. To finance the purchase, the corporation purchased a life insurance policy on both F and G, naming the corporation as beneficiary. The annual premium is $5,000. Can the corporation deduct the premiums?

7-46 *Business Life Insurance.* L, 56, has operated her sole proprietorship successfully since its inception three years ago. This year she has decided to expand. To this end, she borrowed $100,000 from the bank, which would be used for financing expansion of the business. The bank required L to take out a life insurance policy on her own life that would serve as security for the business loan. Are the premiums deductible?

7-47 *Public Policy-Fines, Lobbying, etc.* M is engaged in the construction business in Tucson. Indicate whether the following expenses are deductible.

- **a.** The Occupational Safety and Health Act (OSHA) requires contractors to fence around certain construction sites. M determined that the fences would cost $1,000 and the fine for not fencing would be only $650. As a result, he did not construct the fences and paid a fine of $650.
- **b.** M often uses Mexican quarry tile on the floors of homes that he builds. To obtain the tiles, he drives his truck across the border to a small entrepreneur's house and purchases the materials. On the return trip he often pays a Mexican customs official to "expedite" his going through customs. Without the payment, the inspection process would often be tedious and consume several hours. This year he paid the customs officials $200.
- **c.** M paid $100 for an advertisement supporting the administration's economic policies, which he felt would reduce interest rates and thus make homes more affordable. In addition, he paid $700 for travel to Washington, D.C. to testify before a Congressional Committee on the effects of high interest rates on the housing industry. While there, he paid $100 to a political action committee to attend a dinner, the proceeds from which went to Senator Q.

7-48 *Limitations on Business Deductions.* This is an extension of *Problem 7-22(d).* In that problem, you are asked to determine if the case contains expenditures that are ordinary, necessary, and reasonable under the provisions of Code § 162. Assume the positive criteria of § 162 are met (i.e., the expenditures are ordinary, necessary, and reasonable). Are there any additional provisions in § 162 that will cause the expenditures to be disallowed?

7-49 *Related Taxpayers—Sale.* E sold stock to her son for $8,000. She purchased the stock several years ago for $11,000.

- **a.** What amount of loss will E report on the sale?
- **b.** What amount of gain or loss will the son report if he sells the stock for $12,000 to an unrelated party?
- **c.** If the son sells for $10,000?
- **d.** If the son sells for $4,000?

7-50 *Related Taxpayers—Different Accounting Methods.* G, a cash basis, calendar year taxpayer,—owns 100 percent of XYZ Corporation. XYZ is a calendar year, accrual basis taxpayer engaged in the advertising business. G leases a building to the Corporation for $1,000 per month. In December, XYZ accrues the $1,000 rental due. Indicate the tax treatment to XYZ and G assuming the payment is

a. Made on December 30 of the current year; or

b. Made on April 1 of the following year.

c. Would your answers above change if G owned 30 percent of XYZ?

7-51 *Constructive Ownership Rules.* How much of RST Corporation's stock is B considered as owning?

Owner	*Shares Directly Owned*
B	20
C, B's brother	30
D, B's partner	40
E, B's 60-percent-owned corporation	100
Other unrelated parties	10

7-52 *Expenses of Another Taxpayer.* B is the only child of P and will inherit the family fortune. P, who is in the 28 percent tax bracket, is willing to give B and his wife $500 a month. Comment on the advisability of P paying the following directly in lieu of making a gift.

a. Medical expenses of B, who makes $20,000 during the year; P (the father) provides 55 percent of B's support.

b. Interest and principal payments on B's home mortgage, on which B and his wife are the sole obliges.

c. Same as (b) except that P is also an obligee on the note.

7-53 *Losses.* This year was simply a financial disaster for Z. Indicate the effects of the following transactions on Z's taxable income. Ignore any limitations that may exist.

a. After the stock market crash, Z sold her stock and realized a loss of $1,000.

b. Z sold her husband's truck for $3,000 (basis $2,000) and her own car for $5,000 (basis $9,000). Both vehicles were used for personal purposes.

c. Z's $500 camera was stolen.

d. The land next to Z's house was rezoned to light industrial, driving down the value of her home by $10,000.

7-54 *Planning Deductions.* X, 67, is a widow, her husband having died several years ago. Each year, X receives about $30,000 of interest and dividends. Because the mortgage on her home is virtually paid off, her only potential itemized deductions are her contributions to her church and real estate taxes. Her anticipated deductions are:

Year	*Contribution*
2008	$2,000
2009	3,000
2010	1,000

What tax advice can you offer X?

7-55 *Timing Deductions.* T currently figures that Federal, state, and local taxes consume about 30 percent of his income at the margin. Next year, however, due to a tax law change his taxes should increase to about 40 percent and remain at that level for at least five or six years. Assuming T buys a computer for $4,000 and he has the option of deducting all of the cost this year or deducting it ratably through depreciation over the next five years, what advice can you offer?

7-56 *Classification and Deductibility.* In each of the following independent situations, indicate for the current taxable year the amounts deductible *for* A.G.I., *from* A.G.I., or *not deductible* at all. Unless otherwise stated, assume all taxpayers use the cash basis method of accounting and report using the calendar year.

a. M spent $1,000 on a life insurance policy covering her own life.

b. G is an author of novels. His wife attempted to have him declared insane and have him committed. Fearing the effect that his wife's charges might have on him and his book sales, G paid $11,000 in legal fees, resulting in a successful defense.

c. Taxpayer, a plumber employed by XYZ Corporation, paid union dues of $100.

d. Q Corporation paid T, its president and majority shareholder, a salary of $100,000. Employees in comparable positions earn salaries of $70,000.

e. L operates a furniture business as a sole proprietorship. She rents a warehouse (on a month-to-month basis) used for storing items sold in her store. In late December, L paid $2,000 for rental of the warehouse for the month of January.

f. M is a self-employed security officer. He paid $100 for uniforms and $25 for having them cleaned.

g. N is a security officer employed by the owner of a large apartment complex. He pays $150 for uniforms. In addition, he paid $15 for having them cleaned. His employer reimbursed him $60 of the cost of the uniforms (included in his income on Form W-2).

h. K owns a duplex as an investment. During the year, she paid $75 for advertisements seeking tenants. She was unable to rent the duplex, and thus no income was earned this year.

i. P paid $200 for subscriptions to technical journals to be used in his employment activities. Although P was fully reimbursed by his employer, his employer did not report the reimbursement in P's income.

7-57 *Classification and Deductibility.* In each of the following independent situations, indicate for the current taxable year the amounts deductible *for* A.G.I., *from* A.G.I., or *not deductible* at all. Unless otherwise stated, assume all taxpayers use the cash basis method of accounting and report using the calendar year.

a. O paid the interest and taxes of $1,000 on his ex-wife's home mortgage. The divorce agreement provided that he could claim deductions for the payments.

b. P paid an attorney $1,500 in legal fees related to her divorce. Of these fees, $600 is for advice concerning the tax consequences of transferring some of P's stock to her husband as part of the property settlement.

c. R paid $10,000 for a small warehouse on an acre of land. He used the building for several months before tearing it down and erecting a hamburger stand.

d. H and his wife moved into the city and no longer needed their personal automobiles. They sold their Chevrolet for a $1,000 loss and their Buick for a $400 gain.

e. C is employed as a legal secretary. This year he paid an employment agency $300 for finding him a new, higher-paying job as a legal secretary.

f. X operates his own truck service. He paid $80 in fines for driving trucks that were overweight according to state law.

g. T, an employee, paid $175 to an accountant for preparing her personal income tax returns.

7-58 *Classification and Deductibility.* In each of the following independent situations, indicate for the current taxable year the amounts deductible for A.G.I., from A.G.I., or not deductible at all. Unless otherwise stated, assume all taxpayers use the cash basis method of accounting and report using the calendar year.

a. B sold stock to his mother for a $700 loss. B's mother subsequently sold the stock for $400 less than she had paid to B.

b. Same as (a) but assume the mother sold the stock for $500 more than she had paid to B.

c. D operates three pizza restaurants as a sole proprietorship in Indianapolis. In July he paid $1,000 in air fares to travel to Chicago and Detroit to determine the feasibility of opening additional restaurants. Because of economic conditions, D decided not to open any additional restaurants.

d. T owns and operates several gun stores as a sole proprietorship. In light of gun control legislation, he traveled to the state capital at a cost of $80 to testify before a committee. In addition, he traveled around the state speaking at various Rotary and Kiwanis Club functions on the pending legislation at a cost of $475. T also placed an advertisement in the local newspaper concerning the merit of the legislation at a cost of $50. He pays dues to the National Rifle Association of $100.

e. D is employed as a ship captain for a leisure cruise company. He paid $1,000 for rent on a warehouse where he stores smuggled narcotics, which he sells illegally.

f. M, a plumber and an accrual basis taxpayer, warrants his work. This year he estimates that expenses attributable to the warranty work are about 3 percent of sales, or $3,000.

g. G, a computer operator, pays $75 for a subscription to an investment newsletter devoted to investment opportunities in state and municipal bonds.

7-59 *Employee Business Expenses:* Planning. J is employed as a salesman by Bigtime Business Forms Inc. He is considering the purchase of a new automobile that he would use primarily for business. Are there any tax factors that J might consider before purchasing the new car?

TAX RETURN PROBLEMS

CONTINUOUS TAX RETURN PROBLEMS See Appendix I, Part 1

CUMULATIVE PROBLEMS

H&R BLOCK TaxCut. **7-60** Tony Johnson (I.D. No. 456-23-7657), age 45, is single. He lives at 5220 Grand Avenue, Brooklyn, NY 10016. Tony is employed by RTI Corporation, which operates a chain of restaurants in and around New York City. He has supervisory responsibilities over the managers of four restaurants. An examination of his records for 2008 revealed the following information.

1. During the year, Tony earned $33,000. His employer withheld $2,200 in Federal income taxes and the proper amount of FICA taxes. Tony obtained his current job through an employment agency to which he paid a $150 fee. He previously was employed as a manager of another restaurant. Due to the new job, it was necessary to improve his wardrobe. Accordingly, Tony purchased several new suits at a cost of $600.
2. On the days that Tony works, he normally eats his meals at the restaurants for purposes of quality control. There is no charge for the meals, which are worth $2,000.
3. He provides 60 percent of the support for his father, age 70, who lived with Tony all year and who has no income other than social security benefits of $7,000 during the year. Tony provided more than one-half of the cost of maintaining the home.
4. Dividend income from General Motors Corporation stock that he owned was $350. Interest income on savings was $200.
5. Tony and other employees of the corporation park in a nearby parking garage. The parking garage bills RTI Corporation for the parking. Tony figures that his free parking is worth $1,000 annually.
6. Tony subscribes to several trade publications for restaurants at a cost of $70.

7. During the year, he paid $200 to a bank for a personal financial plan. Based on this plan, Tony made several investments, including a $2,000 contribution to an individual retirement account, and also rented for $30 a safety deposit box in which he stores certain investment related documents.
8. Tony purchased a new home, paying three points on a loan of $70,000. He also paid $6,000 of interest on his home mortgage during the year. In addition, he paid $650 of real property taxes on the home. He has receipts for sales taxes of $534.
9. While hurrying to deliver an important package for his employer, Tony received a $78 ticket for violating the speed limit. Because his employer had asked that he deliver the package as quickly as possible, Tony was reimbursed $78 for the ticket, which he paid.

Compute Tony's taxable income for the year. If forms are used for the computations, complete Form 1040 and Schedule A. (Use 2007 tax forms if the 2008 forms are not available.)

TaxCut **7-61** Wendy White (I.D. No. 526-30-9001), age 29, is single. She lives at 1402 Pacific Beach Ave., San Diego, CA 92230. Wendy is employed by KXXR television station as the evening news anchor. An examination of her records for 2006 revealed the following information.

1. Wendy earned $150,000 in salary. Her employer withheld $22,000 in Federal income taxes and the proper amount of FICA taxes.
2. Wendy also received $10,000 in self-employment income from personal appearances during the year. Her unreimbursed expenses related to this income were: transportation and lodging, $523; meals, $120; and office supplies, $58.
3. Wendy reports the following additional deductions: home mortgage interest, $6,250; charitable contributions, $1,300; state and local income taxes, $3,100; and employment-related expenses, $920.

Compute Wendy's taxable income for 2008 and her tax due (including any self-employment tax). If forms are used for the computations, complete Form 1040, Schedule A, Schedule C, and Schedule SE.

Reminder: FICA and self-employment taxes are composed of two elements: social security (old age, survivor, and disability insurance) and Medicare health insurance (MHI). In 2008, social security is paid at a rate of 6.2 percent (12.4 percent for self-employed individuals) on the first $102,000 of earned income; MHI is paid at a rate of 1.45 percent (2.9 percent for self-employed individuals) on all earned income.

RESEARCH PROBLEMS

7-62 T and two associates are equal owners in LST Corporation. The three formed the corporation several years ago with the idea of capitalizing on the fitness movement. After a modest beginning and meager returns, the corporation did extremely well this year. As a result, the corporation plans on paying the three individuals salaries that T believes the IRS may deem unreasonable. T wonders whether he can avoid the tax consequences associated with an unreasonable compensation determination by paying back whatever amount is ultimately deemed a dividend.

a. What would be the effect on T's taxable income should he repay the portion of a salary deemed a dividend?

b. Would there be any adverse effects of adopting a payback arrangement?

Partial list of research aids:

Vincent E. Oswald, 49 T.C. 645.
Rev. Rul. 69-115,1969-1 C.B. 50.

7-63 C, a professor of film studies at State University, often meets with her doctoral students at her home. In her home, C has a room that she uses solely to conduct business related to the classes she teaches at the university. In the room she and her students often review the movies the students have made to satisfy requirements in their doctoral program. Can C deduct expenses related to her home office?

7-64 R moved to St. Louis in 2007 and purchased a home. After living there for a year, his family had grown and required a much larger home. On August 1, 2008 they purchased their dream house, which cost far more than their first home. Shortly before he closed on the new residence, he put his first house on the market to sell. After two months had passed, however, he had received no offers. Fearing that he would be unable to pay the debt on both homes, R decided to rent his old home while trying to sell it. Surprisingly, he was able to rent the house immediately. However, in order to secure the party's agreement to rent monthly, he was required to perform a few repairs costing $500. Seven months after he had rented the home, R sold it. During the rental period, R paid the utilities and various other expenses. R has come to you for your advice on how these events in 2008 would affect his tax return.

7-65 In November 2008 B, employed as a life insurance salesperson for PQR Insurance Company in Newark, New Jersey, purchased a personal computer for use in his work. B has come to you for help in deciding how to handle this purchase on his 2008 tax return. He, of course, wants to expense the full price of the computer under Code § 179.
B relates the following salient information to you with respect to this purchase:

1. B files a joint return with his wife, L. They have a combined A.G.I. of $65,000 before considering this item. They have sufficient qualified expenditures to itemize deductions on Schedule A, but they have no miscellaneous itemized deductions.
2. B paid $3,000 for the laptop computer, which will be used 100 percent for business use.
3. B bought the computer to analyze client data. He figures this will help him increase his sales because he can analyze the results of various insurance options at the client's home or office (all personalized, of course).
4. PQR does not provide B with company-owned computing equipment. In fact, they refused to pay for B's computer because the expense of providing computers for all of PQR's agents would be too great.

How should B treat this purchase on his 2008 tax return?

7-66 On January 28, 2008 S comes to you for tax preparation advice. She has always prepared her own return, but it has become somewhat complicated and she needs professional advice.

During your initial interview, you discover that S is a teacher at a high school in Chicago, Illinois. She is also the coach of the golf team. In 2005 S decided she wanted to be a professional golfer. So, when she was 32 years old, she began a part-time apprenticeship program with the Professional Golfers' Association of America (PGA), where she was an unpaid assistant to the pro at a local country club. Then, in 2005 she became a member of the PGA and began her professional career.

S has not made much money as a professional golfer. In fact, her expenses exceeded her income in both 2006 and 2007 ($4,000 loss in 2006; $3,500 loss in 2007). Believing she was actively engaged in a trade or business (she kept separate records for her golf activities, practiced about 10 hours each week, and worked with a pro whenever she could), S deducted her golf-related expenses on Schedule C and reported her losses from this activity on her prior returns.

The IRS has challenged S's 2006 and 2007 loss deductions, calling them nondeductible "hobby" losses. Is the IRS correct in this matter? Would she win if the matter is taken to court? What planning steps can S take to ensure that any future losses are deductible trade or business losses?