

# CHAPTER 6

## BUSINESS EXPENSES

2017 Edition	Topic	Status
<b>Questions</b>		
1	Deductibility of expenses - general rules	Unchanged
2	Meal and entertainment expenses - general rules	Unchanged
3	Directly related test versus associated with test	Unchanged
4	Deductibility of automobile expenses	Unchanged
5	Substantiation requirements for gifts, meals, travel and entertainment	Unchanged
6	Deductibility of business gifts	Unchanged
7	Requirements to deduct education expenses	Unchanged
8	Can two taxpayers incur the same education expense but have a different tax treatment	Unchanged
9	Deductibility of employee compensation	Unchanged
10	Difference between business and nonbusiness bad debts	Unchanged
11	Accounting for bad debts	Unchanged
12	Tax benefit rule - bad debts	Unchanged
13	Activities that qualify for production activities deduction	Unchanged
14	Explain qualified production activities income and deduction	Unchanged
15	Deductibility of life insurance premiums	Unchanged
16	Deductibility of sales tax	Unchanged
17	Deductibility of legal fees	Unchanged
18	Why are deductions FOR adjusted gross income "better than" deductions FROM adjusted gross income	Unchanged
19	Accountable employee expense plan	Unchanged
20	Deduction for medical insurance for a self-employed taxpayer	Unchanged
21	Who can deduct a contribution to a conventional Individual Retirement Account	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
22	Difference in tax treatment between conventional IRA and Roth IRA	Unchanged
23	Eligibility requirements to make contributions to Education IRA	Unchanged
24	Deductibility of student loan interest	Unchanged
25	Requirements and type of deductible moving expenses	Unchanged
<b>Problems</b>		
26	Deductibility of entertainment expenses	Unchanged
27	Employer reimbursed entertainment expenses	Unchanged
28	Deductibility of entertainment expenses	Unchanged
29	Entertainment expense - four scenarios	Unchanged
30	Entertainment expense - four scenarios	Unchanged
<b>31 COMM</b>	Entertainment expense - skybox	Unchanged
32	Determining the business and personal portion of using an automobile	Unchanged
33	Determining the business and personal portion of using an automobile	Unchanged
34	Automobile expenses comparing actual expenses versus standard mileage rate	Unchanged
35	Automobile expenses comparing actual expenses versus standard mileage rate	Unchanged
<b>36-COMM</b>	Determining the allowable deduction when a car is used for business/personal purposes	Unchanged
37	Travel, meals, lodging and entertainment - three scenarios	Unchanged
38	Travel, meals, lodging and entertainment - three scenarios	Unchanged
<b>39-COMM</b>	Determining if away from home travel expenses are business or personal	Unchanged
40	Deductibility of travel to investment seminar	Unchanged
41	Deductible portion of away from home travel when accompanied by spouse	Unchanged
42	Deductibility of expense - business gifts versus compensation	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
43	Deductibility of education expenses - four scenarios	Unchanged
<b>44-COMM</b>	Deductibility of education travel expenses	Unchanged
45	Compensation of employees - \$1,000,000 limitation	Unchanged
46	Compensation of employees - \$1,000,000 limitation	Unchanged
47	Bad debt deduction comparing business and nonbusiness	Unchanged
<i>48-CT</i>	Business bad debt deduction	Unchanged
49	Business bad debt deduction - cash versus accrual	Unchanged
<i>50-CT</i>	Bad debt deduction - business and non-business	Unchanged
51	Calculation of qualified production activities income and deduction	Unchanged
52	Calculation of qualified production activities income and deduction	Unchanged
53	Insurance as a business deduction - accrual versus cash	Unchanged
54	Insurance as a business deduction - four scenarios	Unchanged
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58	Deduction for legal fees	Unchanged
59	Deduction for legal fees - five scenarios	Unchanged
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61	Difference between child support and alimony	Unchanged
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63	Accountable employee expense plan	Unchanged
<b>64-COMM</b>	Tax and non-tax benefits of an accountable versus nonaccountable employee expense plan	Unchanged
65	Deductibility of self-employment tax and medical insurance premiums	Unchanged

<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
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67	Deductibility of contributions to individual retirement accounts – four scenarios	Unchanged
68	Deductibility of contributions to individual retirement accounts - three scenarios	Unchanged
<b>69-COMM</b>	Deductibility of contributions to individual retirement accounts	Unchanged
70	Contribution to Roth IRA unmarried taxpayer – four scenarios	Unchanged
71	Contribution to Roth IRA married taxpayer – four scenarios	Unchanged
72	Contribution to Education IRA married taxpayer	Unchanged
73	Contribution to Education IRA unmarried taxpayer	Unchanged
74	Higher education expense deduction	New
75	Deduction for student loan interest – two scenarios	Unchanged
76	Deduction for student loan interest – three scenarios	Unchanged
77	Deduction for moving expenses	Unchanged
78	Tax effect of employer reimbursement of moving expenses	Unchanged
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80-IID	Gifts	Unchanged
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83-IID	Deduction for salary	Unchanged
84-IID	Bad debt deduction	Unchanged
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86-IID	Capitalize or expense an asset	Unchanged
87-IID	Capitalize or expense tax payment	Unchanged
88-IID	Deductibility of retirement contribution	Unchanged
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<b>2017 Edition</b>	<b>Topic</b>	<b>Status</b>
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91	INTERNET Assignment	Unchanged
92	Research Problem	Unchanged
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94	Spreadsheet Problem	Unchanged
95	Tax Form Problem	Unchanged
96	Integrated Tax Return Problem	Unchanged
97-INT	Integrative Problem	Unchanged
98-DC	Deductibility of legal fees	Unchanged
99-DC	Requirements for deducting education expenses	Unchanged
100-DC	Deductibility of moving expenses	Unchanged
101-TPC	Tax effect of sale of stock on \$3,000 capital loss limitation	Unchanged
102-TPC	Comparison of Conventional IRA with Roth IRA	Unchanged
103-EDC-CT	Meals and entertainment - focuses on SSTS #3 and SSTS #6	Unchanged

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## CHAPTER 6

### BUSINESS EXPENSES

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#### DISCUSSION QUESTIONS

1. Most expenditures that have a business purpose and meet the ordinary, necessary, and reasonable requirements are deductible. However, specific rules must be adhered to in determining the deductibility of many expenses that meet this test. Why are these specific rules necessary?

**There are many business expenses that have a personal element to them. As such, they are subject to abuse by taxpayers. For example, meals and entertainment can be valid business expenses. However, due to the potential for taxpayers to attempt to deduct personal meal and entertainment expenses, specific rules on the deductibility of such expenses have been created. In addition to the qualifying requirements, most expenses that are usually considered to be personal in nature (e.g., car expenses) must be adequately substantiated.**

2. What requirements must be met for meal and entertainment expenses to be deductible?

**To qualify as deductible business expenses, meal and entertainment expenses must:**

1. **Have a business purpose,**
  2. **Qualify as an ordinary and necessary expense of the business and not be lavish or extravagant (i.e., reasonable in amount),**
  3. **Be directly related to or associated with the active conduct of the taxpayer's business activity, and**
  4. **Be adequately documented.**
3. How does an entertainment expense directly related to business differ from an entertainment expense associated with business?

**The two entertainment expense classifications are similar in that both:**

1. **Require that the expense be incurred for a business purpose that is related to the active conduct of the taxpayer's business.**
2. **Both must qualify as an ordinary and necessary expense of the business and not be lavish or extravagant (i.e., reasonable in amount).**
3. **Both must satisfy substantiation requirements.**

The two entertainment expense classifications are different in that:

1. A bona fide business activity must take place to qualify as a directly related entertainment expense. To qualify as an associated with expense, the entertainment must directly precede or follow substantial business discussions.
2. Directly related expenses are amounts spent to provide entertainment for the taxpayer and the person(s) involved in the conduct of the business activity. Associated with expenses may include expenses related to persons whose presence is appropriate for business reasons but not necessary for the actual conduct of business. The tax law refers to this requirement as expenses of persons closely connected with the individual who conducted business with the taxpayer. For example, the costs related to the presence of a business associate's spouse at a dinner following a substantial business meeting would qualify as an associated with expense.

The associated with test may be easier to satisfy than the directly related test. In addition, the persons whose expenses qualify for deduction is broader under the associated with test.

4. What problems does the taxpayer who uses an automobile for both business and personal purposes encounter? What option(s) does the taxpayer have regarding the automobile expense deduction?

When an asset is used for more than one purpose, the cost of the asset and any expenditures associated with the asset must be allocated between the two purposes in some reasonable manner. Because the business use of the automobile is deductible and the personal use is not, the automobile is treated as two separate assets for tax purposes. In addition, the expenses of operating the automobile must be allocated between business use and personal use.

The taxpayer may elect to use either the actual cost method or the standard mileage rate method to determine the allowable deductions on the automobile. Both methods require the taxpayer to substantiate the business miles driven. The actual cost method also requires the substantiation of the expenses related to the automobile. The standard mileage rate is 54 cents per mile in 2016.

5. What records are necessary to properly document travel, entertainment, and gift expenses?

A deduction is allowed for substantiated (proven) travel, entertainment, and gift expenses. To properly substantiate an expense, the taxpayer must make a written record as near to the time an expense is incurred as possible to show:

1. The amount of each separate expense,
2. The date of the entertainment or gift, or the time period the taxpayer traveled,
3. Where the entertainment took place, or the travel destination,
4. The description of a gift,
5. The business purpose of the expense, and
6. The business relationship between the taxpayer and persons entertained or given a gift.

6. Under what circumstances are business gifts deductible?

**A taxpayer can deduct up to \$25 in gifts to business customers. The taxpayer is required to maintain documentation describing the taxpayer's relationship with the recipient, the date of the gift, the description of the gift, and the business purpose of the gift. The gift is not subject to the 50% limitation on entertainment and meals expenses.**

7. Explain the criteria used to determine whether an educational expense is deductible or nondeductible and how education expenses are deducted on a taxpayer's return.

**Individuals are allowed to deduct education expenses if the education expense meets either of the following requirements: (1) the education is required by law or by the employer for the taxpayer to retain the taxpayer's job or (2) the expense maintains or improves the skills required in the taxpayer's trade or business.**

**Because education is viewed as a personal capital expenditure, education expenses are not deductible if the expense is incurred to (1) meet the minimum educational requirements required for the taxpayer's job or (2) if the education qualifies the taxpayer for a new trade or business.**

**A taxpayer is allowed a deduction from adjusted gross income for education expenses if the expenses are incurred as a requirement for the taxpayer to continue employment or are incurred to maintain or improve the skills required in their job. For tax years beginning after December 31, 2012 and ending before January 1, 2017, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income.**

8. Can education expense incurred by one taxpayer be deductible whereas the same expense incurred by another taxpayer is not deductible? Explain.

**An education expense is deductible when the expense is either (1) required by law or by the employer for the taxpayer to maintain her/his job, or (2) the expense maintains or improves the skills required in the taxpayer's trade or business. However, an education expense that (1) meets the minimum educational requirements required for the taxpayer's job, or (2) qualifies the taxpayer for a new trade or business might not be deductible. Therefore, an education expense that is deductible for one taxpayer could be treated as a nondeductible expense for another taxpayer.**

**For example, if two individuals are enrolled in the same advanced database management course, the tax treatment can vary based on the background of each individual. Assume that Judy has a B.S. in computer science and works full-time for Hazelnut Corporation as a computer programmer. She enrolls in the course to refresh her skills in database management. On the other hand, Sam is a full-time student who works part-time as a computer programmer for Pine Corporation and is taking the course to meet his undergraduate requirements for a degree. For Judy, the course is considered a deductible education expense because the course maintains or improves her skills. For Sam, the course generally would not be deductible.**



A taxpayer is allowed a deduction from adjusted gross income for education expenses if the expenses are incurred as a requirement for the taxpayer to continue employment or are incurred to maintain or improve the skills required in their job. For tax years beginning after December 31, 2011 and ending before January 1, 2017, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income. .

9. Is all compensation paid to an employee deductible? Discuss the circumstances in which employee compensation cannot be deducted.

Payments for compensation paid to an employee are deductible to the extent that they are ordinary, necessary, and reasonable in amount. Compensation paid that is unreasonable in amount may not be deducted as a business expense. Unreasonable compensation situations generally arise when the payment is being made to a related party. In such cases, taxpayers often try to transfer income from one party to another to lower the total tax paid. However, if the payment made is unreasonable for the duties and responsibilities of the payee, it will not be considered compensation and will not be deductible.

For publicly traded corporations, deductible compensation paid to the CEO and the four highest compensated officers other than the CEO cannot exceed \$1,000,000 for each person.

10. Explain the difference in the tax treatment of business and nonbusiness bad debts.

A business bad debt is deductible in the period in which the fact of the bad debt becomes known. That is, estimates of the amount of the debt may be made at the time the debt is known to be uncollectible. Adjustments for the actual amount of the bad debt are made in subsequent periods. Business bad debt deductions are deductible in full as a trade or business expense.

A nonbusiness bad debt is not deductible until the period in which the actual amount of the debt that will not be collected is known. Thus, estimates of nonbusiness bad debts are not allowed. In addition, nonbusiness bad debts are treated as short-term capital losses. This could result in the debt not being fully deductible in the period in which the amount of the bad debt is determined due to the capital loss deduction limitations (i.e., \$3,000 per year).

11. What accounting method must be used to account for bad debts that result from the sale of merchandise or the provision of services?

Only accrual basis taxpayers are allowed deductions for bad debts. Cash basis taxpayers have not recognized any income related to receivables and therefore, have no basis in the debt to deduct.

With a few limited exceptions, taxpayers must use the specific charge-off method to deduct bad debts. This method allows bad debt deductions only in the period in which

**an account is determined to be worthless. The tax law generally disallows the use of the allowance method of accounting for bad debts.**

12. Explain how the tax benefit rule may apply to bad debt deductions.

**Business bad debts are deductible in the period in which it is determined that the debt will not be collected. The amount of the deduction is based on an estimate of how much of the debt will not be collected. When the actual amount of the bad debt becomes known in a future period, adjustments to the estimate are made. Therefore, if the estimated bad debt turns out to be more than the actual bad debt, the taxpayer will receive amounts that were deducted in a prior period. The tax benefit rule requires any amounts received that were deducted in a prior period to be included in current period income to the extent that a tax benefit was received from the prior period deduction.**

13. What activities qualify for the qualified production activities deduction?

**The following activities qualify for the production activities deduction: (1) the manufacture, production, growth or extraction of qualifying production property by the taxpayer in whole or in significant part within the U.S.; (2) the production of any qualified film by the taxpayer; (3) the production of electricity, natural gas, or potable water by the taxpayer in the U.S.; (4) the performance of construction activities in the U.S. by the taxpayer; and (5) the performance of engineering or architectural services in the U.S. in connection with construction projects in the U.S.**

14. Explain how a taxpayer determines qualified production activities income and how a taxpayer calculates their qualified production activities deduction.

**A taxpayer's qualified production activities income is the excess of domestic production gross receipts minus the cost of goods sold allocable to such receipts and deductions, expenses, or losses directly allocable to such receipts; and a ratable portion of deductions, expenses, and losses not directly allocable to such receipts. A taxpayer's qualified production deduction is equal to 9% of the lesser of the taxpayer's qualified production activities income or taxable income before the qualified production activities deduction. However, the amount of the QPAD cannot exceed 50 percent of the W-2 wages paid by the taxpayer as an employer during the year. An individual calculates the deduction using adjusted gross income in lieu of taxable income.**

15. What requirements must be met to deduct life insurance premiums paid on an employee's policy?

**Premiums paid on group-term life insurance policies are deductible. For other employee life insurance premiums to be deductible, the payment of the premium must constitute income to the employee. For the policy to be considered gross income for the employee, the employer cannot be the beneficiary of the policy.**

16. Are sales taxes deductible? Explain.

**Sales taxes paid on the purchase of business assets that are expensed in the current period (e.g., supplies) are deductible. However, sales taxes paid on the purchase of long-lived assets are capitalized as part of the cost of the asset. Therefore, the sales tax is deducted as the cost of the asset is recovered through time via amortization or depreciation or when the asset is sold. Sales taxes paid on personal use items are not deductible.**

17. Are all legal fees paid by a taxpayer deductible? Explain.

**To be deductible, legal fees must have a business purpose. The origin of the legal fee determines the purpose of the expenditure. If the legal fee originates in a profit motivated activity, then it is deductible. However, if the legal fee is generated for personal reasons, it is not deductible. For example, legal fees related to a divorce originate from a personal action. Therefore, even though the fee may be related in some way to a taxpayer's trade or business or investment assets, the fee is a nondeductible personal expenditure. If part of the fee in a divorce is specified as being for tax advice, that portion of the fee is deductible.**

**Legal fees that have a business purpose must be capitalized if they relate to the acquisition of, or the protection of title to a long-lived asset.**

18. Why are deductions for adjusted gross income "better" than deductions from adjusted gross income?

**Deductions FOR AGI are better because they provide more tax savings than deductions FROM AGI. That is, once the amount of a for AGI deduction is determined, it is not subject to any limits based on the taxpayer's income as are many of the FOR AGI deductions. Second, there is no minimum amount of FOR AGI deductions - whatever the taxpayer incurs is allowed as a deduction. In contrast, taxpayers with small amounts of from AGI deductions will use the applicable standard deduction in lieu of itemizing their actual deductions. Third, deductions FOR AGI reduce the taxpayer's AGI, making the FROM AGI deductions that are subject to an AGI limitation larger.**

19. What is an accountable employee expense reimbursement plan? What is the significance of such a plan?

**An accountable reimbursement plan is one in which employees are required to make an adequate accounting of their allowable expenses with the employer and return any excess reimbursements to the employer.**

**The significance of an accountable plan is that all reimbursements from the plan are deductible for AGI. Only unreimbursed expenses are deducted as miscellaneous itemized deductions, subject to the 2% of AGI limitation. In addition, the 50% meals and entertainment limitation does not apply to reimbursed expenses. If a reimbursement plan is not accountable, all deductions must be taken as miscellaneous itemized deductions, subject to the 2% and 50% limitations.**

20. Why are self-employed taxpayers allowed to deduct their medical insurance premiums and self-employment tax for adjusted gross income?

**The reason for allowing for AGI deductions for these two items is to attempt to equalize the treatment of self-employed taxpayers with employees. That is, employees receive the benefits of employer provided health insurance tax-free because the cost of the premiums is excluded from income. By allowing self-employed taxpayers to deduct the cost of their health insurance for AGI, an element of equality is provided between the two types of taxpayers. Similarly, employers match the Social Security payments of employees, which is not included in the employee's income. Because the self-employment tax is twice the Social Security tax, the deduction of 1/2 of the self-employment tax somewhat equalizes the tax treatment for employees and self-employed taxpayers.**

21. Are all taxpayers allowed a deduction for contributions to a conventional individual retirement account? Explain.

**All taxpayers are allowed to contribute \$5,500 (This amount is indexed for inflation) to an individual retirement account. A taxpayer who is at least 50 years old is allowed to make an additional contribution of \$1,000. However, a deduction for the contribution is allowed only to those taxpayers who are not covered by an employer provided retirement plan. If an unmarried taxpayer is covered by an employer-provided retirement plan, the allowable deduction is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$61,000. For married taxpayers if both the husband and wife are covered by an employer-sponsored plan, the deduction is phased-out ratably over a \$20,000 range beginning at an adjusted gross income of \$98,000. If only one spouse is covered by an employer provided retirement plan the allowable deduction for the spouse not covered by a plan is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$184,000.**

22. How does the tax treatment of a conventional IRA differ from a Roth IRA?

All taxpayers are allowed to **contribute** to an individual retirement account. However, a deduction for the contribution is allowed only to those taxpayers who are not covered by an employer provided retirement plan. If an unmarried taxpayer is covered by an employer-provided retirement plan the allowable deduction is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$61,000. For married taxpayers if both the husband and wife are covered by an employer-sponsored plan, the deduction is phased-out ratably over a \$20,000 range beginning at an adjusted gross income of \$98,000. If only one spouse is covered by an employer provided retirement plan the allowable deduction for the spouse not covered by a plan is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$184,000.

The contribution to a Roth IRA is not deductible. The major benefit of a Roth IRA is that qualified distributions from it, including the income earned on the IRA assets, are not included in the taxpayer's gross income. Unmarried taxpayers with an adjusted gross income of less than \$116,000 may contribute \$5,500 to a Roth IRA. As with an IRA, a taxpayer who is at least 50 years old is allowed to make an additional contribution of \$1,000. However, the amount contributed to a Roth IRA must be reduced by any contributions made to other IRA accounts. When an unmarried taxpayer's adjusted gross income exceeds \$117,000, the amount that can be contributed is reduced ratably over a \$15,000 range until no contribution is allowed when adjusted gross income exceeds \$132,000. For married taxpayers with an adjusted gross income of less than \$184,000, each spouse can contribute \$5,500 to a Roth IRA. The amount that can be contributed is reduced ratably over a \$10,000 range when adjusted gross income exceeds \$184,000 and is fully phased-out when adjusted gross income exceeds \$194,000.

23. Who is eligible to make and receive contributions to a Coverdell Education Savings Account?

All taxpayers can make a nondeductible contribution of up to \$2,000 to a Coverdell Education Savings Account for the benefit of an individual who is not 18 years of age. However, the total amount contributed to a Coverdell Education Savings Account is limited to \$2,000. For unmarried taxpayers, the amount of the contribution is phased out ratably over a \$15,000 range beginning when adjusted gross income exceeds \$95,000 and is fully phased-out when adjusted gross income exceeds \$110,000. For married taxpayers this amount is phased out ratably over a \$30,000 range beginning when adjusted gross income exceeds \$190,000, and is fully phased-out when adjusted gross income exceeds \$220,000.

24. Is the interest on education loans always deductible? Explain

A qualified education loan is one that is used to pay for tuition, fees, room and board, and other necessary education expenses. The maximum amount of interest that can be deducted is \$2,500. Any amount in excess of the maximum is considered personal interest and is not deductible. The interest deduction is phased out ratably for single taxpayers over a \$15,000 range beginning when adjusted gross exceeds \$61,000 and is fully phased-out at \$75,000. For married taxpayers, the \$30,000 phase-out begins when adjusted gross income exceeds \$120,000 and is fully phased out when adjusted gross income exceeds \$150,000.

25. Explain the general requirements that must be met to obtain a deduction for moving expenses and the type of moving expenses that are deductible.

**The two general requirements are the distance and time requirements. The taxpayer's commuting distance from the old residence to the new job must be more than 50 miles than the distance would have been from the old job. The time test requires the taxpayer be employed for 39 weeks in the 12-month period following the move (78 weeks in 2 years for self-employed taxpayers).**

**Only direct moving expenses are deductible for adjusted gross income. Direct moving expenses are limited to:**

- **the cost of moving household goods and personal effects to the new residence.**
- **the transportation and lodging costs of moving the taxpayer and the taxpayer's family from the old residence to the new residence. Mileage is at 19 cents per mile.**

**The taxpayer cannot deduct the cost of meals incurred in moving from the old residence to the new residence.**

**PROBLEMS**

26. A.J. is the vice president for Keane Products, a marketing consulting firm. On a business trip to New York City, he meets with three executives from Keane's top account. After the meeting, A.J. takes them to dinner and then to the theater. The theater tickets cost \$350. The cost of the meal is \$190, including sales tax of \$17 and a tip of \$34. Throughout the evening, A.J. pays \$42 in cab fares. How much can A. J. deduct as an entertainment expense?

**A.J. can deduct \$175 ( $50\% \times \$350$ ) for the theater tickets and \$95 ( $50\% \times \$190$ ) for the meal. The entertainment qualifies as an expense associated with the conduct of the taxpayer's trade or business because it follows a substantial business discussion. The \$42 cab fare is fully deductible as transportation and is not subject to the 50% rule because it is not considered to be an entertainment expense. Thus, A.J.'s total deduction for the evening is \$312 ( $\$175 + \$95 + \$42$ ). Instructor's Note: Even if A.J. and the clients did not have a business meeting before the theater, the entertainment is deductible if they had a business discussion at dinner.**

27. Karl is the vice president of finance for Wyatt Industries. Last month, he took a client to an afternoon baseball game. The box-seat tickets cost \$30 each. Because the client had a plane flight after the game, Karl was unable to take her to dinner. During the game, Karl spent \$15 on sodas and snacks. What amount can Karl deduct as an entertainment expense? Assume that Karl and the client went to dinner and that the meal cost \$88. How much can Karl deduct as an entertainment expense?

**For the entertainment to qualify under the associated with test, two requirements must be met. First, there must exist a clear business purpose, other than goodwill, for the entertainment. Karl probably could establish that this test is met. However, the second test requires that the entertainment occur either preceding or following a substantial business discussion. Given the facts of this example, this did not occur. Therefore, the \$37.50 [ $(\$60 \text{ tickets} + \$15 \text{ food}) \times 50\%$ ] of entertainment expense are considered a nondeductible personal expense. Instructor's Note: The facts of the problem imply that Karl met the client at the game and that no business discussions preceded the game.**

**If Karl went to dinner with the client and business was discussed, Karl can deduct \$44 ( $\$88 \times 50\%$ ) as a business meal expense. In addition, because a business discussion took place following the baseball game, the \$37.50 in entertainment expenses are deductible. Karl's total meal and entertainment expense is \$81.50 ( $\$44 + \$37.50$ ).**

28. Marcel is the former chief executive officer and chairman of the board of Donovan Technology. He is a member of the board of directors and has the title of chairman emeritus. Marcel and his wife enjoy having parties and entertaining clients of Donovan. During the current year, Marcel spends \$15,000 entertaining clients of Donovan and other business associates. The entertainment is not expected of Marcel in his current role. Company policy limits reimbursement for entertainment expenses to the chief executive officer and the chief financial officer. What amount of the entertainment expenses can Marcel deduct on his individual tax return?

**Marcel may not deduct the \$15,000 of entertainment expenses. The entertainment is not an ordinary and necessary expense of Marcel's business. The entertainment is not required or expected in Marcel in his current role with the company. This is evident by the fact that the company does not reimburse Marcel for his entertainment expenses. Although the entertainment might serve a business purpose, to be deductible, the business purpose must create more than client goodwill. The entertainment appears to be more personally motivated (Marcel and his wife enjoy it), and thus, does not meet the business purpose test.**

29. For each of the following situations, explain whether a deduction should be allowed for entertainment expenses:

- a. Neil owns a real estate agency and has an annual Christmas party at his house. The party is only for employees of his firm and costs \$2,600.

**The cost of the Christmas party is fully deductible. Employee recreational expenses, such as a Christmas party, are not subject to the 50% limitation on meals and entertainment.**

- b. Carol is a personal financial planner. Over the years, she has made it a practice to invite her best clients to lunch on the client's birthday. At the lunch, she always makes it a point to ask about any major changes in the client's financial status that she should be aware of. However, most of the conversation relates to personal matters. During the year, Carol spent \$850 on these lunches.

**The key test that Carol must meet for the meal to be deductible under the directly related test is that the principal reason for providing the meal must be to conduct business. For the meal to be deductible under the associated with test, there must be a clear business purpose, other than goodwill, for the meal and it either precedes or follows a substantial business discussion. Because Carol entertains the client on their birthday and the majority of the conversation is not business related, it appears that she does not meet either of these tests. Therefore, the \$850 spent for the lunches is not deductible.**



- c. Vijay is a doctor at a local hospital. Every month, he buys lunch at the hospital for the six residents and interns who assist him in surgery and caring for his patients. The lunches cost \$420 for the year.

**Vijay may not deduct the \$420. Because Vijay is not required as part of his job to pay for these lunches and the lunches are not directly related to or associated with his job as a doctor, the lunches are not considered ordinary and necessary expenses of his job. The expenses related to these meals are nondeductible personal expenses**

- d. Tom, Hillary, and George are friends from college who live and work in the Dallas metropolitan area. They are all stockbrokers for different firms and get together twice a month for lunch to exchange rumors concerning the stock market. In addition, they catch up on personal news and make plans to get together with their spouses and other friends. Last year, George made \$50,000 for a client based on a tip he received from Hillary at one of their meetings. Each stockbroker pays for his or her own lunch, and during the year, George paid \$320.

**George may not deduct any of the expense for the meals. The expense is allowed as a deduction only if George can show a business purpose for the expense and it qualifies as directly related to or associated with his job as a stockbroker. In George's case, the meals appear to be primarily based on personal motives and not directly related to or associated with the active conduct of his business.**

30. For each of the following situations, explain whether a deduction should be allowed for entertainment expenses:

- a. Gayle, a dentist, invites 50 of her best patients to her daughter's wedding reception. The cost of the reception related to the presence of her patients is \$5,000.

**Gayle cannot deduct the \$5,000 of entertainment expenses. The wedding reception is not an ordinary and necessary expense of Gayle's business. The reception is a personally motivated event which lacks a business purpose.**

- b. Stan is one of 5 shift supervisors responsible for 100 employees at Label House, Inc. He regularly meets with the other shift supervisors at the plant. In addition, Stan makes it a practice to go to lunch at least once a week with each of the other 4 shift supervisors in order to network. During the current year, Stan pays \$1,500 for his and the other supervisors' lunches. Stan's job description does not require him to entertain the other supervisors.

**Stan may not deduct the \$1,500. The expenses related to Stan's meals are personal living expenses. Because Stan's supervisory position is not affected by the entertainment (i.e., not required as part of his job), the lunches are not an ordinary and necessary expense of his job.**

- c. Jan is a real estate broker who holds an open house for a different client each Sunday afternoon. During the open house, she provides cookies and soft drinks for whoever visits the house. Jan pays \$2,000 for open house entertainment.

**The \$2,000 Jan paid for refreshments at the open house is deductible. The expenses are in the nature of advertising or promoting goodwill and are an ordinary and necessary expense of a real estate broker. These expenses are not subject to the 50% limitation, under the exception for food and entertainment provided to the general public.**

- d. Felicia is vice-president of sales for Drivitt, Inc. She invited the company's major clients and some of her coworkers from Drivitt to her annual Super Bowl party. Most guests attend with their spouses. The party is held in a separate room at a local sports bar and costs her \$1,500.

**The expense of the party does not qualify as an entertainment expense because it fails both the directly related and associated with tests. The directly related test requires that the entertainment expense meet four test, one of which is that a bona fide business activity take place during the entertainment. This is probably not the case, because the setting for the entertainment is a bar.**

**For the entertainment to qualify under the associated with test, two requirements must be met. First, there must exist a clear business purpose, other than goodwill, for the entertainment. Felicia probably could establish that this test is met. However, the second test requires that the entertainment occur either preceding or following a substantial business discussion. Given the facts of this example, this did not occur. Therefore, the \$1,500 entertainment expense is considered a nondeductible personal expense.**

31. You have just been hired as a tax accountant by a local public accounting firm. One partner is impressed by your writing skills and asks you to write a one-page memo to a client describing the general rules on the deductibility of meals and entertainment. The client also needs to know under what circumstances the cost of its skybox (with 10 tickets) at Optus Park is deductible.

**Instructor's Note:** The memo that each student will prepare will be different. The following answer highlights the points that each student should include in his/her memo.

**Under the general rules for meals or entertainment expenses to qualify as a deductible business expense the expense must:**

- 1. Have a business purpose,**
- 2. Qualify as an ordinary and necessary expense of the business and not be lavish or extravagant (i.e., reasonable in amount),**
- 3. Be directly related to or associated with the active conduct of the taxpayer's business activity, and**
- 4. Be adequately documented.**

**It is extremely difficult for an entertainment expense to qualify under the directly related test because the expense must meet all of the following requirements:**

- There is a general expectation of deriving income or a business benefit from the meals or entertainment,**
- A bona fide business activity takes place during the meal or entertainment,**
- The principal reason for providing the meal or entertainment is to conduct business, and**
- The expenses are related to the taxpayer and people involved in the business.**

**For entertainment to qualify as an associated with expense, only two requirements must be met. First, there must be a clear business purpose, other than goodwill, for the entertainment. Second, the entertainment must directly precede or follow substantial business discussions.**

**No portion of the skybox fee is deductible. However, the client can deduct the cost of the ten tickets. The deduction for each ticket is limited to the price of the most expensive non-luxury box seat. Finally, the student should mention that only 50% of meal and entertainment expenses are deductible.**

32. Pablo is a computer sales representative and spends only 4 days a month in the office. His office is 18 miles from home. Pablo spends 3 nights a month traveling to his out-of-town clients.

- a. What portion of Pablo's travel is considered business?

**Pablo can deduct the cost of traveling from home to his business clients and back. If applicable, he can also deduct the cost of traveling from his office to his clients and back to his office. Finally, any out-of-town traveling he incurs is fully deductible. The cost of traveling to his office and then home, as he does 4 days a month, is considered commuting and is a nondeductible personal expense.**

- b. During the year, Pablo keeps the following record of his travel:

	Miles
Home to office	864
Office to home	864
Home to local clients to home	10,630
Home to out of town clients to home	2,650

The company reimburses Pablo for all of his lodging, meals, and entertainment while he is on the road. If he uses the standard mileage rate, what amount can he deduct as a business expense?

**Pablo's deductible business expense is \$7,171 (13,280 miles x 54 cents). The standard mileage rate for 2016 is 54 cents per mile. In computing his deduction, Pablo may deduct the mileage from home to his clients and back home (10,630), and the miles (2,650) to and from his out of town clients. The miles from home to his office and back are considered commuting and cannot be used to determine his allowable business expense.**

33. Julianita is a sales representative for a food distributor and spends only 1 day of the week in the office. Her office is 12 miles from home. She also has a part-time job as a bartender. Typically, she works 2 nights during the week and 1 night on the weekend. The restaurant where she works is 5 miles from her office and 10 miles from her home.

- a. What portion(s) of Julianita's travel is considered business?

**Julianita can deduct the cost of traveling from home to her business clients and back. She can also deduct the cost of traveling from her office to her clients and back to her office. The cost of traveling to her office and then home, as she does 1 day a week, is considered commuting and is nondeductible. However, the cost of traveling from either her office or clients to her second job as a bartender is deductible. The cost of traveling home from her bartending job is not deductible because the travel is considered commuting. Finally, any out-of-town traveling Julianita incurs is fully deductible.**

- b. During the year, Julianita keeps the following record of her travel:

	Miles
Home to office	588
Office to home	353
Office to restaurant	150
Restaurant to home	1,500
Home to restaurant	500
Home to clients to home	8,850
Clients to restaurant	2,100

If she uses the standard mileage rate, what amount can she deduct as a business expense?

**Julianita's deductible business expense is \$5,994 (11,100 x 54 cents). The standard mileage rate for 2016 is 54 cents per mile. In computing her deduction, Julianita may deduct the mileage from home to her clients and back home (8,850), the miles from her clients to the restaurant (2,100) and the mileage from her office to the restaurant (150). The miles from home to her office and back are considered commuting, as are the miles from her home to the restaurant and from the restaurant to her home.**

34. Cassandra owns her own business and drives her van 15,000 miles a year for business and 5,000 miles a year for commuting and personal use. She purchases a new van in 2016 and wants to claim the largest tax deduction possible for business use. Cassandra's total auto expenses for 2016 are as follows:

Gas, oil, and maintenance	\$ 5,760
Insurance	775
Interest on car loan	1,200
Depreciation	3,160
License	180
Parking fees and tolls (all business)	240

Determine Cassandra's 2016 deduction for business use of the van.

**Because this is the first year Cassandra uses the van, she must select an accounting method to determine the costs associated with the van. She has the option of using either the standard mileage rate method or the actual cost method to determine her deduction on the van. Based on the calculation of the deduction under each method, the standard mileage method results in a \$694 (\$8,340 - \$7,646) larger deduction. Parking and tolls are added separately, because these expenses are all business related. Interest expense is not considered a cost incurred to operate or maintain the vehicle and is deductible under either method if the taxpayer is self-employed. Because Cassandra is self-employed, she can deduct the business portion (75%) of the interest expense under both methods.**

***Standard Mileage Deduction:***

15,000 miles x 54 cents	\$ 8,100
Add: Parking and tolls	240
Total deduction	<u>\$ 8,340</u>

Interest expense (\$1,200 x 75%)	900
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***Actual Cost Deduction:***

Total actual expenses (other than parking, tolls and interest)	\$ 9,875
Business usage percentage (15,000 mi. ÷ 20,000 mi.)	x 75%
Allocated actual cost	<u>\$ 7,406</u>
Add: Parking and tolls	240
Total deduction	<u>\$ 7,646</u>

Interest expense (\$1,200 x 75%)	900
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**Instructor's Note:** For reporting purposes Interest expense is separately stated on Schedule C.

35. Mario owns his own business and drives his car 15,000 miles a year for business and 7,500 miles a year for commuting and personal use. He wants to claim the largest tax deduction possible for business use of his car. His total auto expenses for 2016 are as follows:

Gas, oil, and maintenance	\$ 8,900
Insurance	800
Interest on car loan	480
Depreciation	3,160
License	180
Parking fees and tolls (all business)	290

- a. What is Mario's 2016 deduction using the standard mileage rate?

**Under the standard mileage rate method Mario can deduct \$8,390. He can deduct 54 cents for each mile he uses his car for business. Parking and tolls are added separately because these expenses are all business related. Interest expense is not considered a cost incurred to operate or maintain the vehicle and is deductible under either method if the taxpayer is self-employed. Because Mario is self-employed, he can deduct the business portion (66.7%) of the interest expense.**

***Standard Mileage Deduction:***

15,000 miles x 54 cents	\$ 8,100
Add: Parking and tolls	290
Total deduction	<u>\$ 8,390</u>

Interest expense (\$480 x 66.7%)	320
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- b. What is Mario's 2016 deduction using the actual cost method?

**Under the actual cost method, Mario can deduct \$8,988. Based on the business use of his car he can deduct 66.7% (15,000 mi. ÷ 22,500 mi.) of the cost (other than parking, tolls) of operating the vehicle. Parking and tolls are added separately because these expenses are all business related. Interest expense is not considered a cost incurred to operate or maintain the vehicle and is deductible under either method if the taxpayer is self-employed. Because Mario is self-employed, he can deduct the business portion (66.7%) of the interest expense.**

***Actual Cost Deduction:***

Total actual expenses (other than parking, tolls and interest)	\$13,040
Business usage percentage (15,000 mi. ÷ 22,500 mi.)	x 66.7%
Allocated actual cost	<u>\$ 8,698</u>
Add: parking and tolls	290
Total deduction	<u>\$ 8,988</u>

Interest expense (\$480 x 66.7%)	320
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**Instructor's Note: For reporting purposes Interest expense is separately stated on Schedule C.**

36. Prudy is a recent college graduate who has taken a position with a real estate brokerage firm. Initially, Prudy will be selling both residential and commercial property. She is thinking about buying a new car at a cost of \$14,500. However, the salesperson is trying to sell her a car that costs \$18,000. He has assured her that because she is now self-employed, the entire cost of the car is tax-deductible. Prudy comes to you, her tax accountant, for advice about the purchase of the car. She tells you she expects that 65% of her driving will be for business purposes. She asks you to write her a letter specifying whether she can deduct the entire cost of the car, which expenses she needs to keep track of, and how these expenses are used in computing the business deduction for her car.

**The information provided to Prudy by the car dealer is not correct. Because Prudy will be using her car for more than one purpose, the cost of the car and any expenditures associated with it must be allocated between the business and personal use in some reasonable manner. Therefore, only 65%, not 100%, of the cost of operating the automobile is deductible. The 35% personal portion is a personal expense and not deductible. In essence, the automobile is treated as two separate assets for tax purposes.**

**Prudy may elect to use either the actual cost method or the standard mileage rate method to determine the allowable deductions on the automobile. Both methods require her to substantiate the business miles driven. The actual cost method also requires the substantiation of the expenses related to the automobile. The standard mileage rate is 54 cents per mile in 2016. If she uses the actual cost method, she will need to keep track of the following expenses gasoline, oil, repairs, insurance, and licensing fees. She can also depreciate the cost of the car. Depreciation of automobiles is subject to special rules discussed in Chapter 10.**

**Because she is self-employed, she can deduct the business portion of any ad valorem property taxes and interest she pays on her car loan. Any unreimbursed business parking and tolls are fully deductible.**



37. Juanita travels to San Francisco for 7 days. The following facts are related to the trip:

Round trip airfare	\$ 475
Hotel daily rate for single or double occupancy	175
Meals -- \$40 per day	40
Incidentals -- \$25 per day	25

- a. If she spends 4 days on business and 3 days sightseeing, what amount may she deduct as travel expense?

**Based on time spent on business and personal activities, the trip was primarily for business. As a result, transportation is fully deductible. Other expenses are deducted as follows:**

Airfare	\$ 475
Hotel (\$175 x 4)	700
Meals (\$40 x 4 x 50%)	80
Incidentals (\$25 x 4)	100
Total deduction	<u>\$ 1,355</u>

**Only expenses related to the 4 days devoted to business can be deducted. Meals are further limited to 50% of the deductible amount.**

- b. If she spends 2 days on business and 5 days sightseeing, what amount may she deduct as travel expense?

**Based on the time spent on business and personal activities, the trip was primarily for personal reasons (i.e., fewer days spent on business than on personal). As a result, none of the transportation is deductible. Other expenses are allowed for business days as follows:**

Airfare	\$ -0-
Hotel (\$175 x 2)	350
Meals (\$40 x 2 x 50%)	40
Incidentals (\$25 x 2)	50
Total deduction	<u>\$ 440</u>

**Only expenses related to the 2 days devoted to business can be deducted. Meals are further limited to 50% of the deductible amount.**

- c. Assume the same facts as in part a, except that Juanita's husband Jorge accompanied her on the trip and the hotel's single occupancy rate is \$150. Jorge went sightseeing every day and attended business receptions with Juanita at night. Assume that Jorge's expenses are identical to Juanita's. What amount may Juanita and Jorge deduct as travel expense?

**None of Jorge's expenses are allowed as a business deduction unless there is a substantial business purpose for his presence *and* he is an employee of Juanita's business. Because Jorge fails both of these requirements, none of his expenses are deductible. Because the hotel rate is the greater for a double occupancy than for a single, Juanita can only deduct \$150 per night for lodging. The \$25 difference is considered a personal expense and allocated to Jorge. Juanita can deduct the following amount:**

Airfare	\$ 475
Hotel (\$150 x 4)	600
Meals (\$40 x 4 x 50%)	80
Incidentals (\$25 x 4)	100
Total deduction	<u>\$ 1,255</u>

38. Chai is self-employed and travels to New Orleans for a business conference. The following facts are related to the trip:

Round trip airfare	\$375
Hotel daily rate for single	120
Conference registration fee	190
Meals---\$54 per day	54
Incidentals---\$27 per day	27

- a. If Chai spends 4 days at the conference and 2 days sightseeing, what amount may he deduct as travel expense?

**Based on time spent on business and personal activities, the trip is primarily for business. As a result, transportation is fully deductible. The conference registration fee is also fully deductible. The other expenses are deducted as follows:**

Airfare	\$ 375
Hotel (\$120 x 4)	480
Conference registration	190
Meals (\$54 x 4 x 50%)	108
Incidentals (\$27 x 4)	108
Total deduction	<u>\$ 1,261</u>

**Only expenses related to the 4 days devoted to business can be deducted. Meals are further limited to 50% of the deductible amount.**

- b. If he spends 2 days at the conference and 4 days sightseeing, what amount may he deduct as travel expense?

**Based on time spent on business and personal activities, the trip is primarily for pleasure. As a result, the transportation is not deductible. However, the conference registration fee is fully deductible. The other expenses are deducted as follows:**

Airfare	\$ -0-
Hotel (\$120 x 2)	240
Conference registration	190
Meals (\$54 x 2 x 50%)	54
Incidentals (\$27 x 2)	54
Total deduction	<u>\$ 538</u>

**Only expenses relating to the 2 day devoted to business can be deducted. Meals are further limited to 50% of the deductible amount.**

- c. Next year, Chai would like his wife, Li, who does not work outside their home, to go with him to the conference. Li's expenses would be similar to Chai's, except that the room rate for double occupancy is \$150. Li would probably attend one or two sessions and the receptions at night. What portion of her expenses can they deduct?

**If the primary purpose of his trip is business (as in part a above) then Chai's airfare is fully deductible. Chai will be able to deduct the business portion of his other expenses. The conference registration fee does not have to be allocated because the fee is business related. No portion of his wife's expenses is deductible. Further, if the double occupancy rate is greater than the single occupancy rate (as the facts indicate) Chai's deductible portion for the hotel room is limited to the single occupancy rate (\$120 per business night).**

39. Olga has to travel to Philadelphia for 2 days on business. She enjoys history and is planning to visit the Liberty Bell and other historic sights in the city. If time permits, she would like to make a side-trip to nearby Gettysburg. A friend of Olga's tells her, "The best part of traveling on business is that once the business is over, you can sightsee all you want and the cost is tax-deductible." Olga, who is self-employed, has scheduled her trip over the Labor Day weekend so that she can spend 3 days sightseeing. Write a letter to Olga in which you explain whether her friend's advice is correct.

**Olga's friend has provided her with poor advice. Only the business portion of a combined business and personal trip is deductible. In determining whether the travel cost of a combined business and personal trip is deductible, the taxpayer must determine whether the primary purpose of the trip is business or pleasure. This is determined based on whether more days were spent on business than for pleasure. In Olga's case, because only 2 days are spent on business while 3 days are for pleasure, the primary purpose of the trip is considered pleasure. Therefore, Olga will not be able to deduct the cost of her travel to Philadelphia. However, she can deduct her lodging, meals (limited to 50%) and the cost of incidental expenses (laundry, tips etc.) for the two business days. The costs of the remaining three days are considered nondeductible personal expenditures.**

40. Marisa is an obstetrician. Every February, she attends a 3-day conference on financial planning with Ester, her college roommate. Ester is Marisa's accountant and is a certified financial planner. This year, the seminar was in San Diego, and each had a separate hotel room. The costs of attending the conference for Marisa and Ester are as follows:

	<u>Marisa</u>	<u>Ester</u>
Airfare	\$425	\$375
Hotel daily rate	120	120
Meals - \$35 per day	35	35
Incidentals - \$20 per day	20	20
Registration	170	170
Rental car*	90	90

\* Marisa and Ester split the cost of the rental car.

How much of the trip costs can Marisa and Ester deduct?

**Marisa's expenses are considered nondeductible investment expenses. Travel expenses to attend the investment seminar are only deductible if she is engaged in the trade or business of making investments. Given the facts of this problem, Marisa is in the trade or business of being an obstetrician.**

**Because Ester is a certified financial planner and the seminar deals with financial planning, the conference qualifies as a deductible business expense. As a result, transportation is fully deductible. The conference registration fee is also fully deductible. The other expenses are deducted as follows:**

Airfare	\$ 375
Hotel (\$120 x 3)	360
Conference registration	170
Meals (\$35 x 3 x 50%)	53
Car rental	90
Incidentals (\$20 x 3)	60
Total deduction	<u>\$ 1,108</u>

41. Floyd owns an antique shop. During the year, he and his wife, Amanda, who works as a real estate broker, attend a 3-day antique show in Boston. The expenses related to the antique show are as follows:

Train per person	\$ 110
Hotel daily rate - double occupancy*	115
Meals - \$37 per day per person	37
Incidentals - \$14 per day per person	14

\*The hotel rate for double occupancy is \$20 more than the single occupancy rate.

What amount can Floyd deduct as travel expense? Explain.

**Only Floyd's expenses are deductible because he is the only one engaged in the antique business. Amanda's expenses are deductible only if there is a bonafide business purpose for her presence and she is an employee of the antique business. Amanda fails both of these tests. Because Amanda's expenses are not deductible, the hotel deduction is limited to \$95, the single occupancy rate. Floyd can deduct the following expenses relating to his trip.**

Train	\$ 110
Hotel (\$95 x 3 days)	285
Meals (\$37 x 3 days x 50%)	56
Incidentals (\$14 x 3 days)	42
<b>Total</b>	<b><u>\$ 493</u></b>

42. Jan owns the Mews Bar and Grill. Every year at Christmas, he has a party for his 20 employees and their families. This year's party cost \$1,600. At the party, Jan presented each employee with a \$50 gift certificate redeemable for merchandise at a local department store.

- a. How much can Jan deduct for entertainment and gift expenses?

**Jan may deduct the full \$1,600 cost of the Christmas party. Employee recreational expenses, such as a Christmas party are not subject to the 50% limitation on meals and entertainment. Unless the \$50 gift certificate is considered a de minimus fringe, the gift certificate will be compensation to the employee. It cannot be considered an employee award because it is given to all employees and is not based on length of service or safety. Whether it is a de minimus fringe or compensation Jan can deduct \$1,000 ( $\$50 \times 20$  employees) and his total deduction is \$2,600 (\$1,600 entertainment + \$1,000 business gift). Instructor's Note: The employees would like the gift certificate to be treated as a de minimus fringe benefit since it would not be subject to tax.**

- b. Assume that the party is attended by 10 employees and 10 of the Mews major suppliers. At the party each receives a holiday cheese basket that costs \$30. How much can Jan deduct?

**As in the first part, Jan can deduct the \$1,600 cost of the party. The holiday cheese baskets given to the suppliers are considered a gift and the deduction is limited to \$25 for each basket. The baskets given to the employees are a de minimus fringe benefit and are fully deductible. Jan's total deduction is \$2,150 [ $\$1,600 + (\$25 \times 10) + (\$30 \times 10)$ ].**

43. For each of the following situations determine whether the expenses are deductible as an education expense.

- a. Dorothy owns a real estate business. She is enrolled in a one-year weekend MBA program that meets in a city three-hours away. She takes a train to and from the city. A one-year weekend pass for the train is \$800. The fee for the MBA program including lodging, meals, books and tuition is \$25,000.

**The education costs do not qualify Dorothy for a new trade or business because she owns her own real estate business. As the owner of the business, the education expenses are deductible because the expenses maintain or improve her skills as a manager. The entire cost of her education expenses \$25,800 (\$25,000 + \$800), is deductible. If the business is a sole-proprietorship, Dorothy deducts the education expenses as a business expense.**

- b. Forest is employed as a production manager for a printing company. He is enrolled in a night course costing \$350 at the local college. The course is not required by his employer, but does improve his job skills.

**Although the course is not required by his employer, the cost of the night course is deductible because it improves his job skills. Forest can deduct the \$350 as an unreimbursed employee business expense, which is a miscellaneous itemized deduction and is reduced by 2% of adjusted gross income (see Chapter 8). A taxpayer is allowed a deduction from adjusted gross income for education expenses if the expenses are incurred as a requirement for the taxpayer to continue employment or are incurred to maintain or improve the skills required in their job.**

**A taxpayer is allowed a deduction from adjusted gross income for education expenses if the expenses are incurred as a requirement for the taxpayer to continue employment or are incurred to maintain or improve the skills required in their job. For tax years beginning after December 31, 2011 and ending before January 1, 2017, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income.**



- c. Elise is a recent graduate of law school and has been hired by a local firm. The firm expects her to pass the bar exam on her initial attempt. To prepare for the bar exam, she is taking a law review course that costs \$1,500.

**Even though Elise is a graduate of law school and is working in a local law firm, she is not considered a lawyer until she passes the bar exam. The law review course she takes to pass the bar exam is not deductible because it is an education expense that qualifies her for a new trade or business (e.g., a lawyer).**

**A taxpayer is allowed a deduction from adjusted gross income for education expenses if the expenses are incurred as a requirement for the taxpayer to continue employment or are incurred to maintain or improve the skills required in their job. For tax years beginning after December 31, 2011 and ending before January 1, 2017, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income.**

- d. Simon is the managing partner of a CPA firm and is required to attend 30 hours of continuing education every year. State law requires that 5 hours be in ethics training. The 5-hour ethics course costs \$400; the remaining 25 hours of continuing education cost \$1,800.

**The cost of the ethics seminar is deductible because it is required by law. The cost of the 25 hours of continuing education is deductible for two reasons. First, the 25 hours are required by law so that Simon can maintain his license to practice. Second, the courses either maintain or improve his skills as an accountant.**

44. Paula is single and works as a high school science teacher. Each summer, she travels to a national conference on high school science curriculum. She also spends one week during the summer traveling to areas in the United States to further her science knowledge. This year, she spent one week exploring the caves and rock formations around Carlsbad, New Mexico. She plans on using the knowledge and information from this trip in her earth science class. The costs of each trip are as follows:

	Science Conference	Carlsbad Trip
Airfare	\$350	\$450
Hotel	200	375
Meals	120	250
Incidentals	40	110
Rental car	75	190
Registration	100	-
Tours	-	90

Paula has asked for your advice on the deductibility of these costs as a business expense? Write her a letter explaining her allowable deduction for these costs. If any of the costs are not deductible, explain why she cannot deduct them.

**Because Paula is a high school science teacher and attends the annual science conference to improve her skills as a science teacher, the cost of the conference qualifies as a deductible business expense. The amount she can deduct as an unreimbursed business expense is:**

Airfare	\$ 350
Hotel	200
Meals (\$120 x 50%)	60
Incidentals	40
Car rental	75
Conference registration	100
Total deduction	<u>\$ 825</u>

**Unreimbursed business expenses are treated as a miscellaneous itemized deduction, which are reduced by 2% of adjusted gross income. In addition, the expense would not qualify as an education expense deductible for AGI because the expense was not paid to a qualified educational institution.**

**None of the costs that Paula incurs on her trip to Carlsbad are deductible travel expenses. Travel as a form of education is not deductible. In this case, the travel is intended to improve her job skills (a form of education) and is not deductible.**

45. Cory is the fourth-highest-paid officer of the Mast Corporation, a publicly traded corporation. The company pays Cory a salary of \$1,100,000. What amount can it deduct as salary expense? Would your answer change if Mast is a closely held corporation and the payments are typical of other companies of similar size in the industry?

**Cory's salary is subject to the \$1,000,000 limitation on compensation expense because he is one of the top four paid officers of the corporation. The corporation can deduct only \$1,000,000 of the \$1,100,000 paid to Cory as compensation expense.**

**There is no limit on the amount of compensation paid to any employee of a closely held corporation. The only requirements that must be met for the compensation to be deductible is that the payment is ordinary, necessary, and reasonable in amount. Compensation paid that is unreasonable in amount may not be deducted as a business expense. Unreasonable compensation situations generally arise when the payment is being made to a related party (i.e., a significant owner of a closely held corporation). If the payment made is unreasonable for the duties and responsibilities of the payee, it will not be considered reasonable compensation and the unreasonable portion is not deductible.**

46. Chet is an officer of the Branson Corporation a publicly traded corporation. His salary for the year is \$1,320,000, which is the sixth-highest salary at Branson. What amount can the corporation deduct as salary expense? How would your answer change if Chet's salary is the third-highest at Branson?

**Chet's salary is not subject to the \$1,000,000 limitation on compensation expense because Chet is not the CEO or one of the top four paid officers of the corporation. The corporation can deduct the \$1,320,000 paid to Chet as compensation expense.**

**If Chet has the third highest salary at Branson, then Chet's salary is subject to the \$1,000,000 limitation. Therefore, Branson can deduct only \$1,000,000 of the \$1,320,000 paid to Chet.**

47. Howard loaned \$8,000 to Bud two years ago. The terms of the loan call for Bud to pay annual interest at 8%, with the principal amount due in three years. Until this year, Bud had been making the required interest payments. When Howard didn't receive this year's payment, he called Bud and found out that Bud had filed for bankruptcy. Bud's accountant estimated that only 40% of his debts would be paid after the bankruptcy proceeding. No payments were received. In the next year, Howard received \$2,700 in full satisfaction of the debt under the bankruptcy proceeding. What deductions are allowed to Howard, assuming that the debt was

- a. Related to Howard's business?

**Because the debt is related to Howard's trade or business, he will be allowed a deduction in the current year for an estimate of the worthlessness of the debt. Since 40% is estimated to be received, a bad debt deduction for \$4,800 ( $\$8,000 \times 60\%$ ) will be allowed in the current year as an ordinary deduction.**

**Upon receipt of the \$2,700 in the next year, Howard will be allowed an additional bad debt deduction for the amount of the debt not previously deducted.**

Total debt	\$ 8,000
Amount of bad debt previously deducted	(4,800)
Amount received in payment of bad debt	(2,700)
Current year bad debt	<u>\$ 500</u>

- b. Unrelated to Howard's business?

**If the debt is unrelated to Howard's business, it is a nonbusiness bad debt. Nonbusiness bad debts are deductible as short-term capital losses in the year in which the actual amount of loss is known. No deduction is allowed for the estimated amount of the loss. Howard will have a \$5,300 ( $\$8,000 - \$2,700$ ) short-term capital loss in the year in which he receives the payment. Howard can only utilize \$3,000 of the loss in the current year. The remaining \$2,300 is carried forward and deducted in subsequent years. Note: If Howard has capital gains in the current year, he can offset part or all of the \$5,300 loss against his capital gains.**

- c. How would your answers to parts a and b change if Howard received \$3,300 in satisfaction of the debt in the next year?

**If Howard receives \$3,300 on a business bad debt, he will have to include the tax benefit he received from the overstatement of the deduction in the previous year.**

Total debt	\$ 8,000
Amount of bad debt previously deducted	(4,800)
Amount received in payment of bad debt	(3,300)
Current year gross income	<u>\$ (100)</u>

**Because the calculation results in a negative \$100, under the tax benefit rule, the deduction that was taken in the previous year will be income in the year of receipt. If the receipt is for a nonbusiness bad debt, Howard's short-term capital loss deduction in the year of receipt is \$4,700 ( $\$8,000 - \$3,300$ ).**

48. During the year, Grace Inc. has total sales of \$800,000. Based on total sales, the corporation estimates that its bad debts for the year are 2% of sales. As a result, the corporation deducts \$16,000 in bad debts for financial accounting purposes. At the end of the year, the controller reviews the accounts receivable ledger to identify uncollectible accounts. She determines that \$3,900 in accounts receivable cannot be collected. In addition, the accountant's analysis shows that the corporation has recovered \$1,400 in accounts receivable written off as a bad debt for tax purposes in the previous year. How should this information be reported for tax purposes?

**Although financial accounting permits Grace to deduct the \$16,000 estimate, for tax purposes business bad debts are allowed as a deduction when they become fully or partially uncollectible using the specific charge-off method. Using the specific charge-off method results in a \$3,900 business bad debt deduction in the current year. The recovery of the \$1,400 of bad debts deducted in the previous year must be reported as income in the current year under the tax benefit rule.**

49. The following information is from the financial records of the Adham Corporation at the end of the year:

Accounts receivable	\$ 450,000
Allowance for bad debts account	(34,000)
Net accounts receivable	<u>\$ 416,000</u>

The allowance for bad debts account is based on an aging of the corporation's accounts receivable. At the end of the year, the allowance for bad debts account was increased from \$7,000 to \$34,000. During the year, \$8,000 of the accounts receivable were specifically identified by the company as uncollectible and written off.

- a. If Adham's bad debts arise from the sale of merchandise, how should the adjustments to the allowance for bad debt accounts be reported for tax purposes?

**Financial accounting practices require Adham to use the allowance method for reporting bad debts expense. However, because tax accounting does not generally allow the use of the allowance method for deducting bad debts, Adham must use the specific charge-off method to deduct bad debts for tax reporting. As a result:**

- 1. For tax purposes, the \$8,000 of accounts receivable specifically identified at year end as uncollectible is deducted as the bad debt expense in the current year.**
  - 2. The \$27,000 (\$34,000 - \$7,000) of estimated bad debts expense added to the allowance for bad debts account for financial accounting during the year cannot be deducted for tax reporting.**
- b. If Adham uses the cash method of accounting and the bad debts expense arise from providing consulting advice, how should the adjustments to the allowance for bad debt accounts be reported for tax purposes?

**Because Adham uses the cash method of accounting, the company has not reported the taxable income related to its accounts receivable. As a result, Adham does not have a tax basis in its accounts receivable. Since Adham does not have a tax basis in its accounts receivable, Adham cannot take a bad debt deduction. Adham cannot deduct either the \$8,000 of specifically identified bad debts or the \$27,000 amount shown as an addition to the allowance for bad debts account.**

50. In addition to being an employee of Rock Hard Roofing Material, Lou owns 10% of the company's common stock. Rock Hard falls on hard times in 2015. To forestall bankruptcy, Rock Hard's employees and shareholders loan the company \$1,000,000. Lou's share of the total loan is \$50,000 - \$25,000 related to her position as an employee and \$25,000 related to her ownership of stock. In early 2016, creditors force Rock Hard into bankruptcy. Lou loses her entire \$50,000.

- a. Is Lou's loss related to a trade or business or an investment?

**Lou's loan to the company to protect her job is considered a business debt. The loss on the loan is a bad debt expense that is directly related to Lou's earning a livelihood by working for an employer. Lou's bad debt deduction is a trade or business expense of an employee.**

**The loan related to protecting Lou's stock ownership interest is considered an investment. As a result, the loss on the investment loan is considered to be a nonbusiness bad debt (i.e., short-term capital loss).**

- b. Can Lou deduct her loss as a bad debt expense?

**Lou can deduct both the business and nonbusiness bad debt. The business bad debt is deducted as an employee's business expense and the nonbusiness bad debt is deducted as a capital loss. As a capital loss, the investment deduction is limited to \$3,000 per year until the loss is fully deducted.**

51. The Cavanaugh Corporation owns the licensing rights to the Mississippi Marauders hockey apparel. For 2016, Cavanaugh has gross receipts from qualified production activities of \$6,000,000. The cost of goods sold related to these receipts is \$2,000,000 and the direct costs related to these receipts is \$225,000. Cavanaugh estimates that 15% of its \$500,000 of indirect costs are attributable to its qualified production activities. Cavanaugh's taxable income before the qualified production activities deduction is \$3,200,000.

- a. What is Cavanaugh's qualified production activities income?

**Cavanaugh Corporation's qualified production activities income is \$3,700,000 [ $\$6,000,000 - \$2,000,000 - \$225,000 - \$75,000$  ( $\$500,000 \times 15\%$ )] Cavanaugh's qualified production activities gross receipts of \$6,000,000 are reduced by its \$2,000,000 cost of goods sold, the \$225,000 direct costs attributable to the qualified production activities and \$75,000 ( $\$500,000 \times 15\%$ ) of indirect costs attributable to the qualified production activities income.**

- b. What is Cavanaugh's qualified production activities deduction?

**Cavanaugh's qualified production activities deduction for 2016 is \$288,000 ( $\$3,200,000 \times 9\%$ ). The deduction is based on the lesser of Cavanaugh's \$3,700,000 of qualified production activities income or its taxable income before the QPAD of \$3,200,000.**

- c. Assume that Cavanaugh's W-2 wages allocable to its domestic production gross receipt points (DPGR) are \$190,000. How does this impact Cavanaugh's qualified production activities deduction?

**Cavanaugh's qualified production activities deduction cannot exceed 50 percent of the W-2 wages allocable to the taxpayer's domestic production gross receipts. Because 50% of Cavanaugh's DPGR wages are \$95,000 ( $\$190,000 \times 50\%$ ), its qualified production activities deduction is limited to \$95,000.**

52. The Rollins Group produces training corporate training videos. It operates as a sole proprietorship and is 100% owned by Scott Rollins. For 2016, Rollins has gross receipts from qualified production activities of \$1,500,000. The cost of goods sold related to these receipts is \$1,200,000 and the direct costs related to these receipts is \$100,000. Rollins estimates that 30% of its indirect costs of \$50,000 are attributable to its qualified production activities. Scott's adjusted gross income is \$200,000.

- a. What is Rollins' qualified production activities income?

**Rollins qualified production activities income is \$185,000 [ $\$1,500,000 - \$1,200,000 - \$100,000 - \$15,000 (\$50,000 \times 30\%)$ ] Rollins' qualified production activities gross receipts of \$1,500,000 are reduced by \$1,200,000 cost of goods sold, the \$100,000 direct costs attributable to the qualified production activities, and \$15,000 ( $\$50,000 \times 15\%$ ) of indirect costs attributable to the qualified production activities income.**

- b. What is Rollins' qualified production activities deduction?

**Rollins qualified production activities deduction is \$16,650 ( $\$185,000 \times 9\%$ ). The deduction is based on the lesser of Rollins' \$185,000 of qualified production activities income or Scott's \$200,000 adjusted gross income.**

- c. Assume that Rollins' W-2 wages allocable to its domestic production gross receipts (DPGR) are \$150,000. How does this impact Rollin's qualified production activities deduction?

**Scott's qualified production activities deduction cannot exceed 50 percent of the domestic production gross receipts wages paid during the year. Because 50% of the Rollins Group's DPGR wages is \$75,000 ( $\$150,000 \times 50\%$ ), the W-2 wages limitation does not affect its qualified production activities deduction. Scott's qualified production activities deduction is \$16,650.**



53. KOM pays the following insurance premiums during 2016:

Auto accident and liability insurance:		
Paid 1/1/16	Coverage period 1/1/16 - 12/31/16	\$3,500
Fire, storm, and other casualty insurance:		
Paid 4/1/16	Coverage period 4/1/16 - 3/31/18	\$5,000
Business liability insurance:		
Paid 5/1/16	Coverage period 5/1/16 - 4/30/17	\$3,000

- a. If KOM uses the accrual method of accounting, what is the insurance expense deduction for 2016?

**Using the accrual method of accounting, KOM's 2016 insurance expense deduction is \$7,375 (\$3,500 + \$1,875 + \$2,000). Note: The deduction is only \$7,375 if the business liability insurance is a material expense. The auto accident and liability insurance premium is fully deductible because it relates to the 2016 tax year.**

The fire, storm, and other casualty insurance premium must be deducted ratably over the term of the policy. Because the prepaid premium relates to two tax years, the recurring item exception to the economic performance test does not apply. The 2016 deduction is \$1,875 [ $\$5,000 \times (9 \text{ months} \div 24 \text{ months})$ ].

As an accrual basis taxpayer, KOM is able to deduct the \$3,000 business liability insurance premium in the current year only if the expense meets the recurring item exception to the economic performance test. Congress intended this exception to apply primarily to accrued expenses --- those expenses that have not yet been paid but that meet the all-events test and will be paid within a reasonable time after the close of the year. To meet this exception the expense must be immaterial for both financial accounting and tax purposes and the relationship between the cost of insurance and KOM's other items of income and expenses must be immaterial. If KOM cannot meet this exception then it can only deduct \$2,000 [ $\$3,000 \times (8 \text{ months} \div 12)$ ] months in 2016. The remaining \$1,000 ( $\$3,000 - \$2,000$ ) is deducted in 2017.

- b. If KOM uses the cash method of accounting, what is the insurance expense deduction for 2016?

**KOM's 2016 insurance expense deduction is \$8,375 (\$3,500 + \$1,875 + \$3,000). The auto accident and liability Insurance premium is fully deductible because it relates to the 2016 tax year.**

The fire, storm, and other casualty insurance premium must be allocated to the tax years covered by the policy. Because the prepaid premium relates to two tax years, the prepayment creates an asset that extends substantially beyond the end of 2017 and the one year rule does not apply. The 2016 deduction is \$1,875 [ $\$5,000 \times (9 \text{ months} \div 24 \text{ months})$ ].

The business liability Insurance premium is fully deductible because the prepaid premium does not create an asset that extends substantially beyond the end of 2017 (one-year rule for prepaid expenses). The 2016 deduction is \$3,000.

54. For each of the following situations, state whether the expense related to the transaction can be deducted as an insurance expense:

- a. Baker Company pays the insurance premium to provide each of its employees with a \$50,000 whole life insurance policy. Baker and the insurance company consider the employee the owner of the policy. As owner of the policy, the covered employee designates the beneficiary of the life insurance proceeds in the event of the employee's death. Each employee's policy costs \$2,000 per year.

**The \$2,000 premium paid for each employee is not a deductible insurance expense. Only premiums on group-term life insurance qualify for deduction as life insurance expense. Because Baker does not benefit directly or indirectly from the policy, the insurance premiums are deducted as additional compensation paid to the employee (the employee must include the \$2,000 in gross income). When the employee dies, the beneficiary of the policy excludes the insurance proceeds from gross income.**

- b. Baker Company has a nondiscriminatory self-insured medical reimbursement plan for the benefit of its employees. Once a month, Baker transfers \$1,000 in cash from its general bank account to a special medical reimbursement checking account. The transfer is based on the premium an insurance company would demand to provide the same benefits to the employees.

**The \$1,000 per month deposited into the medical reimbursement checking account is not deductible as an insurance expense. The company still controls the money while it is in the checking account and can withdraw it for general business use at any time. In addition, the amount deposited represents an estimated expense that is not permitted as a tax deduction. The amount actually reimbursed to employees from the medical reimbursement account can be deducted as a medical insurance expense and excluded from the employee's gross income.**

- c. The employees' of Baker Company receive large sums of cash in the mail. To protect against loss, Baker pays a \$500 annual insurance premium for an employees fidelity bond.

**The \$500 premium paid for the employees fidelity bond is deductible as an insurance expense. The purpose of the fidelity bond is to protect Baker from losses due to an employee's dishonesty.**

- d. Baker Company is owned by Ross. Baker pays a \$1,500 annual premium for a sickness and disability income continuation insurance policy on Ross. The purpose of the policy is to give Ross \$3,500 per month if he is unable to work for Baker because he is sick or disabled.

**The \$1,500 premium paid on the income continuation policy is not deductible as an insurance expense but as compensation expense. If Ross collects the \$3,500 per month benefit because he becomes ill or disabled, the payments are excluded from his gross income. The income is excluded because when the company made the payments, the premium amount was included in Ross's income.**

55. State whether the following taxes are allowed as a current deduction for taxes paid by a business:

a. Sales tax on the purchase of a desk

**The sales tax paid on the purchase of an asset is not currently deductible. The sales tax must be added to the basis of the asset and can be recovered through a depreciation deduction. However, a sales tax imposed on a business for items benefiting only the current tax year can be deducted (i.e., supplies, small tools, other consumable items).**

b. State and local income, real estate, and personal property taxes

**State and local income, real estate, and ad valorem personal property taxes are allowed as a deduction when paid or accrued based on the taxpayer's accounting method.**

c. Federal income, estate, and gift taxes

**Federal income, estate, and gift taxes cannot be deducted.**

d. An employer's payment to the IRS of federal income and Social Security taxes withheld from an employee's wages

**Payment to the IRS of taxes withheld from an employee's wages is not deductible by the employer. The payment to the IRS represents a transfer of a payment from the employee to the IRS. The employer is just a middleman who facilitates the payment. The employer does deduct the gross wages paid to the employee. In addition, the employer can deduct the employer's share of the Social Security tax when it is paid to the IRS.**

56. Martin receives the following tax bills, related to a rental dwelling, from the county treasurer.

Special assessment for installing sidewalks and streets	\$ 12,000
Real property tax on dwelling for the 1/1/16 -- 12/31/16 property tax year, due on 10/1/16	\$ 1,500

On May 1, 2016, Martin sells the dwelling for \$70,000. His basis in the dwelling at the date of sale is \$40,000. Martin's basis in the dwelling does not reflect the property tax bills. As part of the sale contract, the buyer agrees to pay the real property taxes when they come due on October 1, 2016, but Martin has to pay the special assessment before the sale closes. What is the proper tax treatment of the tax payments?

**When Martin pays the \$12,000 special assessment for sidewalks and streets, the expenditure is added to his basis in the dwelling. As a result, the basis in the dwelling is increased to \$52,000 (\$40,000 + \$12,000). The special assessment is not a current deduction because it is not an ad valorem property tax. However, it does reduce the gain on the sale of the dwelling through the addition to basis.**

**When the rental dwelling is sold, the annual real estate tax must be allocated between the buyer and the seller of the property. Because Martin owned the property from January 1, through April 30, he can deduct 4/12 of the property taxes. As a result, Martin's real estate tax deduction is \$500 [ $\$1,500 \times (4 \div 12)$ ]. The buyer can deduct the remaining \$1,000 of real estate taxes.**

**Because the buyer pays the real estate tax and Martin is allowed a deduction for taxes he did not directly pay, the sales price of the dwelling is adjusted. The sale price is increased by the amount of Martin's share of the real estate tax liability assumed by the buyer of the dwelling. The sale price of the residence, after adjustment for the real estate tax is \$70,500 (\$70,000 + \$500). As a result of the above adjustments, Martin's income is increased by \$500 (by increasing the gain on the sale of the building) and his deductions are increased by \$500, resulting in a zero net effect on taxable income.**

**Martin has a gain of \$18,500 on the sale of the building:**

Amount realized	$(\$70,000 + \$500)$	\$ 70,500
Adjusted basis	$(\$40,000 + \$12,000)$	(52,000)
Gain on sale		<u>\$ 18,500</u>

**INSTRUCTORS NOTE:** Some students might realize that while the net effect on Martin's taxable income is zero, Martin could benefit because the tax rate for the income portion (i.e., the gain if held more than 12 months) is taxed at 0%, 15%, or 20% depending on the taxpayer's marginal tax rate, while his real estate taxes might be deducted at a higher marginal tax rate depending on Martin's income.

57. The Kimpton Corporation pays the following taxes during 2016:

Federal taxes withheld from employees	\$26,000
State taxes withheld from employees	9,000
Social Security withheld from employees	4,850
Kimpton's share of Social Security taxes	4,850
Federal income tax paid in 2016 with 2015 tax return	1,790
Federal income tax paid in 2016	12,340
Real estate taxes	6,750
State income taxes paid in 2016	5,720
State income taxes paid in 2016 with 2015 return	690
Sales tax on capital acquisitions	2,700
Sales tax on supplies	3,250

Also, the county treasurer notifies Kimpton that it is being assessed a special real estate tax of \$64,000 for upgrading the sidewalks and sewer connections in the area. The special tax is payable in 4 yearly installments of \$16,000. What amount can Kimpton deduct for taxes paid in 2016?

**The Kimpton Corporation can only deduct the taxes that it actually paid in 2016. As an employer, Kimpton is required by the federal government to withhold federal income taxes and Social Security taxes from its employees and remit them to the government. The state government also requires Kimpton to withhold state income taxes. The federal and state taxes withheld from its employees are not deductible by Kimpton. The company can deduct the following taxes:**

Kimpton's share of Social Security taxes	\$ 4,850
Real estate taxes	6,750
State income taxes paid in 2016	5,720
State income taxes paid in 2016 with 2015 return	690
Sales tax on supplies	3,250
<b>Total tax deduction</b>	<b><u>\$ 21,260</u></b>

**The sales tax paid on the capital acquisitions must be added to the basis of the asset and is deducted through depreciation. The special assessment is not deductible because it is not an ad valorem tax; it is added to the basis of Kimpton's property as it is paid. For 2016, Kimpton increases the basis of its property by \$16,000.**

58. Kuerten Manufacturers sue the Rafter Corporation for patent infringement. The court upholds Kuerten's claim and requires Rafter to pay Kuerten \$2,000,000 in damages. However, the court does not allow Kuerten to recover its \$100,000 in legal expenses from Rafter. Can Kuerten deduct the \$100,000 in legal expenses? Would your answer change if Kuerten were allowed to collect the legal fees from Rafter?

**Kuerten can deduct the cost of its legal fees in suing Rafter Corporation for patent infringement. The legal fees are considered an ordinary and necessary business expense. The fact that the court did not allow the company to collect the fees from Rafter does not impact Kuerten's ability to deduct the legal expenses.**

**If Kuerten is reimbursed for the legal fees, the legal fees are still deductible. However, Kuerten will have to include the \$100,000 in income.**

59. Can Joe Corporation deduct the following expenses related to its business?

- a. Legal fee paid (\$40,000) to acquire a competing chain of stores

**The corporation must capitalize the \$40,000 legal fee. The legal fee relates to acquiring the assets of a competing chain of stores and is not deductible. The benefit Joe Corporation derives from acquiring the stores extends substantially beyond the end of the tax year. Therefore, the legal fee must be capitalized.**

- b. Legal fee paid (\$12,000) to determine whether it should become an S corporation

**The legal fee paid to investigate whether Joe's should become an S corporation is deductible because it is an ordinary business expense.**

- c. Legal fee paid (\$5,000) to defend the company's president in a lawsuit filed by a disgruntled customer

**The \$5,000 legal fee paid to defend the company's president is a valid business expense. The origin of the expense is business related and the expense is an ordinary and necessary expense of doing business. Many lawsuits that are filed against a business include one or all of the company's officers as defendants.**

- d. Legal fee paid (\$500) to defend title to a vacant lot Joe is holding for construction of a storage building for use in its business.

**The legal fees related to establishing or defending title to property are not deductible. The corporation should capitalize the \$500 legal fee as part of its basis in the vacant lot.**

- e. Legal fee paid (\$2,500) to defend against damages suffered by a customer who was injured when he fell in the company's store.

**The legal fee originated from a claim against the business. Because the fee is related to protecting the business and its assets, there is a business purpose for the expense. Thus, the corporation can deduct the \$2,500 legal fee as a business expense.**

60. Diane and Peter were divorced in 2016. The divorce agreement states that Peter is to have custody of their son, Stewart, and that Peter will be entitled to the dependency exemption. In addition, Diane is required to pay Peter \$12,000 per year until Stewart turns 18 years of age, when the yearly amount will be reduced to \$8,000. What is Diane's allowable deduction, and how should it be deducted on her return?

**Diane is allowed a deduction for adjusted gross income (alimony) for only \$8,000 of \$12,000 she pays to Peter (who includes the \$8,000 in his gross income). Because the payment will be reduced from \$12,000 to \$8,000 when Stewart turns 18, only \$8,000 is considered alimony and \$4,000 is child-support. The child support payment is not deductible by Diane nor is it taxable to Peter.**

61. During the current year, Carson pays \$1,500 in child support and \$2,000 in alimony to his ex-wife. What is Carson's allowable deduction, and how should it be deducted on his tax return?

**Carson is allowed a deduction for adjusted gross income for the \$2,000 of alimony he paid to his ex-wife (who includes the alimony in her gross income). The child-support payment is not deductible by Carson nor is it taxable to his ex-wife.**



62. Mona works for Leonardo Corporation as a sales representative. Leonardo gives her a travel allowance of \$350 per month. During the current year, she spends the following amounts on valid travel expenses:

Transportation	\$ 2,700
Meals	1,200
Lodging	1,800
Entertainment	300

How should Mona treat the \$350 per month travel allowance and the travel costs she incurs if

- a. Leonardo's reimbursement plan is an accountable plan?

**Mona receives \$4,200 ( $\$350 \times 12$ ) of reimbursement for \$6,000 of expenses, putting her in a net deduction situation. Mona must include the \$4,200 in her gross income.**

**With an accountable plan, Mona is allowed a deduction for adjusted gross income for the \$4,200 of reimbursed expenses. The \$1,800 of unreimbursed expenses are deductible as miscellaneous itemized deductions. The unreimbursed portion of each expense is 30% ( $\$1,800 \div \$6,000$ ). Mona is subject to the 50% limit on meals and entertainment for her itemized deductions, leaving her a deduction of \$1,575:**

Transportation ( $\$2,700 \times 30\%$ )	\$ 810
Meals ( $\$1,200 \times 30\% \times 50\%$ )	180
Lodging ( $\$1,800 \times 30\%$ )	540
Entertainment ( $\$300 \times 30\% \times 50\%$ )	45
Total miscellaneous itemized deduction	<u>\$ 1,575</u>

**The \$1,575 employee business expense is added to any other allowable miscellaneous itemized deductions and the total is deductible to the extent it exceeds 2% of Mona's adjusted gross income.**

- b. Leonardo's reimbursement plan is a nonaccountable plan?

**With a nonaccountable reimbursement plan, the \$4,200 reimbursement must be included in Mona's gross income. Mona is not allowed to deduct any of her expenses for adjusted gross income. Mona can only deduct the costs as miscellaneous itemized deductions, subject to the 2% of adjusted gross income limitation. The meals and entertainment expenses are subject to the 50% limit, resulting in an itemized deduction of \$5,250:**

Transportation	\$ 2,700
Meals ( $\$1,200 \times 50\%$ )	600
Lodging	1,800
Entertainment ( $\$300 \times 50\%$ )	150
Total itemized deduction	<u>\$ 5,250</u>

**The \$5,250 employee business expense is added to any other allowable miscellaneous itemized deductions and the total is deductible to the extent it exceeds 2% of Mona's adjusted gross income.**

63. Alvin is an employee of York Company. During the year, he incurs the following employment-related expenses:

Travel	\$ 4,000
Meals	2,400
Lodging	2,500
Entertainment	1,100

- a. How should Alvin treat these expenses if York Company has an accountable employee business expense reimbursement plan and Alvin is reimbursed

1. \$ 9,000?

**Alvin is in a net deduction situation. The \$9,000 is included in gross income and Alvin is allowed a deduction for adjusted gross income (AGI) for the \$9,000 of reimbursed expenses. The remaining \$1,000 of expenses are deductible as itemized deductions, subject to the 50% meals and entertainment limitation and the overall 2% of AGI limit for all miscellaneous itemized deductions. The from AGI deduction before the 2% limit is \$825, calculated as follows:**

**Reimbursement ratio =  $\$9,000 \div \$10,000 = 90\%$   
Unreimbursed percentage = 10%**

Travel (\$4,000 x 10%)	\$ 400
Meals (\$2,400 x 10% = \$240 x 50%)	120
Lodging (\$2,500 x 10%)	250
Entertainment (\$1,100 x 10% = \$110 x 50%)	55
<b>Total itemized deduction</b>	<b><u>\$ 825</u></b>

2. \$ 10,000?

**Because the plan is accountable and the reimbursement equals actual expenses, no gross income is reported and no deductions are taken.**

3. \$ 11,000?

**Because this is an accountable plan, the \$1,000 excess reimbursement is included in Alvin's gross income and no deductions are allowed.**

- b. How would your answer to part a change if York's reimbursement plan were nonaccountable?

**With a nonaccountable plan, any reimbursement is included in gross income. None of the expenses are deductible for adjusted gross income. The expenses are deducted as miscellaneous itemized deductions, subject to the 50% meals and entertainment limitation and the 2% of AGI limit. In each case, the from AGI deduction before the 2% limit is \$8,250, calculated as follows:**

Travel	\$ 4,000
Meals (\$2,400 x 50%)	1,200
Lodging	2,500
Entertainment (\$1,100 x 50%)	550
<b>Total itemized deduction</b>	<b><u>\$ 8,250</u></b>

- c. How would your answer to part a change if Alvin were self-employed (i.e., receiving no reimbursements)?

**If Alvin is self-employed, the expenses are considered to be trade or business expenses and therefore, deductible FOR AGI. However, the meals and entertainment limitations still apply and Alvin's deduction will be \$8,250 as calculated in part (b) above. However, as FOR AGI deductions they are not subject to any further limitation; that is, the 2% AGI limit is only for unreimbursed employee business expenses.**

64. The Ballaraat Corporation is cutting costs. The vice president of finance has asked the tax department to justify the company's continued use of an accountable employee expense reimbursement plan. You are the manager of the tax department. Prepare a letter to the vice president of finance explaining the tax consequences of not using an accountable employee expense reimbursement plan. Also discuss any non-tax benefits of maintaining the plan.

**An accountable reimbursement plan is one in which employees are required to make an adequate accounting of their allowable expenses with the employer and return any excess reimbursements to the employer. The significance of an accountable plan is that all reimbursements from the plan are deductible for AGI. In addition, the 50% meals and entertainment limitation does not apply to reimbursed expenses. Only unreimbursed expenses are deducted as miscellaneous itemized deductions, subject to the 2% of AGI limitation. If a reimbursement plan is not accountable, all deductions must be taken as miscellaneous itemized deductions, subject to the 2% and 50% limitations. Therefore, by not using an accountable plan, the employer is shifting part of the business costs to the employee. Because the expenses are considered deductions from AGI instead of for AGI, the employee, not the employer, must reduce any meal and entertainment expenses by 50% and the expenses must be reduced by 2% of adjusted gross income. Therefore, even if the employee's reimbursement for the year equaled their expenses, there is a tax cost to the employee. If the employee cannot itemize, the tax cost is even greater.**

**Some of the nontax benefits the vice president of finance should consider are that by having an accountable plan, the company has greater internal control over their business expenses. If the company only provides a monthly stipend for business expenses, the company has no record of how or if the stipend is being spent on attracting new business and/or maintaining old business relationships. In fact, due to the tax disadvantages, employees could be cutting back on entertaining clients and "pocketing" part of the monthly stipend. Another problem the company might face is attracting and retaining quality employees. Because, of the negative tax consequences associated with a nonaccountable plan, the company will have to pay its employees either higher salaries or higher monthly stipends. By paying higher salaries, the company also indirectly increases the cost of its fringe benefits (e.g., pension contribution, Social Security tax).**

65. Evelyn is single and a self-employed engineer. During 2016, Evelyn's income from her engineering business is \$55,000. Evelyn pays \$3,100 for her medical insurance policy.

- a. How should the medical insurance policy payment be reflected on Evelyn's 2016 tax return?

**Evelyn is allowed a deduction for adjusted gross income for the cost of the policy.**

- b. What is Evelyn's 2016 self-employment tax deduction?

**Evelyn is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. Because this deduction reduces her self-employment income, the amount of self-employment income subject to the tax is 92.35% of self-employment income. Her self-employment income subject to the tax is \$50,793. Because she is under the self-employment tax ceiling of \$118,500 in 2016, she will pay a tax of 15.3% on the entire \$50,793. Her tax is \$7,771 and her deduction for adjusted gross income is \$3,886.**

<b>Net Self-employment income (\$55,000 x 92.35%)</b>	<b><u>\$ 50,793</u></b>
<b>Self-employment tax (\$50,793 x 15.3%)</b>	<b><u>\$ 7,771</u></b>
<b>Deduction for one-half of SE tax (\$7,771 x 50%)</b>	<b><u>\$ 3,886</u></b>

66. Thomas is single and a self-employed architect. During 2016, Thomas's income from his business is \$144,000. He also pays \$2,200 for a medical insurance policy.

- a. How should the medical insurance policy payment be reflected on his 2016 tax return?

**Thomas is allowed a deduction for adjusted gross income for the cost of the policy.**

- b. What is his 2016 self-employment tax deduction?

**Thomas is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. Because this deduction reduces his self-employment income, the amount of self-employment income subject to the tax is 92.35% of self-employment income. His self-employment income subject to the tax is \$132,984 (\$144,000 x 92.35%). Because he is over the self-employment tax ceiling of \$118,500 in 2016, he will pay a tax of 12.4% (6.2% x 2) on \$118,500, plus 2.9% (1.45% x 2) on \$132,984. His self-employment tax is \$18,551 and his deduction for adjusted gross income is \$9,276.**

Net Self-employment income (\$144,000 x 92.35%)		<u><b>\$132,984</b></u>
OASDI on \$118,500 x 12.4%	\$ 14,694	
MHI on \$132,984 x 2.9%	<u>3,857</u>	
Total self-employment tax		<u><b>\$ 18,551</b></u>
Deduction for one-half of SE tax (\$18,551 x 50%)		<u><b>\$ 9,276</b></u>

- c. Assume that Thomas' income from his business is \$228,000. What is his 2016 self-employment tax deduction?

**Thomas is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. Because this deduction reduces his self-employment income, the amount of income subject to self-employment tax is 92.35% of self-employment income. His self-employment income subject to the tax is \$210,558 (\$228,000 x 92.35%). Because he is over the self-employment tax ceiling of \$118,500 in 2016, he will pay a tax of 12.4% (6.2% x 2) on \$118,500 plus 2.9% (1.45% x 2). In addition, because his income exceeds \$200,000 he will pay an additional HI tax of \$95 [(\$210,558 - 200,000) x .9%] on the amount that exceeds \$200,000. His self-employment tax is \$20,895 and his deduction for adjusted gross income is \$10,447.**

Net Self-employment income (\$228,000 x 92.35%)		<b>\$210,558</b>
OASDI on \$118,500 x 12.4%	\$14,694	
MHI on \$210,558 x 2.9%	6,106	
HI on (\$210,558 - 200,000) x .9%	<u>95</u>	
Total Self-employment tax		<u><b>\$20,895</b></u>
Deduction for one-half of SE tax (\$20,895 x 50%)		<u><b>\$10,447</b></u>

- d. Assume the same facts as in part a, except that Thomas is married, his wife's salary is \$30,000, and they are covered by a medical policy from her employer.

**If his wife's employer provides her with medical coverage, no deduction is allowed for adjusted gross income for his policy. The \$2,200 policy cost is an itemized medical expense deduction (see Chapter 8).**

67. Carlos and Angela are married, file a joint return, and both are 42 years old. During the current year, Carlos's salary is \$70,000. Neither Carlos nor Angela is covered by an employer-sponsored pension plan. Determine the maximum IRA contribution and deduction amounts in each of the following cases:

- a. Angela earns \$28,000, and their adjusted gross income is \$106,000.

**Both taxpayers have earned income. Because neither Carlos nor Angela is covered by a pension plan, they each can contribute and deduct up to \$5,500. Thus, they may contribute and deduct a total of \$11,000 for adjusted gross income.**

- b. Angela does not work outside the home, and their adjusted gross income is \$75,000.

**Even though Angela does not have earned income, they are allowed to contribute and deduct a maximum of \$11,000 for adjusted gross income because their total earned income exceeds \$11,000. However, they must establish separate IRA accounts and the total amount contributed to each account cannot exceed \$11,000.**

- c. Assume the same facts as in part a, except that Carlos is 52, Angela is 48 and both are covered by an employer-sponsored pension plan.

**Angela is allowed to contribute \$5,500 to her IRA. Because Carlos is at least 50 years of age, he is allowed to contribute \$6,500 to an IRA account. Because both are covered by an employer-sponsored pension plan, the amount of the IRA deduction is reduced when their adjusted gross income reaches \$98,000. The deduction is fully phased out when adjusted gross income exceeds \$118,000. The maximum contribution amount is not affected by this limitation, only the deductible amount of the contribution. Angela's \$5,500 deduction must be reduced by 40%  $[(\$106,000 - \$98,000) \div \$20,000]$  and leaves her with an allowable deduction for adjusted gross income of \$3,300  $[\$5,500 - (\$5,500 \times 40\%)]$ . Carlos's \$6,500 deduction is also reduced by 40%  $[(\$106,000 - \$98,000) \div \$20,000]$  and leaves him with an allowable deduction for adjusted gross income of \$3,900  $[\$6,500 - (\$6,500 \times 40\%)]$ . Their total deduction for AGI is \$7,200  $(\$3,300 + \$3,900)$ .**



- d. Assume the same facts as in part a, except that Carlos is covered by an employer-sponsored pension plan.

**Because Carlos is covered by an employer-sponsored pension plan, the amount of his IRA deduction is reduced because their adjusted gross income exceeds the \$98,000 phase-out level. Therefore, he may contribute \$5,500 but the amount he can deduct must be reduced by 40%  $[(\$106,000 - \$98,000) \div \$20,000]$ . This leaves an allowable deduction for adjusted gross income of \$3,300  $[\$5,500 - (\$5,500 \times 40\%)]$ .**

**Because Angela is not covered by an employer-sponsored pension plan, and their total adjusted gross income does not exceed \$184,000, she may contribute \$5,500 and deduct the entire contribution for adjusted gross income. Therefore, their maximum contribution is \$11,000 and their maximum deduction is \$8,800.**

**Instructor's Note: Carlos's deductible contribution will be fully phased-out when their AGI exceeds \$118,000. When their AGI exceeds \$184,000, Angela's deductible contribution would begin to be phased-out and would be fully phased-out when AGI exceeds \$194,000.**

68. Lois and Kam are married and file a joint return. Lois earns \$64,500 and Kam earns \$40,000. Their adjusted gross income is \$111,000. Determine the maximum IRA contribution and deduction in each of the following cases:

- a. Neither Lois nor Kam is covered by an employee-sponsored pension plan.

**Both taxpayers have earned income. Because neither Lois nor Kam are covered by a pension plan, they each can contribute and deduct up to \$5,500. Thus, they may contribute and deduct a total of \$11,000 for adjusted gross income.**

- b. Both Kam and Lois are covered by an employee-sponsored pension plan.

**They both can contribute \$5,500 to an IRA account. Because both are covered by an employer-sponsored pension plan, the amount of the IRA deduction is reduced when their adjusted gross income reaches \$98,000. The deduction is fully phased out when adjusted gross income exceeds \$118,000. The maximum contribution amount is not affected by this limitation, only the deductible amount of the contribution. Each \$5,000 deduction must be reduced by 65%  $[(\$111,000 - \$98,000) \div \$20,000]$ . This leaves both Kam and Lois with an allowable deduction for adjusted gross income of \$1,925  $[\$5,500 - (\$5,500 \times 65\%)]$ . Their total deduction for AGI is \$3,850  $(\$1,925 \times 2)$ .**

- c. Assume that only Kam is covered by an employer-sponsored pension plan and that their adjusted gross income is \$154,000.

**Both Kam and Lois are allowed to contribute \$5,500 to their IRA accounts. Because Kam is covered by an employer-sponsored pension plan and their adjusted gross income exceeds \$118,000, he is not eligible to deduct his contribution. However, because Lois is not covered by an employer-sponsored pension plan, her contribution is fully deductible if their adjusted gross income is less than \$184,000. Since their adjusted gross income is less than \$184,000, Lois can take deduct the entire \$5,500 contribution.**

69. Kathy, who is single and 25, inherited \$7,000 from her grandmother. A coworker has suggested that Kathy open an Individual Retirement Account with the \$7,000. Her friend says that an IRA is a great way to save because you don't have to pay tax on the income from the investment and you get a tax deduction for your contribution. Write a letter to Kathy explaining whether her friend's advice is correct. To the extent her friend's information is inaccurate, provide Kathy with the correct tax treatment and explain how different facts may lead to different tax treatments.

**Part of the information Kathy's co-worker has provided is accurate. An IRA is an excellent vehicle to save and the income does accumulate tax-free. The information concerning the amount she can contribute and whether she can receive a tax deduction needs to be clarified. Kathy is only allowed to *contribute* up to \$5,500 per year, not \$7,000, into an individual retirement account. Assuming Kathy is not covered by an employer provided retirement plan, she is allowed to deduct the entire \$5,500. If she is covered by an employer-provided retirement plan, her allowable deduction is phased-out over a \$10,000 range beginning when her adjusted gross income exceeds \$61,000. Therefore, when her adjusted gross income exceeds \$71,000 she receives no tax benefit for her contribution.**

**Alternatively, if she is covered by a qualified employer-sponsored pension plan and her adjusted gross income exceeds \$70,000, she could make a \$5,500 nondeductible contribution to a Roth IRA. Kathy is allowed to make a contribution to a Roth IRA if her adjusted gross income does not exceed \$117,000. If her adjusted gross income exceeds this amount, the amount she can contribute is phased out ratably until no contribution is allowed when her adjusted gross income equals \$132,000.**

70. Chanda is 36, single, and an active participant in a qualified employee pension plan. Determine the maximum Roth IRA contribution that she can make in each of the following cases:

- a. Her adjusted gross income for the year is \$66,000.

**A single taxpayer with an adjusted gross income of less than \$117,000 is allowed to make a \$5,500 nondeductible contribution to a Roth IRA. Therefore, the maximum Chandra is allowed to contribute to her Roth IRA is \$5,500. This assumes that she did not make any contributions to other IRA accounts during the year.**

- b. Her adjusted gross income for the year is \$120,000.

**When a taxpayer's adjusted gross income exceeds \$117,000, the amount that can be contributed to a Roth IRA is phased out ratably until no contribution is allowed when adjusted gross income equals \$132,000. The amount of Chandra's Roth IRA deduction must be reduced because her adjusted gross income exceeds the \$117,000 phase-out level. Therefore, she must reduce the amount she contributes by 20%  $[(\$120,000 - \$117,000) \div \$15,000]$  and can contribute only \$4,400  $[\$5,500 - (\$5,500 \times 20\%)]$  to her Roth IRA.**

- c. Her adjusted gross income for the year is \$135,000.

**Because Chandra's adjusted gross income exceeds \$132,000, she is not allowed to make a contribution to a Roth IRA.**

- d. Her adjusted gross income for the year is \$65,000, and she makes a \$3,000 contribution to a deductible IRA account.

**The maximum amount that a taxpayer can contribute to all of his or her IRA accounts is \$5,500. Because Chandra made a \$3,000 contribution to another IRA account, the maximum amount that she can contribute to her Roth IRA is \$2,500  $(\$5,500 - \$3,000)$ .**

71. Kevin and Jill are married and file a joint return. Kevin is 52, and is not an active participant in a qualified employee pension plan, while Jill is 48 and is an active participant in a qualified employee pension plan. Determine the maximum Roth IRA contribution that can be made in each of the following cases:

- a. Their adjusted gross income for the year is \$125,000.

**Generally, married taxpayers with an adjusted gross income of less than \$184,000 may each contribute \$5,500 to a Roth IRA. When a married couple's adjusted gross income exceeds \$184,000, the amount that can be contributed is phased out ratably until no contribution is allowed when adjusted gross income equals \$194,000. However, a taxpayer who is at least 50 years of age can make an additional contribution of \$1,000. Therefore, the maximum Roth IRA contribution Kevin can make is \$6,500. Jill's maximum contribution to her Roth IRA is \$5,500 (total of \$12,000). This assumes that they did not make any contributions to other IRA accounts during the year.**

- b. Their adjusted gross income for the year is \$185,000.

**When a married taxpayer's adjusted gross income exceeds \$184,000, the amount that each can contribute to a Roth IRA is phased out ratably until no contribution is allowed when adjusted gross income equals \$194,000. The amount of their Roth IRA deduction must be reduced because their adjusted gross income exceeds the \$184,000 phase-out level. Therefore, they must reduce the total amount they contribute by 10%  $[(\$185,000 - \$184,000) \div \$10,000]$ . Kevin can contribute \$5,850  $[\$6,500 - (\$6,500 \times 10\%)]$  to his Roth IRA and Jill can contribute \$4,950  $[\$5,500 - (\$5,500 \times 10\%)]$  to her Roth IRA.**

- c. Their adjusted gross income for the year is \$192,000.

**When a married taxpayer's adjusted gross income exceeds \$184,000, the amount that each can contribute to a Roth IRA is phased out ratably until no contribution is allowed when adjusted gross income equals \$194,000. The amount of their Roth IRA deduction must be reduced because their adjusted gross income exceeds the \$184,000 phase-out level. Therefore, they must reduce the total amount they contribute by 80%  $[(\$192,000 - \$184,000) \div \$10,000]$ . Kevin can contribute \$1,300  $[\$6,500 - (\$6,500 \times 80\%)]$  to his Roth IRA and Jill can contribute \$1,100  $[\$5,500 - (\$5,500 \times 80\%)]$  to her Roth IRA.**

- d. How would your answers to parts a and b change if Kevin made the maximum allowable contribution to his deductible IRA.

**In part a, because Kevin is at least 50 years of age, is not covered by an employer-sponsored pension plan, and their total adjusted gross income does not exceed \$184,000, he may contribute \$6,500 to an IRA and deduct the entire contribution for adjusted gross income. Because the maximum amount that Kevin can contribute to all of his IRA accounts is \$6,500, he cannot make a contribution to a Roth IRA in part a. Assuming Kevin limited his contribution in part b to his maximum deduction (\$5,850), he would also be entitled to contribute \$650 (the phase-out calculation is the same as in part b) to a Roth IRA.**

**Jill cannot make a deductible contribution to an IRA because she is covered by an employer-sponsored plan. Therefore, in part a, Jill can make a \$5,500 contribution to her Roth IRA. In part b, Jill's contribution to a Roth IRA is \$4,950.**

**Instructor's Note: Because the tax treatment of a Roth IRA is better (qualified distributions are tax-free) than a nondeductible IRA, Jill should always contribute (assuming she can) to a Roth IRA instead of a nondeductible IRA.**

72. Alex and Carmin are married and have two children, ages 6 and 3. Their adjusted gross income for the year is \$123,000.

- a. What is maximum amount they can contribute to each child's Coverdell Education Savings Account for the year?

**All taxpayers can make a nondeductible contribution of up to \$2,000 to an Education IRA for the benefit of an individual who is not 18 years of age. However, the total amount contributed to an individual's Coverdell Education Savings Account is limited to \$2,000. For married taxpayers, this amount is phased out ratably when their adjusted gross income exceeds \$190,000 and is fully phased-out when adjusted gross income exceeds \$220,000. Because Alex and Carmin's adjusted gross income is less than \$190,000, they can contribute \$2,000 to each child's education savings account.**

- b. If their adjusted gross income is \$208,000, what is the maximum contribution that can be made to each child's education savings account?

**Because their adjusted gross income exceeds \$190,000 the amount that they can contribute to each education savings account is phased out ratably until no contribution is allowed when adjusted gross income equals \$220,000. Therefore, they must reduce the total amount they contribute to each education savings account by 60%  $[(\$208,000 - \$190,000) \div \$30,000]$  and they can contribute \$800  $[\$2,000 - (\$2,000 \times 60\%)]$  to each education savings account.**

73. Gary and Patricia are divorced and have three children, ages 9, 6, and 2. Patricia has custody of the children and is entitled to the dependency exemption for each child. Their adjusted gross incomes are \$48,000 and \$61,000 respectively. During the current year, Gary contributes \$1,500 to each child's Coverdell Education Savings Account. What is the maximum amount that Patricia can contribute to her children's education savings account?

**All taxpayers can make a nondeductible contribution of up to \$2,000 to education savings account education IRA for the benefit of an individual who is not 18 years of age. However, the total amount contributed to an individual's Coverdell Education Savings Account is limited to \$2,000. Because Gary has already contributed \$1,500 to each child's account, the maximum amount that Patricia can contribute to each child's education savings account is \$500.**

74. Lleyton is single and has adjusted gross income for 2016 of \$58,000. He works as a marketing manager for a national clothing store. During the year he enrolls in two business courses at Heath University. Even though the courses improve his job skills, his company does not reimburse him for the \$1,500 in tuition.

a. How should Lleyton account for the education expense on his tax return?

**Individuals are allowed to deduct education expenses if the education expense meets either of the following requirements: (1) the education is required by law or by the employer for the taxpayer to retain the taxpayer's job or (2) the expense maintains or improves the skills required in the taxpayer's trade or business. Because the courses improve his job skills and Lleyton is not reimbursed for the tuition he can deduct the expense on his tax return.**

**For tax years beginning after December 31, 2011 and ending before January 1, 2017, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income. Therefore, some taxpayers can deduct qualified higher education expenses even if the expenses are not incurred as a requirement for the taxpayer to continue employment or do not maintain or improve the skills required in their job. Because Lleyton's AGI is less than \$65,000, he has a deduction for adjusted gross income of \$1,500.**

- b. Assume same the same facts as in part a, except that his tuition is \$4,200.

**Because the education expense exceeds \$4,000, Lleyton can only deduct \$4,000 for adjusted gross income. The remaining \$200 (\$4,200 - \$4,000) is deductible as a miscellaneous itemized deduction that must be reduced by 2% of adjusted gross income, \$1,160 (2% x \$58,000), so no portion of the expense is deductible.**

- c. Assume the same facts as in part a, except that his adjusted gross income is \$82,000.

**Because Lleyton's adjusted gross income is greater than \$80,000 he cannot deduct any portion of the education expense as a deduction for adjusted gross income. The \$1,500 is deductible as a miscellaneous itemized deduction that must be reduced by 2% of adjusted gross income \$1,640 (2% x \$82,000), so no portion of the expense is deductible.**

- d. Assume the same facts as in part a, except that his adjusted gross income is \$73,000 and his tuition is \$3,200.

**Because Lleyton's adjusted gross income is greater than \$65,000 and less than \$80,000, he can only deduct \$2,000 of the education expense as a**

**deduction for adjusted gross income. The remaining \$1,200 (\$3,200 - \$2,000) is deductible as a miscellaneous itemized deduction that must be reduced by 2% of adjusted gross income, \$1,460 (2% x \$73,000), so no portion of the expense is deductible.**

75. Martha graduated from Tassle Tech and immediately started working as an accountant for Creedon Industries. To finance her college education, she borrowed \$23,000 from a local bank pays \$1,800 of interest expense during the year. Her adjusted gross income for the year is \$39,000.

- a. What amount can Martha deduct as student loan interest?

**Martha can deduct the \$1,800 of student loan interest for adjusted gross income. Interest paid on a qualified education loan during the first 60 months that is required to be repaid is deductible for adjusted gross income. A qualified education loan is one that is used to pay for tuition, fees, room and board, and other necessary education expenses. The maximum amount of interest that can be deducted is the lesser of \$2,500 or the amount of interest paid. Any amount in excess of the maximum is considered personal interest and is not deductible. The interest deduction is phased out ratably for unmarried taxpayers with adjusted gross income between \$65,000 and \$80,000.**

- b. Assume that Martha borrowed \$32,000 to finance her education and paid interest during the year of \$2,700. What amount can she deduct as student loan interest?

**Martha can only deduct \$2,500 of the interest for adjusted gross income. The remaining \$200 (\$2,700 - \$2,500) is considered personal interest and is not deductible.**

- c. Assume the same facts as in part a, except that Martha's adjusted gross income is \$70,000. What amount can she deduct as student loan interest?

**When a taxpayer's adjusted gross income exceeds \$65,000, the maximum amount of student loan interest that can be deducted is phased-out ratably over a \$15,000 range. Since Martha's adjusted gross income is greater than \$65,000, the maximum interest deduction of \$2,500 must be reduced by 33.33%  $[(\$70,000 - \$65,000) \div \$15,000]$ . Therefore, the maximum amount of student loan interest she can deduct is \$1,200  $[\$1,800 - \$600 (\$1,800 \times 33.33)]$ . The remaining \$600  $(\$1,800 - \$1,200)$  of interest is treated as nondeductible personal interest.**



76. Simon graduated from Lessard University last year. He financed his education by working part-time and borrowing \$16,000. During the current year, he pays \$1,400 of interest on his student loan.

- a. What amount can Simon deduct as student loan interest if his adjusted gross income is \$33,000?

**Simon can deduct the \$1,400 of student loan interest for adjusted gross income. A qualified education loan is one that is used to pay for tuition, fees, room and board, and other necessary expenses. The maximum amount of interest that can be deducted is the lesser of \$2,500 or the interest paid. Any amount in excess of the maximum is considered personal interest (discussed in Chapter 8) and is not deductible. The interest deduction is phased out ratably for single taxpayers with adjusted gross income between \$65,000 and \$80,000.**

- b. What amount can Simon deduct as student loan interest if his adjusted gross income is \$77,000?

**The maximum amount of student loan interest that can be deducted is phased-out ratably when adjusted gross income exceeds \$65,000. Since his adjusted gross income is greater than \$65,000, the amount that he can deduct must be reduced by 80%  $[(\$77,000 - \$65,000) \div \$15,000]$ . This leaves him with an allowable deduction for adjusted gross income of \$280  $[\$1,400 - \$1,120 (\$1,400 \times 80\%)]$ . The remaining \$1,120  $(\$1,400 - \$280)$  of interest is personal and is not deductible.**

**The amount of the student loan interest that is subject to the phase-out is the lesser of the interest paid or \$2,500. In this example, the amount of interest paid, \$1,400 is less than \$2,500, so \$1,400 is used in the calculation.**

77. Myron graduates from college this year and lands a job with the Collingwood Corporation in Dallas. After accepting the job, he flies to Dallas to find an apartment. Myron uses \$2,000 his grandmother gave him as a graduation gift to pay a moving company to transport his household goods from Atlanta. He doesn't drive directly to Dallas but goes via Panama City to vacation with friends. In going to Dallas via Panama City, he incurs the following expenses:

Transportation of household goods	\$2,000
Lodging	675
Meals	330
Mileage (1,560 miles)	
House-hunting trip:	
Airfare	325
Lodging	165
Meals	110

The expenses listed include \$375 for lodging and \$230 for meals in Panama City. The direct mileage between Atlanta and Dallas is 1,340 miles. When Myron arrives in Dallas, he is informed that the moving van has mechanical problems and will not arrive for two days. Instead of sleeping on the apartment floor, he stays in a local hotel, paying \$55 per night; he also spends \$60 for meals. What is Myron's allowable moving deduction?

**Myron can deduct \$2,555 of moving expenses for adjusted gross income.**

Transportation of household goods	\$ 2,000
Lodging during move (\$675 - \$375)	300
Transportation (1,340 x \$.19)	255
<b>Total</b>	<b><u>\$ 2,555</u></b>

**Myron can only deduct his direct moving expenses. Direct moving expenses include the cost of moving household goods and personal effects to the new residence, and the transportation and lodging costs of Myron moving from his old residence to his new residence. His mileage is deductible at \$.19 per mile. However, Myron can only deduct the direct mileage from Atlanta to Dallas. The additional mileage via Panama City is personal. The housing hunting expenses, the hotel costs upon arriving in Dallas, and all his meal expenses are considered personal in nature and are not deductible. The \$2,000 gift from his grandmother is not taxable and does not affect the amount of his deductible moving expenses.**

78. During the current year, the Coetzer Corporation hires Marcelo, and agrees to reimburse him for all his moving costs. Marcelo submits the following expenses to Coetzer for reimbursement:

Transportation of household goods	\$2,700
Airfare	340
Temporary living	
Lodging	430
Meals	120
House-hunting trip:	
Transportation	330
Lodging	280
Meals	110

- a. What amount can Marcelo deduct as moving costs?

**Marcelo can deduct \$3,040 of moving expenses for adjusted gross income.**

Transportation of household goods	\$ 2,700
Airfare	340
<b>Total</b>	<b><u>\$ 3,040</u></b>

**Marcelo can only deduct his direct moving expenses. Direct moving expenses include the cost of moving household goods and personal effects to the new residence, and Marcelo's airfare to his new residence. The housing hunting expenses and temporary living expenses are considered personal in nature and are not deductible.**

- b. If Marcelo is in the 28% marginal tax bracket, what is the effect of the reimbursement on his taxable income and his total tax liability?

**Because Marcelo is reimbursed for all of his moving costs, he will have to include the \$4,310 he is reimbursed in income but is only allowed to deduct \$3,040 of these expense. Therefore, the net effect is that he will report \$1,270 of income. Since he is in the 28% marginal tax bracket, he will pay an additional \$356 in taxes.**

Total moving expenses reimbursed	\$ 4,310
Deductible moving expenses	(3,040)
Net increase in income	\$ 1,270
Marginal tax rate	x 28%
Increase in Marcelo's tax liability	<b><u>\$ 356</u></b>

**ISSUE IDENTIFICATION PROBLEMS**

In each of the following problems, identify the tax issue(s) posed by the facts presented. Determine the possible tax consequences of each issue you identify.

79. Marjorie is an accountant and Alana is an attorney. They have been business acquaintances for about 10 years. They meet every Friday at 6 P.M. at a local tavern to socialize. As always happens with attorneys and accountants, they discuss what is happening in their offices. They take turns paying the bar tab, which averages \$30 for each meeting. Because Marjorie has kept the receipts for the nights she paid, she would like to claim a deduction for her \$600 of expenses.

**The issue is whether Marjorie can deduct the cost of the Friday night meetings as an entertainment expense. Marjorie may not deduct any of the expense for reciprocal entertainment. The expense is allowed as a deduction only if Marjorie can show a business purpose for the expense and it qualifies as directly related to or associated with her accounting practice. In Marjorie's case, the entertainment appears to be primarily based on personal motives and not directly related to or associated with the active conduct of her business.**

80. Salvador is an insurance representative for the Hendricken Insurance Company. Recently, he heard that the controller of his largest account, Gore Plastics, was asking other insurance representatives to submit quotes on the cost of providing workers' compensation insurance for the company. Hendricken's contract with Gore is due to expire in two months. Knowing that the controller of Gore is an avid golfer, Salvador sends him the new Big Whomper Driver. The golf club costs \$350. Salvador submits the bill for the golf club to the company, and the expense is approved for reimbursement by the vice president of finance.

**The issue is whether the Hendricken Company can deduct the cost of the golf club as an ordinary and necessary business expense. The deduction for business gifts is limited to \$25. Therefore, the Hendricken Company will only be allowed a deduction of \$25 for the golf club. Because Salvador's intent in making the gift has a business purpose -- retaining Gore as a client -- the controller of Gore must include the value of the golf club in gross income. It does not qualify as an excludable gift.**

81. Jennifer is self-employed. At Christmas, she gives the elevator operator in the building where her office is located a pair of gloves. She makes similar gifts to the two parking lot attendants who park her car.

**The issue is whether Jennifer can deduct the cost of the gloves given to the elevator operator and parking attendants as a business expense. Because the gloves are a gift, the maximum Jennifer could deduct is \$25 for each pair of gloves. Her total deduction would be \$75 (\$25 x 3). However, she can only deduct the expense as a gift if it is made to business customers or she can show a direct connection between the expenditure and her business. Given the facts, she cannot take a deduction for the gloves. Instructor's Note: The problem is based on *Richard Sutter* 21 TC 170 (1953).**

82. Carla has a B.S. degree in history and is employed as an administrative assistant for a public accounting firm. After work, she attends Wittman College where she is enrolled in an accounting course. Her goal is to take the necessary courses to sit for the CPA exam. Her firm does not reimburse her for the cost of the course.

**The issue is whether the accounting course can be deducted as an education expense. Generally, an individual is allowed to deduct an education expense if the education expense is either: (1) required by law or by the employer for the taxpayer to retain the taxpayer's job or (2) maintains or improves the skills required in the taxpayer's trade or business. An education expense is not deductible if the course (1) meets the minimum educational requirements required for the taxpayer's job or (2) qualifies the taxpayer for a new trade or business. Carla might be able to argue that the introductory accounting course(s) help improve her skills.**

**A taxpayer is allowed a deduction from adjusted gross income for education expenses if the expenses are incurred as a requirement for the taxpayer to continue employment or are incurred to maintain or improve the skills required in their job. For tax years ending before January 1, 2017, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income.**

83. Vince is the third highest paid executive for Sensor Corporation, a publicly traded-corporation. His salary is \$1,250,000.

**The issue is how much of Vince's salary is deductible. Because Vince is one of the top four officers of the corporation, his salary is subject to the \$1,000,000 limitation on compensation expense. The corporation can deduct only \$1,000,000 of the \$1,250,000 paid to him as compensation expense.**

84. Jake loaned his cousin, Arnold, \$10,000 in March 2014 to open a cybercafe in Santa Barbara. Arnold signed a loan agreement to pay Jake 7% interest annually, with the principal due in 2017. Jake received his 2014 interest payment but did not receive any interest payment in 2015. In March 2016, Jake's father informs him that his cousin has filed for bankruptcy.

**There are three potential issues. The first is whether the loan is a valid bad debt. Assuming it is a valid bad debt, the second issue is whether the debt is a business or nonbusiness bad debt. The third issue is when (i.e., what year) the bad debt is deductible. It appears that the loan is a valid debt since it contains a written promise to pay, a stated interest rate, and a date for repayment. Because the loan is not related to Jake's business, the loan is considered a nonbusiness bad debt and is deductible as a short-term capital loss in the year in which the actual amount of the loss is known. Therefore, Jake will be entitled to a bad debt deduction (i.e., short-term capital loss) when the bankruptcy proceedings are concluded.**

85. Susan loaned \$2,000 to her minister a year ago. The loan is not evidenced by a note and does not bear interest. The minister has moved out of town without paying her back. She doesn't want to embarrass him by asking him to repay the loan.

**There are three potential issues. The first is whether the loan is a valid bad debt. Assuming it is a valid bad debt, the second issue is whether the debt is a business or nonbusiness bad debt. The third issue is when (i.e., what year) the bad debt is deductible. There is little indication that a valid debt exists. The loan does not contain the common elements of a valid loan - written promise to pay, stated interest rate, period and terms of repayment, collateral, etc. In addition, the loan appears to be motivated by reasons other than the opportunity to earn interest income. As such, the lack of repayment would not be viewed as a deductible nonbusiness bad debt. Susan has, in effect, made a gift to the minister as a result of forgiving the loan. If she is able to claim it as a nonbusiness bad debt, should could deduct it as a short-term capital loss in the current year.**

86. The Copeland Corporation acquires a machine for \$5,000 and pays \$250 in state sales tax. The machine has a tax life of 7 years.

**There are two issues in this problem. The first is whether the cost of the machine can be deducted in the current year. The second issue is whether the sales tax on the machine can be deducted in the current year. Because the tax life of the machine is longer than one year, the cost of the machine must be capitalized and deducted through depreciation over its useful life (i.e., 7 years – discussed in Chapter 10). In addition, all costs associated with acquiring a capital asset, including sales tax, must be added to the basis of the asset and depreciated over the tax life of the machine.**

87. The town of Dinsmore passed a bill requiring that all homes be connected to the town sewer system. Baskin Ridge is the only section of town that does not have town sewers. Dinsmore will finance the project by assessing each homeowner in Baskin Ridge \$10,000, payable over a 10-year period.

**The issue is whether the sewer assessment can be deducted in the current period. The special assessment is not deductible because it is not an ad valorem tax; the tax is added to the basis of each homeowner's property as it is paid. Assuming each homeowner pays \$1,000 ( $\$10,000 \div 10$ ) per year, the basis in their home will increase by \$1,000 each year.**

88. Scott is single and wants to maximize his retirement income. He contributes the maximum allowable to his company's qualified pension plan. His adjusted gross income for the year is \$73,000.

**The issue is what type of retirement vehicle Scott can use to maximize his retirement income. Scott cannot make a deductible contribution to an IRA account because he is an active participant in a qualified retirement plan and his adjusted gross income exceeds \$71,000. He could make a \$5,500 nondeductible contribution to a nondeductible IRA account. However, upon retiring, a portion of the distribution (i.e., the income earned on the IRA assets) will be included in his gross income.**

**A better choice is to make a \$5,500 nondeductible contribution to a Roth IRA. Although the contribution to a Roth IRA is not deductible, upon retiring, the entire amount of the qualified distribution from the Roth IRA, including the income earned on the IRA assets, is excluded from his gross income.**

89. **TAX SIMULATION.** Sam, the owner of The Perfect Cut, a wholesale meat distributor, unexpectedly dies during the current year. In an effort to provide equally for his two children, Sam's will provides that the entire business less 40% of its accounts receivables be left to his daughter Helen. Sam's son, Phil, is to receive the other 40% of the businesses receivables and the majority of Sam's other assets. The following year, after extensive legal action, Phil is unable to collect a \$5,000 receivable from his father's business and the receivable is deemed worthless.

Required: Determine how Phil should treat the worthless receivable on his tax return. Search a tax research database and find the relevant authority (ies) that form the basis for your answer. Your answer should include the exact text of the authority (ies) and an explanation of the application of the authority to Phil's facts. If there is any uncertainty about the validity of your answer, indicate the cause for the uncertainty.

**Sec. 166(a) allows a deduction for any debt which becomes worthless during the year.**

***Sec. 166 (a) General Rule. — Wholly worthless debts. There shall be allowed as a deduction any debt which becomes worthless within the taxable year.***

However, the general rule does not apply if the debt that becomes worthless is considered a nonbusiness bad debt. Sec. 166(d)(2) defines a nonbusiness bad debt as any debt not created in the taxpayers trade or business.

Nonbusiness debt defined. ***For purposes of paragraph (1), the term "nonbusiness debt" means a debt other than—***  
***(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or***  
***(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.***

The question that needs to be resolved is whether the bad debt that Phil inherited, which was incurred in his father's trade or business, is treated as a business bad debt. Reg. Sec 1.166-5(b)(1) expands the definition set forth in the Code, by defining a nonbusiness bad debt in the negative. That is, it defines a nonbusiness bad debt as any debt other than a debt created or acquired in the taxpayers trade or business and without regard to the relationship of the debt to the taxpayers trade or business at the time the debt becomes worthless.

Nonbusiness debt defined. ***For purposes of section 166 and this section, a nonbusiness debt is any debt other than— A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or***

***Although this might appear to indicate that Phil can treat the debt as a business bad debt, Reg. Sec 1.166-5(b)(2) states that whether a debt is considered a nonbusiness debt will be determined on a case by case basis.***



***A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See §1.165-5, relating to losses on worthless securities.***

In an effort to provide guidance to taxpayers, Reg. Sec 1.166-5(d) provides six examples of what constitute a nonbusiness bad debt. Example 4 is very similar to Phil's situation. Specifically, the example explains that because Phil is not in the trade or business of running a wholesale meat business, the debt is considered a nonbusiness bad debt.

***The application of this section may be illustrated by the following examples involving a case where A, an individual who is engaged in the grocery business and who makes his return on the basis of the calendar year, extends credit to B in 1955 on an open account: In 1956 A dies, leaving the business to his son, C, but leaving the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.***

Once it has been determined that the bad debt is a nonbusiness bad debt, two things need to be determined. The first is the amount Phil can deduct and the second is the tax treatment (i.e., ordinary loss, capital loss). The amount that Phil can deduct is determined by Sec. 166 (b) and is limited to his basis in the receivable.

***Sec 166 (b) Amount of deduction. For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.***

The tax treatment of the nonbusiness bad debt is determined by Sec. 166(d)(1)(A) and (B). This section provides that a nonbusiness bad debt of an individual taxpayer is treated as a short-term capital loss.

Nonbusiness debts. General rule. *In the case of a taxpayer other than a corporation—*

*(A) subsection (a) shall not apply to any nonbusiness debt; and*  
*(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.*

Finally, according to Reg. Sec 1.166-5(b)(2), the taxpayer cannot deduct a nonbusiness bad debt until the tax year in which the debt becomes totally worthless.

*A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.*

**NOTE:** The student should indicate that the amount of the deduction cannot be determined since the problem does not specify Phil's basis in the inherited receivable.

90. **INTERNET ASSIGNMENT** The use of a “flat tax” to replace the current income tax system has received a considerable amount of interest in recent years. Various flat-tax proposals have been made, but the gist of a flat tax is the use of a single tax rate with very few deductions. Using a search engine or one of the tax directory sites provided in Exhibit 16-6 (Chapter 16), find a flat-tax proposal and explain how it would affect the deductions currently allowed by the income tax system.

One possible starting point is the Yahoo search engine (<http://www.yahoo.com>). Starting at the Yahoo homepage, the student should further specify the search heading to Government. Under the Government heading, the search can be further specified to the topic Taxes. Within Taxes search using the term "flat tax", which will provide numerous websites. Two websites the student can go to find information on the flat tax are:

- The National Center For Policy Analysis: Flat Tax  
<http://www.ncpa.org/pi/taxes/tax7.html>
- Flat Tax -Citizens for Tax Justice  
<http://www.ctj.org/html/flattx.htm>

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

91. **INTERNET ASSIGNMENT** The Internet is a useful resource for gathering tax information. An important aspect of taxes discussed in this chapter is how deductible IRA's and Roth IRA's can be used to save for retirement. One site that provides a comparison of these two retirement vehicles is found at: <http://research.scottrade.com/public/calculators/ira/ira.asp>

Go to that site and find the retirement planning calculators under "Your Plan" in the middle of the page. Fill out the worksheet with your personal information. Provide the information you used in filling out the IRA comparison calculator and the results of the calculation.

**The following information was used to determine whether a taxpayer should invest in a deductible IRA or a Roth IRA.**

1	Your current age	22
2	Your anticipated age at retirement, or age at which you expect to take withdrawals from your IRA	65
3	AGI	105,000
4	Annual IRA Contributions	5,500
5	Expected rate of return on your IRA investments	8.0%
6	Participant in employer plan?	yes
7	Filing Status	single
8	Maximum Annual IRA Contributions	no

**Note: Withdrawals from an IRA before age 59½ are generally subject to a 10% early penalty. Also, withdrawals from a Roth IRA that has been open for fewer than five years may be subject to tax and penalties.**

	<b>Roth IRA</b>	<b>Deductible IRA</b>
<b>Annual IRA contribution</b>	<b>\$5,500</b>	<b>\$5,500</b>
<b>Annual tax savings</b>	<b>\$0</b>	<b>\$1,375</b>
<b>Effect on annual net income</b>	<b>(\$5,000)</b>	<b>(\$4,125)</b>
<b>IRA total at retirement (after federal income taxes)</b>	<b>\$1,809,073</b>	<b>\$1,430,095</b>

**Your results are based on:**

<b>Contribution period:</b>	<b>43 years</b>
<b>Current federal tax rate:</b>	<b>25%</b>
<b>Tax rate in retirement:</b>	<b>25%</b>

**Taxes for classic IRAs are paid at distribution (calculation does not factor state and local taxes, if any). Qualified distributions from a Roth IRA are taken tax-free if over age 59½ and contribution period is greater than five years.**

**INSTRUCTOR'S NOTE:** Information on the Internet is developing at a rapid pace. Therefore, this solution may become outdated. We suggest that you do the assignment prior to assigning it to your students. This will allow you to provide students with any additional information they may need to complete the assignment.

92. **RESEARCH PROBLEM** Pierre is a certified high school teacher in Kansas. During the year, his wife's company transfers her to New Jersey. In applying for a job in New Jersey, Pierre is informed that he will be granted only a 6-month provisional teaching certificate unless he completes two additional math courses. During the summer, Pierre completes the two courses at a local university and receives his teaching certificate. Can he deduct the cost of the courses as an education expense?

The Tax Court, in *Hartrick*, (1963) TC Memo 1963-36, allowed the taxpayer to deduct courses required to renew a provisional certificate. In addition, in *Woodard*, 22 CCH TCM 145, the Tax Court allowed the taxpayer to deduct courses leading to a permanent certificate where the taxpayer had been teaching under an annually renewable emergency certificate.

In addition, in Rev. Rul. 71-58, 1971-1 C.B. 55, the IRS allowed a teacher who has met the minimum educational requirements for one state to be considered to have met the minimum educational requirements in a new state, even if he or she has to take additional education to be certified in the new state. Thus, an employed teacher who met the minimum education requirements of one state could deduct the cost of required courses to qualify as a teacher in another state. Her change of employers and location was a change of duties in the same general type of work as a teacher and wasn't a new trade or business.

93. **RESEARCH PROBLEM** Evander, an officer in the Marine Corps, was appointed commanding officer of the Marine training base in Beaufort, S.C. As is customary in connection with changes in command, he hosts a party at his home for officers and guests the night before he assumes command of the base. Can Evander deduct the cost of the party as an entertainment expense?

The Tax Court, in *Fogg*, 89 TC 310 (1987), allowed a Marine Corps officer to deduct entertainment expenses in connection with change of command ceremonies. The expenses qualified as trade or business expenses because hosting the party at his home for guests of the ceremony was in keeping with the customs and traditions of the Corps. In addition, all commanding officers were required (as evidenced by a written memo by the commanding general), to engage in official entertaining in the performance of their duties and change-of-command receptions were considered official entertainment.

94. **SPREADSHEET PROBLEM** Sonya works as a sales representative for a computer manufacturer. Using the information below as a guide, prepare a spreadsheet calculating the amount she must report as income, her deduction for adjusted gross income, and her deduction from adjusted gross income. The spreadsheet should be flexible enough that it can calculate the information regardless of whether the company maintains an accountable or non-accountable plan and the amount of reimbursement or expense. Assume that during the year, she receives \$18,000 in reimbursements for the following employment-related expenses (a template to assist the student in solving this problem can be found at [www.cengagebrain.com](http://www.cengagebrain.com)):

Travel	\$10,000
Meals	3,600
Lodging	4,500
Entertainment	1,900

**Input Area:**

Type of Plan	A	
Reimbursement		\$18,000
Reimbursement Included as Income		\$18,000

Expense	Total
Travel	\$10,000
Meals	\$3,600
Lodging	\$4,500
Entertainment	\$1,900
Total Expense	\$20,000

**Input Area:**

Type of Plan	A	
Reimbursement	18000	
Reimbursement Included as Income	=IF(B2="N",B3,IF(AND(B2="A",B3>C12),(B3-C12),IF(B3<C12,B3,0)))	

Expense	Total	For AGI
Travel	10000	=IF(AND((\$B\$2="A"),(\$B\$3>\$C\$12)),C8,IF(\$B\$2="A",(\$B\$3/\$C\$12)*C8,0))
Meals	3600	=IF(AND((\$B\$2="A"),(\$B\$3>\$C\$12)),C9,IF(\$B\$2="A",(\$B\$3/\$C\$12)*C9,0))
Lodging	4500	=IF(AND((\$B\$2="A"),(\$B\$3>\$C\$12)),C10,IF(\$B\$2="A",(\$B\$3/\$C\$12)*C10,0))
Entertainment	1900	=IF(AND((\$B\$2="A"),(\$B\$3>\$C\$12)),C11,IF(\$B\$2="A",(\$B\$3/\$C\$12)*C11,0))
Total Expense	=SUM(C8:C11)	=IF(\$B\$3>\$C\$12,C12,IF(\$B\$2="A",(\$B\$3/\$C\$12)*C12,0))

**From AGI**

=C8-D8  
 =(C9-D9)\*0.5  
 =C10-D10  
 =(C11-D11)\*0.5  
 =SUM(E8:E11)

95. **TAX FORM PROBLEM** Stephanie Zane is the sole proprietor of Shear Madness, a hair salon. Her revenue comes from two sources, haircuts and the sale of hair products. Stephanie has three employees whose compensation consists of a weekly salary and a 40% commission on the services they provide to the customer. Stephanie uses a hybrid method of accounting - the cash method for haircuts and the accrual method for sales of hair products. For the current year she has the following revenue and expenses:

Revenue from haircuts	\$141,650
Revenue from the sale of products	36,240
Beginning inventory of product	1,756
Ending inventory of product	1,469
Product purchased	18,345
Gross salaries (including commission)	66,000
Social Security taxes	5,049
Employee withholding:	
Social Security taxes	5,049
Federal taxes	15,200
State taxes	4,200
Other payroll taxes	375
Advertising	1,200
Rent	12,100
Utilities	1,600
Phone	570
Postage	220
Accounting fees	1,200
Legal fees	625

Complete Form 1040 Schedule C (Profit or Loss From Business) and Form 1040 Schedule SE (Self-Employment Tax) using the above information. Stephanie's Social Security number is 123-62-7897, her employer ID number is 05-9987561 and her business address is 99 Fortin Lane, Metuchen, New Jersey 07865. Forms and instructions can be downloaded from the IRS web site (<http://www.irs.gov/formspubs/index.html>).

**The expenses are grouped as follows:**

Line 17 - Legal and professional services	(\$625 + \$1,200)	\$1,825
Line 18 - Office expenses:	(\$570 + \$ 220)	790
Line 23 - Taxes and licenses:	(\$5,049 + \$375)	5,424

**Instructor's Note:** The complete tax form solution is included separately in files **SM\_Ch\_06\_Problem\_95.pdf** and **SM\_Ch\_06\_Problem\_95\_SE.pdf** located on the Instructor's Resource CD within the folder 'Solutions Manual' and also on the companion website, [www.cengagebrain.com](http://www.cengagebrain.com).



**96. Integrative Tax Return Problem**

This is the fourth part of a six part problem that allow you to prepare the 2015 tax return for Laurie and Lynn Norris. As with the previous parts, this part of the problem will ask you to prepare a portion of their tax return. You should complete the appropriate portion of each form or schedule indicated in the instructions for each problem. The following basic information is provided for preparing their 2015 tax return:

- Lynn Norris is the sole proprietor of Internet business that provides handyman advice and tips to do-it-yourself home improvement projects. The site also serves as a portal for those looking for reputable contractors that provide a wide variety of home repair services. Lynn also has compiled his advice in an Ebook that is sold via his website. For the current year, he has the following revenue and expenses:

Revenue from advertising on his site	\$ 45,000
Revenue from referrals	27,450
Revenue from book sales	8,700
Home improvement conference registrations	4,500
Travel to conferences	1,250
Hotels	420
Meals	190
Accounting fees	1,200
DSL Internet fees	1,850
Legal fees	625
One-time development costs with ebook	6,800
Office supplies	240
Advertising on other sites	4,000

- Both Laurie and Lynn contribute the maximum amount to their Individual Retirement Accounts.
- Lynn enrolled in an advanced Java course at the local community college. The tuition was \$1,100. The software and textbook for the course cost was \$225.

**Required:** Based on the information provided above, only fill out the appropriate portions of Form 1040, Form 1040 Schedule C, Form 1040 Schedule SE, and finish Form 8829. Lynn's employer ID number is 05-7861342 and his principal business code is 541990.

**INTEGRATIVE PROBLEM**

97. Based on the information provided in the text, calculate Rufus and Rhonda's taxable income and their tax liability. Assume that they are cash basis taxpayers and want to be as aggressive as possible in taking their allowable deductions. In addition, you are required to calculate the self-employment tax on Rhonda's law practice income.

**Rufus and Rhonda's taxable income is \$85,135 resulting in a 2016 income tax liability of \$12,026, a self-employment tax liability of \$7,254 and a total tax liability of \$19,760 (\$12,026 + 480 + \$7,254):**

**Gross income**

Rufus's salary	\$ 78,000	
Less: qualified pension payment	(3,120)	
Less: flexible benefits payment	<u>(2,400)</u>	\$ 72,480
Group term life insurance		191
Country club dues paid by employer		2,300
Disability payment		2,650
Interest income		1,900
Cash dividends		3,200
Net rental income		-0-
Rhonda's business income		<u>51,336</u>
Gross income		<u>\$ 134,057</u>
<b>Deductions for adjusted gross income</b>		
One-half of self-employment tax		(3,627)
Capital loss from sale of stock		<u>(3,000)</u>
Adjusted gross income		<u>\$ 127,430</u>
<b>Deductions from adjusted gross income</b>		
Other allowable itemized deductions	\$ 19,220	
Interest and taxes - vacation home	<u>2,825</u>	(22,045)
Personal exemptions (5 x \$4,050)		<u>(20,250)</u>
Taxable income		<u><u>\$ 85,135</u></u>

Tax on ordinary income of \$81,935 (\$85,135 - \$3,200):

\$10,367.50 + [25% x (\$81,935 - \$75,300)] =	\$ 12,026
Tax on dividend income of \$3,200 x 15%	480
Rhonda's self-employment tax	<u>7,254</u>
Total tax liability	<u><u>\$ 19,760*</u></u>

- \* Instructor's Note: Because Rufus and Rhonda's children are all less than 17 years old, they are entitled to a child tax credit of \$3,000 (3 x \$1,000). Although the child tax credit is mentioned in Chapter 1, it is not incorporated in the original solution since the child tax credit is not discussed in detail until Chapter 8.

Rufus's \$78,000 annual salary is reduced by the \$3,120 ( $\$78,000 \times 4\%$ ) that he pays into the qualified pension plan and the \$2,400 ( $\$200 \times 12$ ) he pays into the flexible benefits plan. The matching payment to his pension plan by his employer is excluded from current period income. Payments received from the flexible benefits plan are also excluded from gross income as is the payment of the nondiscriminatory medical insurance. Premiums paid on \$50,000 of group-term life insurance are also excluded. Rufus's \$106,000 [ $(\$78,000 \times 2) - \$50,000$ ] excess coverage is taxable per the IRS table (Table 4-1 in the text). The premiums for a 46 year old are \$1.80 per year per thousand dollars of coverage, resulting in \$191 ( $\$1.80 \times 106$ ) of taxable income. Rufus must also include the \$2,300 of country club dues paid by Plowshare.

Rhonda's Business Income is calculated as follows:

Revenues	\$17,000 + \$87,000	\$ 104,000
Less: Expenses		
Office rent	\$14,400	
Secretary salary	24,000	
Payroll tax paid - Social Security	1,836	
Entertainment	1,500	
Seminar costs	940	
Building insurance	333	
Supplies	2,250	
Bar dues and licensing fees (\$600 + \$725)	1,325	
Automobile costs	5,400	
Business gifts	280	
Salary paid to son	400	(52,664)
Net business income		<u>\$ 51,336</u>

As a cash basis taxpayer, Rhonda recognizes income as it is received. Therefore, Rhonda includes the \$17,000 received from previous year's billings and the \$87,000 from current year billings in her 2016 income, not the amount she billed in 2016.

Rhonda cannot deduct the amounts withheld from her secretary's salary - she is acting as a collection agency for the government. The matching Social Security payment is a deductible payroll tax expense.

The \$1,000 in dues paid to the social club is not deductible. The entertainment and meal costs are 50% deductible. The meals and open house costs are directly related to her business.

Meals with clients	\$ 1,200
Open house costs	1,800
Total allowable entertainment costs	<u>\$ 3,000</u>
Meals and entertainment limitation	$\times 50\%$
Deductible entertainment costs	<u>\$ 1,500</u>

The seminar costs are deductible because they relate to a client's business. However, she is only allowed to deduct the single hotel rate and cannot deduct her son's meals because he did not have a business purpose for being on the trip. Rhonda's meals are also subject to the 50% limitation.

Airfare	\$ 325
Lodging (\$175 x 3 nights)	525
Meals [(\$200 - \$80) x 50%]	60
Taxi	30
Total deductible costs	<u>\$ 940</u>

The building insurance must be allocated over the life of the policy (two years). She can deduct \$333 [ $\$1,600 \times (5 \text{ months} \div 24 \text{ months})$ ]. Because she has used the standard mileage rate method in prior years, Rhonda must continue to use the method. In 2016, the standard mileage rate is 54 cents per business mile, resulting in a \$5,400 ( $10,000 \times 54 \text{ cents}$ ) deduction. The limitation for business gifts is \$25 per donee, exclusive of any wrapping, engraving, or other preparation costs. Rhonda can deduct \$35 per gift, and a total of \$280 [ $8 \times (\$25 \text{ gift} + \$5 \text{ engraving} + \$5 \text{ wrapping})$ ] for the gifts. Only \$400 (the cost she would have paid an unrelated party) of the amount paid to her son is deductible.

Rhonda is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. Because this deduction reduces her self-employment income, the amount of self-employment income subject to the tax is 92.35% of her self-employment income. Her self-employment income subject to the tax is \$47,409 ( $\$51,336 \times 92.35\%$ ). Because she is under the self-employment tax ceiling (\$118,500 in 2016), she will pay a tax of 15.3% on the entire \$47,409. Her self-employment tax is \$7,254 and her deduction for adjusted gross income is \$3,627.

The receipt of the \$2,650 in disability pay from the Plowshare policy is taxable. The damage and medical payments are excluded. The interest received on the Puerto Rico Development Bonds is excluded as municipal bond interest. Stock dividends are not taxable.

This cabin is a vacation home because the personal use of the home (25 days) exceeds the greater of 14 days or 4 days (10% of rental days). Therefore, the deductions are limited to rental income and must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 75% [ $75 \div 100$  ( $75 + 25$ )] of the expenses are related to the rental activity. This results in \$8,475 allocated to the rental and \$2,825 as a personal itemized deduction.

Rental income	\$ 10,000
Interest and taxes [ $\$11,300 \times (75 \div 100)$ ]	<u>(8,475)</u>
Balance of income	\$ 1,525
Utilities and maintenance [ $\$840 \times (75 \div 100)$ ]	<u>(630)</u>
Balance of income	\$ 895
Depreciation [ $\$7,500 \times (75 \div 100) = \$5,625$ ]	<u>(895)</u>
Net rental income	<u><u>-0-</u></u>

The \$4,730 ( $\$5,625 - \$895$ ) of depreciation not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The sale of the stock is a capital loss and is deductible for adjusted gross income. However, the \$4,500 loss is limited to \$3,000 per year. The remaining \$1,500 capital loss is carried forward to be used in 2017.

**DISCUSSION CASES**

98. Norman was the sole shareholder and operator of two successful video arcades. While he was in the hospital with heart problems, his wife, Helen, filed for divorce and took a number of legal steps, including obtaining a temporary restraining order against him, to gain control of his businesses. In addition, Helen and her boyfriend fired the two corporations' employees, and took cash and equipment from the businesses.

When Norman got out of the hospital, he engaged a law firm to help him regain possession of his businesses and recover the assets his wife took, and to represent him in the divorce action. Norman incurred \$65,000 in legal fees in trying to get back his business and the divorce action. Are his legal fees deductible?

**To be deductible, legal fees must have a business purpose. The origin of the legal fee determines the purpose of the expenditure. If the legal fee originates in a profit motivated activity, then it is deductible. However, if the legal fee is generated for personal reasons, it is not deductible. Therefore, the origin of the Norman's legal fees must be from a trade or business. Norman can argue that the legal fees are deductible because the expense was incurred so he that he can regain control of his business. The fact that Norman's wife took the business from him does not make the legal fees non deductible. The portion of the legal fees that are attributable to Norman divorcing his wife are a result of a personal transaction and are non deductible.**

**Instructor' Note: The facts of the discussion case are based on *Liberty Vending, Inc.*, TC Memo 1998-177.**

99. Felix and Ismael were college roommates. Five years after they graduate, Ismael is a tax manager in a large public accounting firm, and Felix is still in his first job as an engineer for a construction company. Felix is not sure whether he wants to stay in engineering or change careers. Either way, he knows he will need to take some courses at the local university. While reading the Sunday paper, Felix notices an ad for the university: "Enroll now: The cost of post-baccalaureate courses is tax-deductible!!" The small print advises, "Consult your tax adviser about the deductibility of each course."

Felix calls Ismael the next day. After he explains that he may pursue a new career, Ismael explains to Felix under what circumstances education expenses are deductible. If you were Ismael what would you have said to Felix?

**The newspaper ad placed by the university is misleading. An education expense is deductible when the expense is either (1) required by law or by the employer for the taxpayer to maintain her/his job, or (2) the expense maintains or improves the skills required in the taxpayer's trade or business. However, an education expense that (1) meets the minimum educational requirements required for the taxpayer's job, or (2) qualifies the taxpayer for a new trade or business might not be deductible. Therefore, an education expense that is deductible for one taxpayer could be treated as a nondeductible expense for another taxpayer.**

**If Felix decides to pursue a new career, the expense of his education is not deductible because the coursework qualifies him for a new trade or business. However, if Felix enrolls in an advanced engineering course, the cost of the course is tax deductible because the education either maintains or improves his skills as an engineer.**

**In 2016, a taxpayer with adjusted gross income less than \$65,000 (\$130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of \$4,000 of qualified higher education expenses. If a taxpayer's adjusted gross income exceeds \$65,000 (\$130,000 for a married couple filing a joint return) but does not exceed \$80,000 (\$160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of \$2,000 of qualified higher education expenses. If the taxpayer's adjusted gross income exceeds these amounts \$80,000 (\$160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income. Therefore, some taxpayers can deduct qualified higher education expenses even if the expenses are not incurred as a requirement for the taxpayer to continue employment or do not maintain or improve the skills required in their job. Qualified higher education expenses are limited to tuition and fees paid to attend the institution.**

100. Brad graduated from law school in Detroit in May 2015. He had lived in the area for 5 years before enrolling in law school. Following his graduation, he prepared for the Michigan bar exam, which he took in July 2015. In August 2015, Brad moved some of his possessions from Detroit to New York City where he began a graduate law program. While in New York, he rented out his Detroit home. The following May, Brad graduated with a master's degree in tax law (i.e., LLM). Brad never practiced law before enrolling in the graduate program. Although he was notified in October 2015 that he had passed the bar exam, he was not formally admitted to the bar until June 2016. Brad incurred \$2,200 of expenses in moving from New York City back to Detroit where he began working for a law firm. In filing his 2015 tax return, Brad used his Detroit address as his home address. Explain whether Brad can deduct the \$2,200 he incurred as moving expenses.

**For Brad to deduct his moving expenses he must meet two explicit tests, a distance test and time test. In addition, he must also meet an implicit test that his principal residence was New York City.**

**The distance test requires that the taxpayer's commuting distance from the old residence to the new job is at least 50 miles more than the old residence was from the old job. Clearly, the distance from Detroit to New York City allows him to meet the distance requirement.**

**The second test requires that Brad be employed for 39 weeks in the 12 month period following the move. Assuming he remains employed for 39 weeks Brad will meet this test.**

**Brad fails to meet the third test because he lives in New York City less than one year. Supporting the argument that his New York City residence is only temporary is the fact that Brad used his Detroit address in filing his 2015 tax return.**

**Instructor's Note: The facts of this discussion case are based on the Tax Court case *Wassenaar v. Commissioner*, 72 TC 1195 (1979).**

**TAX PLANNING CASES**

101. In 2014, Samantha loaned her friend Lo Ping \$15,000. The loan required Lo Ping to pay interest at 8% per year and to pay back the \$15,000 loan principal on July 31, 2016. Lo Ping used the loan to start a clothing store. Lo Ping paid Samantha interest on the loan in 2014 and 2015. Although her store appeared to be very successful, her accountant continued to inform her that her business was barely making a profit because of its “high cost structure.” In early 2016, Lo Ping became suspicious of her accountant’s claims and hired a local CPA firm to examine her accounting records. The CPA firm discovered that Lo Ping’s accountant had embezzled \$30,000. As a result, Lo Ping had to file for bankruptcy. It is estimated that Samantha will receive 30% of the amount she loaned Lo Ping and that the bankruptcy proceedings will conclude in either December 2016 or January 2017. Samantha also is considering whether to sell 200 shares of stock in late 2016 or early 2017. The shares are expected to generate a \$2,500 loss. This is the only sale of stock Samantha anticipates making. Explain to Samantha why it is important to determine the date that the bankruptcy proceedings will be concluded before selling her 200 shares of stock.

**Because the debt is unrelated to Samantha’s business, it is a nonbusiness bad debt. Nonbusiness bad debts are deductible as short-term capital losses in the year in which the actual amount of loss is known. No deduction is allowed for the estimated amount of the loss. Therefore, it is important for Samantha to know when the bankruptcy proceedings will be concluded.**

**If the proceedings will conclude in 2016, she has a short-term capital loss of \$10,500 [ $\$15,000 \times (1 - 30\%)$ ] from the bad debt in 2016. As a result, Samantha’s loss from the bad debt will exceed the \$3,000 maximum capital loss deduction and the loss on the stock she might sell cannot be used in the current year. Therefore, if she believes that in 2017 the market price of the stock will increase, even marginally, she should wait until 2017 before selling it. However, if she believes that the market price of the stock will continue to decline in 2017, from a cash flow perspective she should sell the stock in 2016.**

**If Samantha knows that the proceedings will not conclude until 2017, she should sell the stock in 2016 to take advantage of the \$3,000 maximum capital loss deduction. Unless she has other stock holdings that she is planning on selling in 2017, if she waits until 2017 to sell the stock, her total capital loss deduction for 2017 will be \$13,000 ( $\$2,500 + \$10,500$ ). The maximum she can deduct assuming no other capital gains is \$3,000 and her capital loss carryforward to 2018 would be \$10,000.**



102. Harold and Maude are both 55 years of age and have two married children. Harold is an engineer and is an active participant in his company's qualified pension plan. Maude is a retired school teacher and works for an educational non-profit organization. Harold and Maude plan on retiring at age 60 and relocating to South Carolina. Because the non-profit organization does not have a qualified pension plan for its employees, Maude must decide whether to set up a conventional deductible IRA or a Roth IRA. With either IRA, she plans on making the maximum allowable contribution for each of the next five years and does not anticipate making any contributions after retiring. Harold and Maude will not draw on the account until they are age 65. At that time, they plan to draw down the fund balance equally over a ten-year period to use for trips with their children and grandchildren. Determine whether Maude will have more funds available for her trips with a conventional deductible IRA or a Roth IRA. In making this determination, assume the following:

- Any current tax savings from a deductible IRA will be invested in a tax-free municipal bond fund that will earn 4% annually until age 65
- The earnings on either IRA account will be 6% annually until age 65
- Their marginal tax rate will be 28% while both are working and 25% when they retire
- Their adjusted gross income is expected to be less than \$150,000 for each year that they both are working.

**Regardless of the investment vehicle (Conventional IRA or Roth IRA) Maude chooses, because she is over 50 years of age, she can contribute \$6,500 per year.**

**Both the Conventional IRA and Roth IRA will yield \$51,982 from the contributions at the end of ten years.**

<u>Year</u>	<u>Contribution</u>	<u>Future Value (FV) Factor</u>	<u>Dollar Yield</u>
2016	\$6,500	1.791	\$11,642
2017	\$6,500	1.689	\$10,979
2018	\$6,500	1.594	\$10,361
2019	\$6,500	1.504	\$ 9,776
2020	\$6,500	1.419	\$ 9,224
<b>Total</b>			<b>\$51,982</b>

**If Maude opens a Conventional IRA the reinvested tax savings will yield \$12,473 at the end of ten years.**

<u>Contribution</u>	<u>Tax Rate</u>	<u>Tax Savings</u>	<u>FV Factor</u>	<u>Dollar Yield</u>
\$6,500	28%	\$1,820	1.480	\$ 2,694
\$6,500	28%	\$1,820	1.423	\$ 2,590
\$6,500	28%	\$1,820	1.369	\$ 2,492
\$6,500	28%	\$1,820	1.316	\$ 2,395
\$6,500	28%	\$1,820	1.265	\$ 2,302
<b>Total</b>				<b>\$12,473</b>

**At the end of the ten-year period, Maude will have accumulated \$51,982 in the Roth IRA and \$64,455 (\$51,982 + \$12,473) in the Conventional IRA.**

The next aspect that Maude must consider is the tax treatment of the distributions from the IRA's. The distribution from the deductible IRA is fully taxable to her because she does not have a basis in either the contributions (i.e., tax-deductible) or the earnings (i.e., income has been tax-deferred). However, the distributions from the municipal fund and the Roth IRA are tax-free. Maude has a basis in the contributions (i.e., not tax deductible) and the earnings on the account are not taxable.

Given the assumptions, over the five years the Roth IRA is slightly better than the IRA/Bond fund. If Maude opens a Roth IRA instead of a conventional IRA, she will have \$53 (\$5,198 - \$5,145) more per year to travel.

**Deductible IRA/ Bond Fund:**

Distribution from deductible IRA ( $\$51,982 \div 10$ years)	\$5,198
Withdrawal from tax-free bond fund ( $\$12,473 \div 10$ years)	1,247
Tax on deductible IRA distribution ( $\$5,198 \times 25\%$ )	(1,300)
Net after-tax cash available	<u>\$5,145</u>

**Only Roth IRA:**

Distribution from Roth IRA ( $\$51,982 \div 10$ years)	\$5,198
Tax on Roth IRA distribution ( $\$5,198 \times 0\%$ )	-0-
Net after-tax cash available	<u>\$5,198</u>

**ETHICS DISCUSSION CASE**

103. Tom is a CPA for a large regional firm. In preparing the tax return for Espresso Industries, he notices that the firm has an unusually high amount of travel, meal, and entertainment expenses. Therefore, he decides to examine the supporting documentation. In doing so, Tom notices that the business purpose for many of the meals is not provided. When Tom questions Frank, the company controller, Frank assures him that all the meal and entertainment expenses are legitimate. After further examination, Tom finds that for every business day in June, July, and August, four of the corporation's senior officers have been reimbursed for their lunch and dinner costs. He confronts Frank and the assistant controller, Doug, with this information. He informs Frank that his firm will not prepare the return unless the meals and entertainment that do not have a business purpose are omitted. Frank, angered by Tom's decision, tells Tom to prepare the return and that he will take it from there. The following Saturday, Tom is playing golf with Doug and asks him what Frank means by his remarks. Doug tells Tom that Frank will simply replace Tom's number with one that includes the entire meal and entertainment expense. Can Tom prepare the tax return, knowing that the company will change the meal and entertainment expense? If he does prepare the return, what ethical standards (refer to Statements on Standards for Tax Services, which can be found at [www.cengagebrain.com](http://www.cengagebrain.com)), if any, has Tom violated? Assume that Tom prepares the return. If asked, should he prepare next year's return?

**The Statements on Standards for Tax Services (SSTS) does not address this issue directly. Under SSTS #3, the CPA, in preparing the return is not required to verify the information prepared by the client. However, the CPA is required to make reasonable inquiries if the information provided to him does not appear to be accurate. Given the facts of this case, in substantiating the meal and entertainment deduction Tom discovered that the company was deducting meals and entertainment expenses that lacked a business purpose. Although he exceeded the requirements set forth by SSTS #3, once he discovers a problem he cannot ignore it and prepare the return with the full amount of the meal and entertainment expenses. Therefore, he must prepare the return with only the meal and entertainment expenses that have a valid business purpose.**

**Upon completing the return with the correct expenses set forth and delivering it to the client, Tom's obligation with respect to the return ceases. Although Tom has extremely reliable information that the return will be changed he has not violated any of the Statements on Standards for Tax Services. From a tax preparer's perspective, if the client chooses to change Tom's return, the filed return would be the responsibility of Espresso and not Tom. If the client does submit a revised return, Tom's responsibilities under the SSTS's, specifically SSTS #6, are not applicable until he is asked to prepare the following year's tax return.**

**Whether Tom can prepare the following year's return is a difficult question to answer. Given the facts, it will be impossible for Tom to know which return was filed. That is, has the client filed the return Tom prepared or a revised return? If Tom knew that the client filed the revised return, he would not be permitted to prepare the following year's tax return. SSTs #6 states that if a CPA is asked to prepare a tax return and discovers an error or is aware of an error on a previous year's return, the preparer should consider whether to withdraw from the engagement unless appropriate action is taken to correct the error.**

**SSTs #6 allows the preparer to continue the professional relationship if steps are taken to ensure the error is not repeated. For example, if Tom wanted to continue the engagement, he could insist that the client sign the return in his presence. Tom could then take the return to the post office, ensuring that the correct return was filed. If the client amended the return at a later date, solely for meals and entertainment, the amended return would probably result in an inquiry from the IRS. In conclusion, if the client fails to comply with Tom's requirement that the return be signed in his presence and Tom mail it, Tom should withdraw from the engagement.**

## Chapter 6

### Check Figures

26. \$312
27. \$0; \$81.50
28. \$0 - no business purpose
29. a. \$2,600  
c. No deduction
30. a. No deduction  
c. \$2,000
31. N/A
32. a. N/A
33. a. N/A
34. \$7,646 actual cost deduction;  
plus \$900 of interest
35. a. \$8,390 standard mileage deduction  
plus \$320 of Interest
36. 65% is deductible
37. a. \$1,355  
c. \$1,255
38. a. \$1,261  
c. wife's expenses nondeductible
39. Only business portion deductible (2 days)
40. Ester: \$1,108; Marisa: \$0
41. \$493
42. \$2,600
43. a. \$25,800 deductible  
c. Not deductible
44. \$825 deduction
45. Publicly held: \$1,000,000; Closely held: \$1,100,000 deduction
46. 6<sup>th</sup> highest paid: \$1,320,000; 3<sup>rd</sup> highest paid: \$1,000,000 deduction
47. a. Current year bad debt \$500  
c. Income of \$100



70. a. \$5,500  
c. No contribution allowed
71. a. \$11,000  
c. K - \$1,300; J - \$1,100
72. a. \$2,000 each child
73. \$500 each child
74. a. \$1,500 for AGI  
c. \$0 from AGI
75. a. \$1,800  
c. \$1,200
76. a. \$1,400
77. \$2,595
78. a. \$3,040
- b. \$4,400  
d. \$2,500
- b. K- \$5,850; J - \$4,950  
d. Kevin: a. - \$0, b. - \$650 (IRA)  
Jill: a. - \$4,950, b. - \$ -0- (IRA)
- b. \$800 each child
- b. \$4,000 for AGI; \$0 from AGI  
d. \$2,000 for AGI; \$0 from AGI
- b. \$2,500
- b. \$280
- b. \$356 additional tax liability