

CHAPTER 7

LOSSES - DEDUCTIONS AND LIMITATIONS

2017 Edition	Topic	Status
Questions		
1	Explain the differences and similarities between deductions and losses	Unchanged
2	Explain the difference between annual losses and a transaction loss	Unchanged
3	Net operating loss carryback and carry forward periods	Unchanged
4	Describe the characteristics of a tax shelter	Unchanged
5	Discuss the difference between a taxpayer's at-risk amount and basis	Unchanged
6	Discuss the difference between nonrecourse and recourse debt	Unchanged
7	What is the purpose of the passive loss rules	Unchanged
8	Are the passive loss rules a disallowance or deferral provision	Unchanged
9	Describe the difference in the passive loss rules as they apply to an individual, a corporation, and a closely-held corporation	Unchanged
10	Rules for measuring a business casualty loss	Unchanged
11	Limitations on the deductibility of capital losses by individuals	Unchanged
12	When can the sale of a security be deducted as an ordinary loss	Unchanged
13	Purpose of the related party rules	Unchanged
14	Related party rules	Unchanged
15	Discuss the wash sale rules	Unchanged
16	Explain the difference in treatment between business and personal casualty losses	Unchanged
Problems		
17	Difference in treatment of a loss by an S corporation and a corporation	Unchanged
18	Compute corporate tax liability for five different years - utilizing NOL's	Unchanged
19-COMM	Should a corporation carryback or carryforward an NOL	Unchanged

**2017
Edition****Topic****Status**

20	Application of recourse and nonrecourse loan on taxpayer's amount at-risk	Unchanged
21	Limit on deductible loss because of at-risk rules	Unchanged
22	Limit on deductible loss because of at-risk rules (Relates to #21)	Unchanged
23	Limit on deductible loss because of at-risk rules	Unchanged
24	Amount of deductible passive loss - five scenarios	Unchanged
25	Amount of deductible passive loss - three scenarios	Unchanged
26	Determining if an activity is passive - five scenarios	Unchanged
27	Determining if an activity is passive - five scenarios	Unchanged
28	Determining the amount of deductible loss by applying the at-risk rules and passive loss rules	Unchanged
29-CT	Determining if a taxpayer material participates in a passive activity and the impact on AGI	Unchanged
30	Determining if a taxpayer material participates in a passive activity and the impact on AGI - three scenarios	Unchanged
31	Comparing the deductibility of passive losses between a material and active participant	Unchanged
32	Comparing the deductibility of passive losses between a material and active participant	Unchanged
33	Deductibility of a rental loss if a taxpayer is an active participant - four scenarios	Unchanged
34	Deductibility of rental loss if taxpayer is an active participant - four scenarios	Unchanged
35	Amount of deductible and suspended passive loss - three passive activities	Unchanged
36	Amount of deductible and suspended passive loss - three passive activities (Relates to #35)	Unchanged
37	Impact of passive losses on taxable income	Unchanged
38-CT	Sale of passive activity (Relates to #37)	Unchanged
39	Sale of passive activity	Unchanged

2017 Edition	Topic	Status
40	Deductibility of suspended passive losses when taxpayer dies and FMV of passive activity exceeds basis (Relates to #39)	Unchanged
41	Deductibility of suspended passive losses when taxpayer dies and FMV of passive activity is less than basis (Relates to #39)	Unchanged
42	Deductibility of suspended passive losses if taxpayer gifts passive activity (Relates to #39)	Unchanged
43	Disposition of passive activity by sale, by gift and at death	Unchanged
44-COMM	Disposition of passive activity by gift	Unchanged
45	Determining the deductible amount of loss - five scenarios	Unchanged
46	Determining the deductible amount of loss - seven scenarios	Unchanged
47	Business casualty loss with insurance - two scenarios	Unchanged
48	Business casualty loss with insurance - two scenarios (Relates to #47)	Unchanged
49-COMM	Business casualty loss with insurance - two scenarios	Unchanged
50	Business casualty loss	Unchanged
<i>51-CT</i>	Deductibility of ordinary loss and capital loss from an S corporation	Unchanged
52	Netting of capital gains and losses and carryforward of loss	Unchanged
53	Netting of capital gains and losses and carryforward of loss	Unchanged
<i>54-CT</i>	Difference in treatment of capital gains and losses by corporation and S corporation	Unchanged
55	Effect of capital gains and losses on corporation over five years	Unchanged
56	Effect of capital gains and losses on corporation over five years	Unchanged
57	Comparison of tax treatment of "regular" stock and small business stock sold at a loss	Unchanged
58	Tax treatment of loss on small business stock	Unchanged
59-COMM	Determining if an asset sold is a business asset or an investment asset	Unchanged
60	Sale of stock to a related party	Unchanged

2017 Edition	Topic	Status
61	Sale of stock to a related party	Unchanged
62-COMM	Sale of land to a related party	Unchanged
63	Wash sale	Unchanged
64	Wash sale	Unchanged
65	Wash sale	Unchanged
66	Personal casualty loss - three assets	Unchanged
67	Personal casualty loss	Unchanged
68	Personal and business casualty losses	Unchanged
69-COMM	Determining the personal and business casualty loss on a mixed use asset	Unchanged
<i>70-CT</i>	Determining the personal and business casualty loss on a mixed use asset	Unchanged
71	Determining the deductible loss on the sale of assets	Unchanged
72	Determining the deductible loss on the sale of assets	Unchanged
73-IID	Net operating loss	Unchanged
74-IID	At-risk rules	Unchanged
75-IID	Deductibility of rental loss	Unchanged
76-IID	Active or passive activity	Unchanged
77-IID	Sale of passive activity	Unchanged
78-IID	Suspended loss at death	Unchanged
79-IID	Business theft deduction	Unchanged
80-IID	Sale of business asset at loss	Unchanged
81-IID	Sale of stock at loss	Unchanged
82-IID	Sale of stock to related party	Unchanged
83-IID	Wash sale	Unchanged
84-IID	Casualty loss	Unchanged
85	Tax Simulation Problem	Unchanged

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86	INTERNET	Unchanged
87	INTERNET	Unchanged
88	Research Problem	Unchanged
89	Research Problem	Unchanged
90	Spreadsheet Problem	Unchanged
91	Tax Form Problem	Unchanged
92-ITR	Integrated Tax Return Problem	Unchanged
93-C	Calculating taxable income of a corporation with various loss transactions - five parts	Unchanged
94-DC-CT	Discuss how rental real estate is still a viable tax shelter	Unchanged
95-DC	Discuss if a casualty loss can be taken when there is no damage to property, but a decline in property value	Unchanged
96-DC	Determining the amount of deductible loss by applying the at-risk rules and passive loss rules	Unchanged
97-TPC-CT	Determining when to sell small business stock to maximize tax loss - considers the time value of money.	Unchanged
98-TPC-COMM	Determining whether to invest in a limited partnership or an annuity - considers the time value of money.	Unchanged
99-EDC-CT	Deductibility of a personal casualty loss if an insurance claim is not filed - focuses on SSTS #6	Unchanged

CHAPTER 7

LOSSES - DEDUCTIONS AND LIMITATIONS

DISCUSSION QUESTIONS

1. How are deductions and losses different? How are they similar? Explain.

Differences - The main difference is that most deductions are for current expenditures and amortization of capital expenditures, whereas losses result from either an excess of deductions over income (annual loss) or an excess of basis over the amount realized on the disposition of an asset (transaction loss).

Similarities - Both deductions and losses represent amounts invested to produce income and are reductions in taxable income under the ability-to-pay concept. In addition, the general approach to the deductibility of losses is similar to the approach taken for deductions. That is, tax relief is the result of legislative grace and any deductions allowed must be specified in the tax law. The categorization of losses by those incurred in a trade or business, production of income losses, and personal use losses is identical to the approach for deductions. The limitation on losses is similar to the limitations placed on deductions within each category.

2. Discuss the basic differences between annual losses and transaction losses.

Annual losses result from an excess of deductions over income for a single accounting period. Thus, they represent the effect of all the transactions affecting an entity during the accounting period.

Transaction losses result when the amount realized from a sale or other disposition of property is less than the basis of the property. That is, a transaction loss represents an incomplete capital recovery on a single transaction by an entity.

3. What are the net operating loss carryback and carryforward periods? Does a taxpayer have a choice of the years to which a net operating loss can be carried? Explain.

A net operating loss can be carried back 2 years to obtain a refund of taxes paid. The loss must be carried to the earliest year in the carryback period first. If the loss is not entirely used up in the earliest year, the previous year is then used. If the entire loss is not used up during the 2-year carryback, any remaining loss can be carried forward for 20 years. A taxpayer may elect not to carryback any of the loss and only use the carryforward period.

4. What are the characteristics of a *tax shelter* as the term is commonly used by tax practitioners?

A tax shelter is an activity that is designed to produce losses through the use of allowable deductions. These losses are then passed through to the owners of the activity who use the losses to reduce their tax on other income sources. The owners of the shelter may pay a tax when they sell their investment. However, such a sale (if it does occur) will take place in the future, thus providing the tax shelter owner with a time value of money tax savings.

5. How is a taxpayer's amount at risk in an activity different from the taxpayer's basis in the same activity? What purpose does the amount at risk serve in regard to losses?

The amount at risk is the amount that the taxpayer stands to lose if the activity should fail. Therefore, it represents any amounts invested in the activity that have not yet been recovered, as well as any liabilities the taxpayer has to pay should the activity be unable to pay the liabilities.

The amount at risk in an activity is very similar to the basis in the activity. That is, the at-risk amount is adjusted in the same manner as basis for additional capital investments, the share of income (loss) from the activity and any withdrawals or other capital recoveries which the taxpayer receives from the activity. The primary difference between the at risk amount and basis is the treatment of nonrecourse debt used to finance real estate in the activity. Because the taxpayer is not liable for nonrecourse debt, it is not added to basis. However, the tax law allows nonrecourse debt used to finance real estate to increase the amount at risk in an activity if the borrowing is made on reasonable commercial terms.

The purpose of the at risk rules is to limit loss deductions to an amount that the taxpayer actually stands to lose should the activity fail. Therefore, the taxpayer can only deduct losses from an activity to the extent she or he is at risk.

6. What is a nonrecourse debt? How is financing using nonrecourse debt different from financing using recourse debt?

A nonrecourse debt is a liability that is only secured by the underlying property related to the debt; the other assets of the entity borrowing the money cannot be used to pay the debt if the entity defaults on the loan. A recourse debt is one that is secured by the property underlying the debt and the other assets of the entity borrowing the money.

The main difference between the two financing methods is that nonrecourse debt is generally not added to basis in the activity and can only increase the at-risk amount in the activity if the financing relates to the holding of real estate. A recourse debt is always added to basis in the activity and always increases the amount at risk in the activity.

7. What is the purpose of the passive loss rules?

The basic intention of the passive loss rules is to disallow the deduction of losses from passive activities against other forms of income. That is, a passive loss cannot be deducted against earned income or portfolio income of the taxpayer.

8. Are the passive loss rules disallowance-of-loss provisions or are they loss deferral provisions? Explain.

The passive loss rules are deferral of loss provisions. Any net passive loss not deductible in the year it is incurred is suspended and carried forward to future years and used to offset passive income. In addition, any suspended loss on an activity is deductible in the year in which the taxpayer's entire interest in the activity is disposed of in a taxable transaction.

9. For purposes of the passive loss rules, what is a closely held corporation? How is the tax treatment of passive losses incurred by a closely held corporation different from the tax treatment of passive losses incurred by

A closely held corporation has five or fewer shareholders who own less than 50% of the stock of the corporation during the last half of the tax year. Closely held corporations are allowed to deduct passive losses against active business income but not against portfolio income.

a. Individuals?

Individuals are only allowed to deduct passive losses against passive income under the general passive loss rules. However, for rental real estate two major exceptions exist. First, if a taxpayer passes the real estate professional exception, the activity is not passive and all losses are deductible. To qualify under this exception, a taxpayer must spend more than 50% of her/his personal service time in a real property trade or business, the amount of time spent in the real property trade or business must be greater than 750 hours and the taxpayer must materially participate in the rental activity. To be a material participant, the taxpayer must either spend greater than 500 hours managing the rental activity or must spend more than 100 hours a year in the activity, and the 100 hours must be more hours than any other owner or non-owner spends on the activity (known as the 100-hour test). The second exception is for taxpayers who meet the active participant test. To meet the active participant test, the taxpayer must own at least a 10% interest in the property and have a significant and bonafide involvement in the activity. Under this exception, an individual can deduct up to \$25,000 of losses from the rental activity each year against active and portfolio income. However, the maximum allowable deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The \$25,000 maximum deduction is reduced \$.50 for every dollar of adjusted gross income in excess of \$100,000. The \$25,000 is completely phased out when the taxpayer's adjusted gross income exceeds \$150,000.

b. Corporations?

Corporations are not subject to the passive loss rules. Therefore, they may deduct all passive losses against any form of income.

10. When a business sustains a loss from a casualty, one of two measurement rules is used to determine the amount of the loss. Why is the use of two measurement rules necessary for determining a business casualty loss?

Two measurement rules are necessary to insure that the amount of the capital recovery from the loss does not exceed the amount invested in the asset. That is, the amount of the loss from a casualty is generally the decline in the value of the asset. However, when business property is partially destroyed, the measurement rule is the lesser of the decline in value of the property or the property's basis. This insures that the amount of loss can never exceed the amount invested in the property (basis). For business property fully destroyed or stolen, the measurement of loss is the property's basis. This also insures that the full amount of the taxpayer's unrecovered investment in the property is allowed as a loss. If the first measurement rule were always used, assets whose values have declined below their basis would not get a full capital recovery when they were destroyed.

11. What are the limitations on the deductibility of capital losses by individuals? How do the limitations compare with those for corporations?

Capital losses of individuals are netted against other capital gains that the individual has during the year. If the result of the netting is a loss, the individual can deduct the net capital loss up to a maximum of \$3,000. Any excess loss is carried forward and used in the next year's capital gain and loss netting.

Corporations also net together capital losses and capital gains. However, if the result of the netting is a net capital loss, the loss is not deductible in the period in which it is incurred. The net capital loss can be carried back 3 years and netted against any net capital gains on which the corporation paid tax to obtain a refund of the taxes paid. If the carryback period is not sufficient to fully absorb the loss, any remaining loss can be carried forward for 5 years and used to offset capital gains.

12. Most sales of securities at a loss result in capital losses. Under what circumstances would a loss on the sale of a security be treated as an ordinary loss? Explain the rationale for allowing this treatment.

Ordinary loss treatment is accorded to sales of securities in which the security does not meet the definition of a capital asset. For example, a sale of a security by a dealer in securities receives ordinary loss treatment because the securities represent inventory for the dealer.

A second exception is provided for losses on the sale of qualified small business stock. This exception allows an individual to deduct up to \$50,000 (\$100,000 for a married couple) of losses on the sale of small business stock as an ordinary loss each year. Any loss in excess of the limit is a capital loss.

The rules were adopted to encourage individuals to invest in small businesses. Recent statistics suggest that 85% of the new jobs created in the U.S. are by small businesses. This provides protection (and incentive to invest in small businesses) to investors who otherwise would be able to deduct only \$3,000 in losses each year.

13. What is the purpose of the related party rules as they apply to sales of property?

The related party rules are designed to stop individuals from creating losses through the sale of securities (or other property) to related parties at prices that are not bargained at arms-length. This is accomplished by disallowing all losses on the sale of property to a related party. Any disallowed loss can be used to reduce any gain on the subsequent sale of the property to an unrelated party.

14. Losses incurred on the sale of business assets are generally deductible in full in the year the loss is realized. Describe a situation in which a realized loss on the sale of a business asset is not deductible in the current year, and explain why it would not be deductible.

If a business sells business assets at a loss to a related party, the realized loss is not deductible by the business. The purpose of the related party provisions is to stop businesses from creating losses by selling assets to related parties at prices that are not made at arms-length.

15. What is a wash sale? How is the treatment of a wash sale different from the treatment of other sales of securities?

A wash sale occurs when securities are sold at a loss and the securities are replaced with substantially identical securities within 30 days (before or after) of the loss sale.

Losses on shares that are replaced within the 30 day wash sale period are disallowed. The disallowed loss is added to the basis of the replacement shares. This treatment effectively views the replacement shares as a continuation of the investment in the shares sold at a loss.

16. How are the rules for deducting personal casualty and theft losses different from the rules for business casualty and theft losses? Explain the difference in treatments and the rationale for the difference.

The differences in the rules involve the measurement of the loss and limitations on the deductions. The measurement of the loss is different for property fully destroyed – the loss on business property fully destroyed (stolen) is the adjusted basis; personal property losses are measured as the lesser of 1) the adjusted basis, or 2) the decline in fair market value resulting from the casualty or theft. This measurement rule prevents individuals from deducting any loss in value that occurred prior to the casualty (a personal use loss).

Personal casualty losses are only deductible as itemized deductions. Each loss occurring during the year is reduced by the \$100 statutory limit. The sum of all casualty losses for the year is further reduced by 10% of the taxpayer's adjusted gross income. This treatment is based on administrative convenience. A business casualty loss is fully deductible.

PROBLEMS

17. The Graves Corporation was incorporated in 2015 and incurred a net operating loss of \$35,000. The company's operating income in 2016 was \$47,000. Because of a downturn in the local economy, the company suffers a net operating loss of \$21,000 in 2017. What is the treatment of the 2017 loss?

A corporation is a taxable entity that is responsible for the payment of tax on its income. Therefore, it is allowed a deduction for a net operating loss. The 2015 NOL is carried forward and used to reduce the 2016 operating income to \$12,000 (\$47,000 - \$35,000). Graves pays a tax of \$1,800 (15% x \$12,000) on the income in 2016. The 2017 loss is carried back to 2016 and \$12,000 of the \$21,000 loss is used to reduce the 2016 income to zero. This results in a refund of the \$1,800 of tax paid in 2016. The remaining \$9,000 of loss is carried forward to 2018 and used to reduce income.

	2015	2016	2017
Operating income	<u>\$ (35,000)</u>	<u>\$ 47,000</u>	<u>\$ (21,000)</u>
Carryforward of 2015 loss		(35,000)	
2016 Taxable Income		<u>\$ 12,000</u>	
Carryback of 2017 loss to 2016		<u>(12,000)</u>	12,000
Carryforward of 2017 loss to 2018			<u><u>\$ (9,000)</u></u>
2016 Taxable income		\$ 12,000	
Tax rate on \$12,000 of income		x 15%	
2016 Tax paid (refund of carryback)		<u><u>\$ 1,800</u></u>	

Instructor's Note: Graves has the option of electing not to carry the 2017 loss back to 2016 and carrying the \$21,000 loss forward to 2018. Graves should make the election if it feels that its marginal tax rate will increase and the net present value of the tax savings of carrying the loss forward exceed carrying back the current year's loss.

How would your answer change if Graves were an S corporation?

An S corporation is a conduit entity that does not pay tax on its income. The shareholders of Graves are taxed on any income and also receive their proportionate share of any losses generated by Graves. For 2017, the \$21,000 operating loss is distributed to each shareholder. The shareholder then takes the appropriate allowable deduction on his/her return. Because the income and loss is passed through to the individual shareholders each year, S corporations do not have net operating loss carryforwards or carrybacks.

18. Habiby, Inc., has the following income and expenses for 2014 through 2017. What is the amount of tax that Habiby should pay each year? Use the corporate tax rate schedules in Appendix B to compute the tax liability.

	2014	2015	2016	2017
Income	\$ 280,000	\$ 300,000	\$ 290,000	\$ 320,000
Expenses	(180,000)	(200,000)	(600,000)	(220,000)
Taxable Income	\$ 100,000	\$ 100,000	\$ (310,000)	\$ 100,000

Using the corporate tax rate schedules, Habiby would have paid a tax of \$22,250 each year on its 2014 and 2015 taxable income of \$100,000. The \$310,000 NOL in 2016 could be carried back and used to offset the \$200,000 of taxable income for 2014 and 2015, resulting in a refund of all tax paid (\$22,250) each year. For 2017, \$100,000 of the remaining \$110,000 of the 2016 NOL is carried forward and deducted against 2017 income reducing 2017 taxable income to \$0. The remaining \$10,000 (\$110,000 - \$100,000) can be carried forward to offset income in future years.

	2014	2015	2016	2017
Operating income	\$ 100,000	\$ 100,000	\$(310,000)	\$100,000
Carryback of 2016 loss	(100,000)	(100,000)	200,000	
Taxable Income	<u>\$ -0-</u>	<u>\$ -0-</u>		
Tax refund	<u>\$ 22,250</u>	<u>\$ 22,250</u>		
Remaining carryforward			<u>\$ (110,000)</u>	
Carryforward of 2016 loss				(100,000)
Taxable Income				<u>\$ -0-</u>
Remaining carryforward				<u>\$ 10,000</u>

19. Post Haste, incorporated in 2014, suffers a net operating loss of \$80,000 in 2016. Post Haste had a net operating loss of \$30,000 in 2014 and taxable income of \$65,000 in 2015. Allison, the financial vice president of Post Haste, expects 2017 to be a banner year, with operating income of approximately \$200,000. Write a memo to Allison advising her how to treat the \$80,000 loss in 2016. Post Haste normally earns 9% on its investments.

Post Haste has the option of carrying back the \$80,000 loss to 2015 and the unused loss forward or carrying the entire loss forward for 20 years. To determine the optimal choice, the present value of the tax savings of each option must be calculated. A carryback to 2015 will result in a refund of \$5,250 (\$35,000 x 15%). Only \$35,000 of the loss is used up in the carryback because the \$30,000 loss carryforward from 2014 reduced 2015 taxable income to \$35,000 (\$65,000 - \$30,000). The remaining \$45,000 (\$80,000 - \$35,000) of loss will be carried forward to 2017 and reduces taxable income to \$155,000 (\$200,000 - \$45,000) resulting in a tax savings of \$17,550.

$$\begin{aligned} \text{Corporate tax on } \$200,000 &= \\ \{ \$22,250 + [(\$200,000 - \$100,000) \times 39\%] \} &= \$61,250 \end{aligned}$$

$$\begin{aligned} \text{Corporate tax on } \$155,000 &= \\ \{ \$22,250 + [(\$155,000 - \$100,000) \times 39\%] \} &= (43,700) \\ \text{Tax savings from carrying forward } \$45,000 &= \$17,550 \\ \text{Present value factor} &= \times .917 \\ \text{Present value of tax savings of the carryforward} &= \$16,093 \\ \text{Present value of tax savings of carryback} &= 5,250 \\ \text{Total present value of tax savings} &= \underline{\underline{\$21,343}} \end{aligned}$$

Because the savings is one year in the future, it is discounted at 9% to obtain a present value tax savings of \$16,093 (\$17,550 x .917). The present value of the tax savings using the carryback is \$21,343 (\$5,250 + \$16,093).

If the loss carryforward option is elected, the tax savings on the carryforward to 2017 is \$31,200 (see below) and the present value of the tax savings is \$28,610 (\$31,200 x .917). Therefore, by foregoing the carryback, and carrying the entire loss forward, Post Haste realizes a present value tax savings of \$7,267 (\$28,610 - \$21,343).

$$\begin{aligned} \text{Corporate tax on } \$200,000 &= \\ \{ \$22,250 + [(\$200,000 - \$100,000) \times 39\%] \} &= \$61,250 \end{aligned}$$

$$\begin{aligned} \text{Corporate tax on } \$120,000 &= \\ \{ \$22,250 + [(\$120,000 - \$100,000) \times 39\%] \} &= (30,050) \\ \text{Tax savings from carrying forward of } \$80,000 &= \$31,200 \\ \text{Present value factor} &= \times .917 \\ \text{Total present value of tax savings} &= \underline{\underline{\$28,610}} \end{aligned}$$

20. Marlene opens an outdoor sports complex that features batting cages, miniature golf, and a driving range. She invests \$100,000 of her own money and borrows \$750,000 from her bank. She uses \$475,000 of the loan proceeds to acquire land and construct the office building for the sports complex. The remaining loan proceeds are used to acquire equipment and furnishings. The loan is secured by the land, building, and equipment. What is Marlene's amount at risk in the business if the \$750,000 debt was obtained on reasonably commercial terms and is secured by

- a. The business assets purchased, and Marlene is personally liable if the business assets are insufficient to satisfy the debt?

Marlene is at risk for \$850,000. She is at risk for the \$100,000 of personal funds she invested and for the \$750,000 she borrowed because she is personally liable for the debt.

- b. The business assets purchased, and Marlene is not personally liable if the business assets are insufficient to satisfy the debt?

Marlene is at risk for \$100,000. She is only at risk for the \$100,000 of personal funds she invested in the business. She is not considered at-risk for the nonrecourse loan because she is not personally liable on any of the debt and the loan is not used in the trade or business of holding real property.

- c. Assume the same facts as in part b, except that Marlene uses the \$750,000 loan to purchase an apartment complex.

Marlene is at risk for \$575,000. She is at risk for the \$100,000 of personal funds invested and the \$475,000 of the loan proceeds used to acquire the land and building. Although she is not personally liable on any of the debt, a nonrecourse loan that is used in the trade or business of holding real property that is secured by the real property used in the business is considered at risk. Therefore the \$475,000 debt on the land and building is at risk, but the remaining \$275,000 (\$750,000 - \$475,000) that is used for equipment and furnishings is not at risk.

21. Carlos opens a dry cleaning store during the year. He invests \$30,000 of his own money and borrows \$60,000 from a local bank. He uses \$40,000 of the loan to buy a building and the remaining \$20,000 for equipment. During the first year, the store has a loss of \$24,000. How much of the loss can Carlos deduct if the loan from the bank is nonrecourse? How much does Carlos have at risk at the end of the first year?

Carlos is at risk for \$30,000. He is only at risk for the \$30,000 of personal funds he invested in the business. He is not considered at-risk for the nonrecourse loan because he is not personally liable on any of the debt and the loan is not used in the trade or business of holding real property. Because he is considered at risk for \$30,000, he can deduct the entire \$24,000 loss. The \$24,000 loss reduces Carlos' amount at-risk to \$6,000 (\$30,000 - \$24,000).

22. Return to the facts of problem 21. In the next year, Carlos has a loss from the dry cleaning store of \$18,000. How much of the loss can Carlos deduct? Explain.

Because his at-risk amount in the dry cleaning store is only \$6,000, Carlos can deduct only \$6,000 of the \$18,000 loss. The remaining \$12,000 (\$18,000 - \$6,000) of the loss is suspended due to the at-risk rules. He will be able to deduct the loss when his at-risk amount is increased either through additional investment in the business or when the business generates taxable income.

23. Wayne owns 30% of Label Maker Corporation. Label Maker is organized as an S corporation. During 2016, Label Maker has a loss of \$160,000. At the beginning of 2016, Wayne's at-risk amount in Label Maker is \$30,000.

- a. Assuming that Wayne's investment in Label Maker is not a passive activity, what is his deductible loss in 2016?

As an S corporation, the income and losses are passed through to its shareholders for taxation. In 2016, Wayne's share of the loss is \$48,000 (\$160,000 x 30%). Wayne cannot deduct any loss in excess of his at-risk amount in Label Maker. Therefore, Wayne's 2016 loss deduction is limited to \$30,000 (reducing his at-risk amount to zero). The remaining \$18,000 of his loss is suspended until his at-risk amount increases.

- b. In 2017, Label Maker has a taxable income of \$50,000. What is the effect on Wayne's 2017 income?

The net effect on Wayne's income is zero. Wayne's share of the income is \$15,000 (\$50,000 x 30%), which is included in his 2017 gross income. However, the \$15,000 of income from Label Maker increases his amount at-risk by \$15,000 and he is allowed to deduct \$15,000 of the \$18,000 suspended loss from 2016. After deducting the loss, Wayne's at risk amount is reduced to zero. His suspended loss in the activity due to the at-risk rules is \$3,000 (\$18,000 - \$15,000).

24. A taxpayer has the following income (losses) for the current year:

Active Income	Portfolio Income	Passive Income
\$18,000	\$31,000	\$(35,000)

What is the taxpayers taxable income (loss) if

- a. The taxpayer is a publicly held corporation?

Publicly held corporations are not subject to the passive activity loss rules. The taxpayer reports income of \$14,000 (\$18,000 + \$31,000 - \$35,000).

- b. The taxpayer is a closely held corporation?

A closely held corporation is allowed to deduct passive losses against active income of the corporation, but not against portfolio income. In this case, \$18,000 of the passive loss is deducted against the \$18,000 of active income, leaving the corporation with a taxable income of \$31,000 (i.e., the portfolio income).

- c. The taxpayer is a single individual and the passive income is not from a rental activity?

An individual cannot deduct passive losses against active or portfolio income. The taxpayer has taxable income of \$49,000 (\$18,000 + \$31,000) and a suspended loss of \$35,000.

- d. The taxpayer is a single individual and the passive income is the result of a rental activity for which the taxpayer is a qualified real estate professional?

An individual who qualifies as real estate professional can deduct all losses from the activity against active and portfolio income. The taxable income is \$14,000 (\$18,000 + \$31,000 - \$35,000).

- e. The taxpayer is a single individual and the passive income is the result of a rental activity for which the taxpayer fails to qualify as a real estate professional but does meet the active participation test?

An individual who is an active participant in a rental real estate activity is allowed to deduct up to \$25,000 of losses from rental activities against active and portfolio income. The taxable income is \$24,000 (\$18,000 + \$31,000 - \$25,000).

25. A taxpayer has the following income (losses) for the current year:

Active Income	Portfolio Income	Passive Income
\$43,000	\$29,000	\$(27,000)

What is the taxpayers taxable income (loss) if

- a. The taxpayer is a single individual and the passive income is not from a rental activity?

An individual cannot deduct passive losses against active or portfolio income. The individual taxpayer has taxable income of \$72,000 (\$43,000 + \$29,000) and a suspended loss of \$27,000.

- b. The taxpayer is a single individual and the passive income results from a rental activity for which the taxpayer qualifies as a real estate professional?

An individual who qualifies as real estate professional can deduct all losses from the activity against active and portfolio income. The taxable income is \$45,000 (\$43,000 + \$29,000 - \$27,000).

- c. The taxpayer is a single individual and the passive income results from a rental activity for which the taxpayer fails to qualify as a real estate professional but does meet the active participation test?

An individual who is an active participant in a rental real estate activity is allowed to deduct up to \$25,000 of losses from rental activities against active and portfolio income. The taxable income is \$47,000 (\$43,000 + \$29,000 - \$25,000).

26. Which of the following would be a passive activity? Explain.

- a. Kevin is a limited partner in Marlin Bay Resort and owns a 15% interest in the partnership.

A limited partnership interest is always considered to be a passive activity. As a limited partner, Kevin has no involvement in managing the partnership's assets, so he does not meet the material participation test.

- b. Tom owns a 15% interest in a real estate development firm. He materially participates in the management and operation of the business.

The real estate development firm qualifies as a trade or business. Because Tom materially participates in the management of the firm, it is not considered a passive activity.

- c. Jasmine owns and operates a bed-and-breakfast.

The activity is not a rental activity under the passive activity loss rules because Jasmine provides significant personal services in operating the bed-and-breakfast. In addition, she is a material participant in the business. The activity is not passive for Jasmine.

- d. Felicia owns a 25% working interest in an oil and gas deposit.

A working interest in an oil and gas deposit is specified as not being a passive activity.

- e. Assume the same facts as in part d, except that Felicia owns a 25% interest in a partnership that owns a working interest in an oil and gas deposit. She does not materially participate in the management and operation of the partnership.

Generally, a working interest in an oil and gas deposit is specified as not being a passive activity. However, because the deposit is owned by a partnership, each individual partner must be evaluated for material participation in the partnership to determine whether the investment in the partnership is passive. In this case, because Felicia does not materially participate in the management and operation of the partnership, the activity is passive for her.

27. Which of the following are passive activities?

- a. Marvin is a limited partner in the Jayhawk Beach Club and owns a 20% interest in the partnership. The partnership's sole asset is a resort hotel.

A limited partnership interest is always considered to be a passive activity. Although a hotel is listed as an exception to the passive activity rules because the activity provides significant services, Marvin can only meet this exception if he materially participates in the hotel's operations. As a limited partner, Marvin has no involvement in managing the resort and does not meet the material participation test.

- b. Marcie owns a royalty interest in an oil and gas operation.

A royalty interest in an oil and gas operation is considered portfolio income.

- c. Neil owns an 18-hole semiprivate golf course. He is a certified professional golfer and serves as the club pro. He provides lessons and is involved in the daily management of the business.

A golf course is not considered a rental activity under the passive activity rules because managing a golf course requires the individual to provide significant services. Neil qualifies for this exception if he materially participates in the golf courses operations. Based on the facts, Neil is a material participant in the business and the activity is not passive.

- d. Assume the same facts as in part c, except that Neil plays on the professional tour. When on break from the tour, he mingles with the members and conducts golf clinics. The club is managed by his brother and sister.

A golf course is not classified as a rental activity under the passive activity rules, because it entails significant services. However, to qualify for this exception the individual must materially participate in the activity. Neil does not qualify for this exception, because he does not materially participate in the management of the golf course. The work Neil performs is more "promotional" than management. Because his brother and sister manage the golf course, the activity is passive for Neil.

- e. Laura owns a commercial office building. She spends more than 500 hours a year managing the building. She also spends 1,700 hours working in her own real estate development firm.

Laura qualifies as a real estate professional. She spends more than 50% of her personal service time in a real property trade or business, the amount of time spent in the real property trade or business is greater than 750 hours, and she materially participates in the rental activity (i.e., spends greater than 500 hours managing the rental activity). Because she qualifies as a real estate professional, the office building is not a passive activity.

- f. Assume the same facts as in part e, except that Laura hires a full-time manager for the commercial office building. She spends 75 hours meeting with the manager and reviewing the operations.

The office building is a passive activity. Because Laura does not spend more than 500 hours managing the rental property, she does not qualify as a real estate professional.

28. Sidney and Gertrude Pearson own 40% of Bearcave Bookstore, an S corporation. The remaining 60% is owned by their son Boris. Sidney and Gertrude do not participate in operating or managing the store and they invested \$19,000 in the business when it opened in 2013. The bookstore reported the following net income (loss) for the years 2013 through 2016:

2013	2014	2015	2016
\$ (24,000)	\$ (14,000)	\$ (12,000)	\$ 5,000

- a. How much do Sidney and Gertrude have at-risk in Bearcave at the end of each year (2013-2016)?

The amount at-risk is the amount that Sidney and Gertrude stand to lose if the activity should fail. Therefore, it represents the amount they have invested in the activity that has not yet been recovered. At the beginning of 2013, the amount they have at-risk is their investment of \$19,000. The amount at-risk is increased by the income from the activity and is reduced by any losses incurred by the activity. Therefore, at the end of 2013, the amount at-risk is reduced by their share, \$9,600 (\$24,000 x 40%), of the loss to \$9,400. In 2014, their share of the loss, \$5,600 (\$14,000 x 40%), reduces the amount they are at risk to \$3,800 (\$9,400 - \$5,600). In 2015, their share of the loss, \$4,800 (\$12,000 x 40%), exceeds the amount that they have at-risk. Therefore, \$1,000 of the loss is suspended due to the at-risk rules. In 2016, when their share of the bookstore income is \$2,000 (\$5,000 x 40%), the amount of the loss suspended due to the at-risk rules is eliminated and their at-risk amount is \$1,000.

	2013	2014	2015	2016
Investment/Beginning Amount at-risk	\$ 19,000	\$ 9,400	\$ 3,800	\$ -0-
Share of income (loss)	(9,600)	(5,600)	(4,800)	2,000
Ending at risk	<u>\$ 9,400</u>	<u>\$ 3,800</u>	<u>\$ -0-</u>	<u>\$ 1,000</u>
Suspended at-risk			<u>\$ (1,000)</u>	

- b. What amount can they recognize as income or loss from Bearcave for each year (2013-2016)?

Because Sidney and Gertrude do not materially participate in the bookstore, it is a passive activity and their share of the losses can only offset income from other passive activities. In 2013, when Sidney and Gertrude are at-risk for the amount of the loss incurred, the loss is suspended due to the passive activity rules. In 2014, the \$5,600 loss is also suspended due to the passive activity rules. In 2015, when the loss exceeds the amount they have at-risk, \$3,800 is suspended due to both the at-risk rules and the passive activity rules and \$1,000 is suspended due to the at-risk rules. In 2016, when the bookstore produces income of \$2,000, the amount suspended due to the at-risk rules is eliminated. In addition, they are allowed to offset the \$2,000 of income with \$2,000 of the loss suspended under the passive activity rules.

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Investment/Beginning				
Amount at-risk	\$ 19,000	\$ 9,400	\$ 3,800	\$ -0-
Share of income (loss)	<u>(9,600)</u>	<u>(5,600)</u>	<u>(4,800)</u>	<u>2,000</u>
Ending at risk	<u>\$ 9,400</u>	<u>\$ 3,800</u>	<u>\$ -0-</u>	<u>\$ 1,000</u>
Amount of income/loss	\$ (9,600)	\$ (5,600)	\$ (4,800)	\$ 2,000
Allowable loss	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>(2,000)</u>
Suspended passive loss	<u>\$ (9,600)</u>	<u>\$ (5,600)</u>	<u>\$ (4,800)</u>	<u>N/A</u>
Total suspended				
passive loss	<u>\$ 9,600</u>	<u>\$ 15,200</u>	<u>\$ 20,000*</u>	<u>\$18,000</u>
Total suspended at-risk			<u>\$ 1,000</u>	

* In a particular year, a loss can be suspended under both the at-risk and passive activity rules. In 2015, \$1,000 is suspended under both sets of rules.

- c. Assume that Sidney and Gertrude materially participate in Bearcave for each year (2013-2016). What amount can they recognize as income or loss from Bearcave for each year (2013-2016)?

	<u>2013</u>	<u>2014</u>	<u>2015</u>	<u>2016</u>
Investment/Beginning				
Amount at-risk	\$ 19,000	\$ 9,400	\$ 3,800	\$ -0-
Share of income (loss)	<u>(9,600)</u>	<u>(5,600)</u>	<u>(4,800)</u>	<u>2,000</u>
Ending at risk	<u>\$ 9,400</u>	<u>\$ 3,800</u>	<u>\$ -0-</u>	<u>\$ 1,000</u>
Amount of income/loss	\$ (9,600)	\$ (5,600)	\$ (4,800)	\$ 2,000
Allowable loss (at-risk)	<u>\$ (9,600)</u>	<u>\$ (5,600)</u>	<u>\$ (3,800)</u>	<u>\$ (1,000)</u>
Suspended at-risk			<u>\$ 1,000</u>	

Because Sidney and Gertrude materially participate in the bookstore, they can deduct losses from the activity up to the amount they are at-risk in the activity. In 2013, Sidney and Gertrude are at-risk for the entire amount of the loss, so they can deduct their \$9,600 loss. In 2014, they can deduct their \$5,600 loss. In 2015, Sidney and Gertrude only can deduct \$3,800 of the loss because of the at-risk limitation. In 2016, when the bookstore produces income of \$2,000, their amount at-risk increases by their share of the income (\$2,000). The amount that they will report as income on their tax return is \$1,000. The \$2,000 of 2016 income is reduced by the \$1,000 of loss they could not deduct in 2015 due to the at-risk limitations.

29. Aretha and Betina own a 10-unit apartment complex. Aretha owns a 60% interest in the apartment complex, and Betina has a 40% interest. Aretha is an investment banker and spends 120 hours helping to manage the apartment complex. Betina is the co-owner of a real estate agency where she works 1,600 hours a year. She also spends 520 hours managing the apartment complex. During the current year, the apartment complex generates a loss of \$24,000. Aretha's adjusted gross income before considering the loss from the apartment complex is \$175,000, and Betina's is \$162,000.

- a. How much of the loss can Aretha deduct?

To qualify under the real estate professional exception, an individual must spend more than 50% of their personal service time in a real property trade or business, the amount of time spent in the real property trade or business must be greater than 750 hours, and the taxpayer must materially participate in the rental activity. To materially participate in the activity the taxpayer must either spend greater than 500 hours managing the rental real estate activity, or spend more than 100 hours in the activity and that must be more time than any owner or non-owner spends on the activity.

Aretha fails to qualify as a real estate professional. However, she is an active participant in the activity. As an active participant, Aretha can deduct up to \$25,000 in losses from the rental activity. However, because her adjusted gross income exceeds the \$150,000 phase-out limit, she cannot deduct any portion of her \$14,400 (\$24,000 - \$9,600) share of the loss. The loss is suspended as a passive loss and can be deducted in the following year either against passive income or under next year's \$25,000 limit. Aretha's adjusted gross income remains at \$175,000.

- b. How much of the loss can Betina deduct?

Only Betina qualifies under the real estate professional exception. She spends more than one-half of her time in a real property trade or business, the amount of time spent on the activities is greater than 750 hours and she spends more than 500 hours managing the rental activity. Accordingly, the rental activity is not passive and she can deduct her \$9,600 (\$24,000 x 40%) share of the loss against her other income. Betina's adjusted gross income after the loss is \$152,400 (\$162,000 - \$9,600).

- c. Assume the same facts except that Aretha's adjusted gross income before the rental loss is \$145,000 and Betina's is \$140,000. How much of the loss can Aretha deduct? How much of the loss can Betina deduct?

Betina can still deduct the full amount of her share of the loss. Betina's adjusted gross income is \$130,400 (\$140,000 - \$9,600). Because Aretha's adjusted gross income is less than \$150,000, she can deduct some of her loss from the rental activity. However, because her adjusted gross income exceeds \$100,000, she must reduce the \$25,000 maximum by \$.50 for each dollar of adjusted gross income in excess of \$100,000. As a result, Aretha must reduce the \$25,000 maximum by \$22,500 $[(\$145,000 - \$100,000) \times \$0.50]$ to \$2,500. Because Aretha's loss from the passive activity (\$14,400) exceeds the \$2,500 limit, her adjusted gross income can only be reduced by \$2,500. Her adjusted gross income is \$142,500 (\$145,000 - \$2,500). The remaining loss of \$11,900 (\$14,400 - \$2,500) is suspended as a passive loss and can be deducted in the following year either against passive income or under next year's \$25,000 limit.

- d. Assume the same facts as in part a, except that the apartment complex qualifies under federal guidelines as low-income housing. How much of the loss can Aretha deduct? How much of the loss can Betina deduct?

Investments in low-income housing are not generally considered to be passive activities. Therefore, both Aretha and Betina can deduct the full amount of their share of the loss from the rental activity. Aretha's adjusted gross income is \$160,600 (\$175,000 - \$14,400). Betina's adjusted gross income after the loss deduction is \$152,400 (\$162,000 - \$9,600).

Instructor's Note: The solution to this problem assumes that Betina and Aretha have enough at-risk to deduct the losses.

30. Carlos is a 25% owner of CEBJ Builders, a company that specializes in residential construction. The other 75% of CEBJ is owned by his three brothers. During the year, Carlos spends 1,800 hours managing the operations of CEBJ. He also is the 100% owner of four rental properties and spends 125 hours a year maintaining the properties, more than any other individual. During the current year, the four properties generate a loss of \$18,500. His adjusted gross income before considering the rental loss is \$118,000.
- a. What amount of the loss can Carlos deduct in the current year?

Carlos qualifies under the real estate professional exception because he spends more than 50% of his personal service time in real property trade or businesses, the amount of time spent in real property trade or businesses is greater than 750 hours, and he materially participates in the rental activity (i.e., he is the sole owner and spends more than 100 hours). The rental activity is not considered passive and he is allowed to offset the \$18,500 loss against his active and portfolio income. Carlos's adjusted gross income after considering the loss is \$99,500 (\$118,000 - \$18,500).

- b. Assume that Carlos's ownership interest in CEBJ is 4%. What amount of the loss can he deduct?

Because Carlos only owns 4% (he must own greater than 5%) of the construction business, the 1,800 hours he spends in the construction business is not considered as time spent in a real property trade or business. Thus, only 6.5% (125 hours ÷ 1,925 hours) of his time is in a real property trade or business and he fails to qualify as a real estate professional. However, Carlos does meet the active participant exception. Because Carlos's adjusted gross income exceeds \$100,000, Carlos must reduce the \$25,000 maximum allowance by \$.50 for each dollar in excess of \$100,000. Thus, Carlos must reduce the maximum allowance by \$9,000 (\$118,000 - \$100,000 = \$18,000 x .50 = \$9,000) to \$16,000 (\$25,000 - \$9,000). The maximum loss Carlos is entitled to deduct is \$16,000. Carlos's adjusted gross income after considering the loss is \$102,000 (\$118,000 - \$16,000). The remaining \$2,000 (\$18,000 - \$16,000) is considered a suspended loss.

Instructor's Note: Even though Carlos meets the active participant test, the rental property is still considered passive.

- c. Assume that Carlos spends only 600 hours managing CEBJ Builders and 1,200 hours managing a microbrewery he acquired earlier in the year. What amount of the loss can he deduct?

To qualify as a real estate professional, Carlos must spend more than 50% of his time in real property trade or businesses. Because Carlos spends only 37.7% $[(600 + 125 = 725 \text{ hours}) \div (125 + 600 + 1,200 = 1,925 \text{ hours})]$ of his time in real property trade or businesses, he fails the material participant test. Therefore, he is considered an active participant and, as in part a above, he can only deduct \$16,000 of his loss. His adjusted gross income is \$102,000.

- d. Assume that Carlos hires his brother-in-law to help him manage the properties. Carlos spends 125 hours and his brother-in-law spends 225 hours managing the rental properties. What amount of the loss can Carlos deduct?

Carlos meets the first two requirements of the real estate professional exception. Although Carlos spends more than 100 hours managing the rental properties, he fails the third requirement because the amount of time he spends on the activity is not more hours than any other owner or non-owner spends on the activity. Therefore, Carlos is considered an active participant and, as in part a above, he is only allowed to deduct \$16,000 of the rental loss.

31. Mort is the sole owner of rental real estate that produces a net loss of \$18,000 in 2015 and \$20,000 in 2016 and income of \$6,000 in 2017. His adjusted gross income, before considering the rental property for the years 2015 through 2017, is \$120,000, \$140,000, and \$90,000, respectively.
- a. What is Mort's adjusted gross income for 2015, 2016, and 2017 if he qualifies as a real estate professional?

As a real estate professional, the rental activity is not passive and Mort can deduct the 2015 and 2016 losses. In 2017, when the rental property has net income of \$6,000, the amount is added to his adjusted gross income.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Adjusted gross income before rental	\$ 120,000	\$ 140,000	\$ 90,000
Rental income (loss)	(18,000)	(20,000)	6,000
Adjusted gross income	<u>\$ 102,000</u>	<u>\$ 120,000</u>	<u>\$ 96,000</u>

- b. What is Mort's adjusted gross income for 2015, 2016, and 2017 if he actively participates in the rental activity?

An active participant is allowed to deduct up to \$25,000 per year against active and portfolio income. However, the \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000.

In 2015, when Mort's adjusted gross income is \$120,000, the \$25,000 maximum loss is reduced to \$15,000 $\{ \$25,000 - [(\$120,000 - \$100,000) \times \$0.50] \}$. The remaining \$3,000 of loss $(\$18,000 - \$15,000)$ is suspended and carried forward to 2016. The loss can be used either against passive income or next year's \$25,000 limit. His adjusted gross income for the year is \$105,000 $(\$120,000 - \$15,000)$.

In 2016, the \$25,000 maximum loss is reduced to \$5,000 $\{ \$25,000 - [(\$140,000 - \$100,000) \times \$0.50] \}$. The remaining \$15,000 of loss $(\$20,000 - \$5,000)$ is suspended and carried forward with the \$3,000 loss suspended in 2015. Mort's total suspended loss is \$18,000 $(\$3,000 + \$15,000)$. His adjusted gross income for the year is \$135,000 $(\$140,000 - \$5,000)$.

In 2017, Mort's adjusted gross income is less than \$100,000, so he is eligible to deduct up to \$25,000 of losses from his rental activities. Although Mort has income for the current year from the rental real estate of \$6,000, he can offset the income with the \$18,000 of suspended losses. His adjusted gross income for the year is \$78,000 $[\$90,000 - \$12,000 (\$6,000 - \$18,000)]$.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Adjusted gross income before rental	\$ 120,000	\$ 140,000	\$ 90,000
Rental income (loss)	(15,000)	(5,000)	(12,000)
Adjusted gross income	<u>\$ 105,000</u>	<u>\$ 135,000</u>	<u>\$ 78,000</u>

32. Katrina is the sole owner of rental real estate that produces a net loss of \$18,000 in 2015 and \$22,000 in 2016 and income of \$9,000 in 2017. Her adjusted gross income, before considering the rental property for the years 2015 through 2017, is \$115,000, \$137,000, and \$88,000, respectively.
- a. What is Katrina's adjusted gross income for 2015, 2016, and 2017 if she qualifies as a real estate professional?

As a real estate professional, the rental activity is not passive and Katrina can deduct the 2015 and 2016 losses. In 2017, when the rental property has net income of \$9,000, the amount is added to her adjusted gross income.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Adjusted gross income before rental	\$ 115,000	\$137,000	\$ 88,000
Rental income (loss)	(18,000)	(22,000)	9,000
Adjusted gross income	<u>\$ 97,000</u>	<u>\$ 115,000</u>	<u>\$ 97,000</u>

- b. What is Katrina's adjusted gross income for 2015, 2016, and 2017 if she actively participates in the rental activity?

An active participant is allowed to deduct up to \$25,000 per year against active and portfolio income. However, the \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000.

In 2015, when Katrina's adjusted gross income is \$115,000, the \$25,000 maximum loss is reduced to \$17,500 $\{ \$25,000 - [(\$115,000 - \$100,000) \times \$0.50] \}$. The remaining \$500 of loss $(\$18,000 - \$17,500)$ is suspended and carried forward to 2016. The loss can be used either against passive income or next year's \$25,000 limit. Her adjusted gross income for the year is \$97,500 $(\$115,000 - \$17,500)$.

In 2016, the \$25,000 maximum loss is reduced to \$6,500 $\{ \$25,000 - [(\$137,000 - \$100,000) \times \$0.50] \}$. The remaining \$15,500 of loss $(\$22,000 - \$6,500)$ is suspended and carried forward with the \$500 loss suspended in 2015. Katrina's total suspended loss is \$16,000 $(\$500 + \$15,500)$. Her adjusted gross income for the year is \$130,500 $(\$137,000 - \$6,500)$.

In 2017, Katrina's adjusted gross income is less than \$100,000, so she is eligible to deduct up to \$25,000 of losses from her rental activities. Although Katrina has income for the current year from the rental real estate of \$9,000, she can offset the income with the \$16,000 of suspended losses. Her adjusted gross income for the year is \$81,000 $[\$88,000 - \$7,000 (\$9,000 - \$16,000)]$.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Adjusted gross income before rental	\$ 115,000	\$ 137,000	\$ 88,000
Rental income (loss)	(17,500)	(6,500)	(7,000)
Adjusted gross income	<u>\$ 97,500</u>	<u>\$ 130,500</u>	<u>\$ 81,000</u>

33. Ivan and Olga own a duplex. They collect the rents and make repairs to the property when necessary. That is, they are active participants in the rental activity. During the current year, the duplex has gross rents of \$16,000 and total allowable deductions of \$31,000. What is the effect of the duplex rental on their taxable income if their adjusted gross income is

a. \$87,000?

Individuals who are active participants in rental property are allowed to deduct up to \$25,000 of losses from rental real estate against active and portfolio income. In this case, Ivan and Olga are allowed to deduct the entire \$15,000 (\$16,000 - \$31,000) rental real estate loss.

b. \$155,000?

The \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000. Thus, the special rental real estate deduction is not available to taxpayer's whose adjusted gross income exceeds \$150,000. Because Ivan and Olga have \$155,000 of adjusted gross income, they are not allowed to deduct any of the \$15,000 rental loss. The \$15,000 loss is suspended as a passive loss and can be deducted in the following year against either passive income or under next year's \$25,000 limit.

c. \$122,000?

The \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000. In this case, the \$25,000 allowable maximum is reduced by \$11,000 $[(\$122,000 - \$100,000) \times \$.50]$ to \$14,000. Because Ivan and Olga's loss of \$15,000 is greater than the \$14,000 maximum, only \$14,000 of loss is deductible. The \$1,000 loss that is not deducted is suspended as a passive loss and can be deducted in the following year either against passive income or under next year's \$25,000 limit.

d. \$139,000?

The \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000. In this case, the \$25,000 allowable maximum is reduced by \$19,500 $[(\$139,000 - \$100,000) \times \$.50]$ to \$5,500. Thus, Ivan and Olga are only allowed to deduct \$5,500 of the \$15,000 rental loss. The \$9,500 that is not deducted is suspended as a passive loss and can be deducted in the following year either against passive income or under next year's \$25,000 limit.

34. Jacqueline is a 60% owner of a rental property and has a significant role in the management of the property. During the current year, the property has a rental loss of \$21,500. What is the effect of the rental property on her taxable income, if her adjusted gross income is

a. \$ 71,000?

Individuals who are active participants in rental property are allowed to deduct up to \$25,000 of losses from rental real estate against active and portfolio income. As a 60% owner, Jacqueline's share of the loss is \$12,900 ($\$21,500 \times .60$). Because her adjusted gross income is less than \$100,000 she can deduct the entire \$12,900 rental real estate loss.

b. \$129,000?

The \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000. In this case, the \$25,000 allowable maximum is reduced by \$14,500 [$(\$129,000 - \$100,000) \times \$.50$] to \$10,500. Because Jacqueline's \$12,900 loss is greater than the maximum allowable amount of \$10,500, she can deduct only \$10,500 of the loss. The remaining \$2,400 ($\$12,900 - \$10,500$) of the rental loss is suspended as a passive loss and can be deducted in the following year against either passive income or under next year's \$25,000 limit.

c. \$187,000?

The \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000. Thus, the special rental real estate deduction is not available to taxpayers whose adjusted gross income exceeds \$150,000. Because Jacqueline has \$187,000 of adjusted gross income, she cannot deduct any of the \$12,900 rental loss. The \$12,900 rental loss is suspended as a passive loss and can be deducted in the following year against either passive income or under next year's \$25,000 limit.

d. \$107,000?

The \$25,000 rental real estate deduction is reduced when an individual's adjusted gross income exceeds \$100,000. The amount of the reduction is \$.50 for every \$1 of adjusted gross income in excess of \$100,000. In this case, the \$25,000 allowable maximum is reduced by \$3,500 [$(\$107,000 - \$100,000) \times \$.50$] to \$21,500. Thus, Jacqueline is allowed to deduct the entire \$12,900 of rental real estate loss.

35. Janet has a taxable income of \$54,000 from her salary and investment assets. She also owns 3 passive activities that have the following income (loss) for the year:

Passive Activity 1	\$ 12,000
Passive Activity 2	\$ (18,000)
Passive Activity 3	\$ (9,000)

- a. What is the effect of the passive activities on Janet's income? Explain.

Janet has a net passive loss of \$15,000:

Passive Activity 1	\$ 12,000
Passive Activity 2	(18,000)
Passive Activity 3	(9,000)
Net passive loss	<u>\$ (15,000)</u>

Individuals are not allowed to deduct passive losses against non passive income. Janet would include the \$12,000 of income from PA1 in her gross income and is allowed to deduct \$12,000 of the loss from PA2 and PA3 against this income. The net passive loss of \$15,000 is suspended and carried forward to subsequent years for netting against passive income. The net result is a taxable income of \$54,000 (i.e., the income from her salary and investment assets).

- b. How much suspended loss does Janet have in each passive activity?

The \$15,000 of suspended loss must be allocated between PA2 and PA3 based on their relative contribution to the loss:

$$\text{PA2} - (\$18,000 \div \$27,000) \times \$15,000 = \$10,000$$

$$\text{PA3} - (\$ 9,000 \div \$27,000) \times \$15,000 = \$ 5,000$$

36. Return to the facts of problem 35. In the next year, Janet has a taxable income from her salary and investment activities of \$62,000. The results for her 3 passive activities are

Passive Activity 1	\$ 15,000
Passive Activity 2	\$ (8,000)
Passive Activity 3	\$ (2,000)

- a. What is the effect of the passive activities on Janet's income? Explain.

There would be no effect on Janet's \$62,000 taxable income. The \$15,000 of suspended loss from the previous year would be netted against the current year's passive income and losses resulting in a net passive loss of \$10,000:

Passive activity 1	15,000
Suspended loss passive activity 2	(10,000)
Passive activity 2	(8,000)
Suspended loss passive activity 3	(5,000)
Passive Activity 3	(2,000)
Net Passive Loss	<u>\$ (10,000)</u>

The total loss from passive activity 2 of \$18,000 (\$10,000 + \$8,000) and passive activity 3 of \$7,000 (\$5,000 + \$2,000) reduce the net passive activity income for the year to zero. The total suspended loss from PA2 and PA3 is \$10,000.

- b. How much suspended loss does Janet have in each passive activity?

The suspended loss must be allocated based on the proportion of passive loss from each activity over the two years to the total passive loss from all the activities for the two years. Using this weighted average formula, the remaining suspend loss for passive activity 2 and passive activity 3 is \$7,200 and \$2,800 respectively.

Formula:

$$\frac{\text{Total passive loss from activity}}{\text{Total passive losses all activities}} \times \text{Remaining suspended loss}$$

$$\text{PA2 - } \frac{(\$10,000 + \$8,000)}{(\$15,000 + \$10,000)} \times \$10,000 = \$7,200$$

$$\text{PA3 - } \frac{(\$5,000 + \$2,000)}{(\$15,000 + \$10,000)} \times \$10,000 = \$2,800$$

37. Mason owns a passive activity that generates a loss of \$14,000 in 2015, \$12,000 in 2016, and income of \$4,000 in 2017. In 2016, Mason purchases a second passive activity that has passive income of \$6,000 in 2016 and \$10,000 in 2017. Discuss the effect of Mason's passive activity investments on his taxable income in 2015, 2016, and 2017. Assume that neither passive activity involves rental real estate.

Mason's \$14,000 loss in 2015 is suspended and carried forward to 2016. This results in a net passive loss of \$20,000, which is carried forward to 2017. The \$20,000 passive loss carryforward is used to offset the \$14,000 (\$4,000 + \$10,000) of passive income Mason receives in 2017. The \$6,000 passive loss is carried forward to 2018. The passive activities have no effect on Mason's taxable income for any of the three years.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Suspended loss from prior years		\$ (14,000)	\$ (20,000)
Current year loss	\$ (14,000)	(12,000)	-0-
Current year income		6,000	14,000
Net passive loss	<u>\$ (14,000)</u>	<u>\$ (20,000)</u>	<u>\$ (6,000)</u>

38. Return to the facts of problem 37. At the end of 2017, Mason sells the passive activity that generated the losses for \$16,000. What is the effect on his taxable income if his basis in the activity sold is

a. \$4,000?

Mason has a long-term capital gain of \$12,000 (\$16,000 - \$4,000) on the sale of the passive activity. In addition, the \$6,000 suspended loss in the activity is deductible for adjusted gross income. The total effect of the sale is to increase Mason's income by \$6,000. Note: The \$12,000 long-term capital gain must be netted with other capital gains and losses. Long-term capital gains are taxed at 0%, 15%, or 20% depending on the taxpayers filing status and taxable income. Therefore, depending on Mason's other capital asset transactions, the increase in his tax may not correspond directly with the increase in taxable income from the sale.

b. \$21,000?

Mason has a long-term capital loss of \$5,000 (\$16,000 - \$21,000) from the sale of the passive activity. In addition, the \$6,000 suspended loss in the activity is deductible for adjusted gross income. The capital loss must be netted with Mason's other capital gains and losses for the year. If Mason has no other capital gains in 2017, then only \$3,000 of the loss is deductible. This would result in a \$9,000 reduction in his taxable income. Note: If Mason does have other capital gains in 2017, then, to the extent that the loss on the sale of the passive activity cancels out the gains, Mason's taxable income is effectively decreased versus what it is without the sale.

39. Jeremy owns a passive activity that has a basis of \$30,000 and a suspended loss of \$16,000. His taxable income from active and portfolio income is \$81,000.
- a. What is the effect on Jeremy's taxable income if he sells the passive activity for \$37,000?

Any suspended loss on a passive activity is deductible in full when the entire interest in the activity is disposed of through a sale of the activity. In this case, Jeremy has a capital gain of \$7,000 (\$37,000 - \$30,000) on the sale of the activity and a deduction of \$16,000 for the suspended loss on the activity. This results in a net deduction of \$9,000. However, the \$7,000 capital gain is netted with any other capital gains and losses that Jeremy has during the year. Long-term capital gains are taxed at 0%, 15%, or 20% depending on the taxpayers filing status and taxable income, which further complicates the tax effect of Jeremy's net deduction of \$9,000.

- b. What is the effect on Jeremy's taxable income if he sells the passive activity for \$25,000?

In this case, Jeremy has a \$5,000 capital loss (\$25,000 - \$30,000) on the sale of the passive activity and is allowed a deduction for the \$16,000 suspended loss. The capital loss must be netted with any other capital gains and losses that Jeremy had during the year and therefore, may not be deductible in full. For example, if Jeremy has no other capital gains and losses during the year, only \$3,000 of the capital loss may be deducted in the year of sale.

40. Return to the facts of problem 39. Assume that Jeremy dies when the passive activity has a fair market value of \$37,000. What is the effect on Jeremy's taxable income for the year he dies?

A deduction is allowed for a suspended loss on a passive activity held at death, but only to the extent of the excess of any suspended loss over the unrealized gain on the passive activity. In this case, the unrealized gain is \$7,000 (\$37,000 - \$30,000) and the suspended loss is \$16,000, resulting in an excess of \$9,000. Therefore, Jeremy is allowed a deduction of \$9,000.

41. Return to the facts of problem 39. Assume that Jeremy dies when the passive activity has a fair market value of \$25,000. What is the effect on Jeremy's taxable income for the year he dies?

A deduction is allowed for a suspended loss on a passive activity held at death, but only to the extent of the excess of any suspended loss over the unrealized gain on the passive activity. In this case, there is no unrealized gain (\$25,000 - \$30,000 = \$5,000 loss) and Jeremy is not allowed any deduction for the suspended loss.

42. Return to the facts of problem 39. Assume that Jeremy gives the property to his son Felipe when the property has a fair market value of \$37,000. What is the effect of the gift on Jeremy's taxable income? Felipe's taxable income?

No suspended loss deduction is allowed for a gift of a passive activity. The donee (Felipe) takes a basis in the activity equal to the sum of the donor's basis and the amount of the suspended loss. Felipe's basis in the activity is \$46,000 (\$30,000 + \$16,000). Neither Jeremy nor Felipe receive a deduction for the \$16,000 suspended loss. This treatment prevents Felipe from using the suspended loss deduction against passive income.

43. Masaya owns a passive activity that has a basis of \$32,000 and a suspended loss of \$13,000. Masaya's taxable income from active and portfolio income is \$73,000.

- a. What is the effect on Masaya's taxable income if he sells the passive activity for \$46,000?

Any suspended loss on a passive activity is deductible in full when an entire interest in an activity is disposed of through a sale of the activity. In this case, Masaya has a capital gain of \$14,000 (\$46,000 - \$32,000) on the sale of the activity and a deduction of \$13,000 for the suspended loss on the activity. This results in a net increase in income of \$1,000. However, the \$14,000 capital gain is netted with any other capital gains and losses that Masaya has during the year. Long-term capital gains are taxed at 0%, 15%, or 20% depending on the taxpayers filing status and taxable income, which further complicates the tax effect of the net increase in Masaya's income of \$1,000.

- b. What is the effect on Masaya's taxable income if he sells the passive activity for \$26,000?

In this case, Masaya has a \$6,000 capital loss on the sale of the passive activity and is allowed a deduction for the \$13,000 suspended loss. The capital loss must be netted with any other capital gains and losses that Masaya had during the year and therefore, may not be deductible in full. For example, if Masaya has no other capital gains and losses during the year, only \$3,000 of the capital loss may be deducted in the year of sale.

- c. What is the effect on Masaya's taxable income if he dies this year while the fair market value of the passive activity is \$40,000?

A deduction is allowed for a suspended loss on a passive activity held at death, but only to the extent of the excess of any suspended loss over the unrealized gain on the passive activity. In this case, the unrealized gain is \$8,000 (\$40,000 - \$32,000) and the suspended loss is \$13,000, resulting in an excess of \$5,000. Therefore, Masaya is allowed a deduction of \$5,000.

- d. What is the effect on Masaya's taxable income if he dies this year while the fair market value of the passive activity is \$22,000?

A deduction is allowed for a suspended loss on a passive activity held at death, but only to the extent of the excess of any suspended loss over the unrealized gain on the passive activity. In this case, there is no unrealized gain (\$22,000 - \$32,000 = \$10,000 loss) and Masaya is not allowed a suspended loss deduction of \$10,000.

- e. What is the effect on Masaya's taxable income if he gives the passive activity to his daughter Hideko when the fair market value of the passive activity is \$40,000? What would the effect of this be on Hideko's taxable income?

A suspended loss deduction is not allowed for a gift of a passive activity. The donee has a basis in the activity equal to the sum of the donor's basis and the amount of the suspended loss. Hideko's basis in the activity is \$45,000 (\$32,000 + \$13,000). Neither Masaya nor Hideko receive a deduction for the \$13,000 suspended loss. This treatment prevents Hideko from using the suspended loss deduction against passive income.

44. Claudio owns a passive activity that has a basis of \$28,000 and a fair market value of \$38,000. The activity has suspended losses of \$16,000. To reduce their estate, every year Claudio and his wife give their son Anthony and his wife a gift of approximately \$40,000. During the year, Anthony sells stock that results in a \$10,000 short-term capital loss. A friend of Claudio's suggests that he give his passive activity to Anthony. The friend says that this will allow Claudio to avoid tax on the \$10,000 capital gain and let his son offset his short-term capital loss with the \$10,000 (\$38,000 - \$28,000) gain from the sale of the passive activity. In addition, Claudio can use the suspended loss from the passive activity to offset his other ordinary income. Write a letter to Claudio explaining the tax consequences of making the passive activity a gift to his son.

The information Claudio's friend gave him is not accurate. If Claudio gifts the passive activity to his son, Anthony's basis in the passive activity is \$44,000. Anthony's basis in the passive activity is the sum of Claudio's basis of \$28,000 and Claudio's suspended loss of \$16,000. Although Anthony's basis is increased by the \$16,000 suspended loss, neither Claudio nor Anthony receives a deduction for the suspended loss. This treatment prevents Anthony from using the suspended loss deduction against other passive income. Further, unlike Claudio's friend suggested, if Anthony quickly sells the passive activity he will not recognize a \$10,000 gain, but rather a \$6,000 (\$38,000 - \$44,000) long-term capital loss.

45. ABC Company owns a chain of furniture stores. How much loss can ABC Company deduct in each of the following cases? Explain.

- a. ABC closes a store in a depressed part of the county. Rather than move furniture to other stores, ABC sells furniture that had cost \$275,000 for \$140,000.

The \$135,000 (\$140,000 - \$275,000) loss on the sale of the inventory is an ordinary loss that is fully deductible. All losses incurred in a trade or business are deductible as ordinary losses.

- b. A fire severely damages one store. The cost of repairing the damage is \$127,000. ABC's basis in the store building is \$320,000. ABC's insurance company reimburses ABC \$100,000 for the fire damage.

The loss from the fire damage is measured as the lesser of the decline in the value of the property or the property's basis. The cost of repairing the damage may be used as the measure of the decline in value. The \$127,000 of repairs is reduced by the \$100,000 of insurance proceeds to determine the net casualty loss of \$27,000.

- c. ABC decides to begin replacing some of its older delivery vans. It sells for \$4,200 one van that had a basis of \$7,300.

The sale of a business asset results in an ordinary loss. The loss on the sale of the van is \$3,100 (\$4,200 - \$7,300).

- d. ABC discovers that one of its buildings is infested with termites. The building is old and has been fully depreciated for tax purposes. The cost of getting rid of the termites is \$8,400, none of which is covered by insurance.

Termite infestation is not a casualty. However, any loss incurred in a trade or business is deductible. The question is whether the cost of fixing the termite damage can be deducted immediately as a loss or must be capitalized as a betterment that extends the life of the building.

- e. Someone breaks into one store by destroying the security system. Cash of \$9,000 is missing from a safe. In addition, televisions that had cost \$17,500 and were marked to sell for \$34,000 are gone. The security system has a basis of \$10,800. Because the system is outdated, a security expert estimates it is worth only \$2,700 at the time it is destroyed.

Thefts of business property are measured at their basis. The theft loss is \$26,500 (\$9,000 cash + \$17,500 televisions). The loss on the security system is the \$10,800 basis, for a total loss of \$37,300 (\$26,500 + \$10,800).

46. The Goodson Company is a chain of retail electronics stores. How much of a loss can Goodson deduct in each of the following cases. Explain.
- a. An employee drops a 65 inch 3D television, cracking the plastic case on the back. The television normally sells for \$3,300. The cost of the set is \$2,400 and Goodson's sells the damaged set for \$1,500.

The question is whether the damage by dropping the television is considered a casualty loss. A casualty must be sudden, unexpected and unusual in nature. In most cases, the damage to the television from dropping it would be treated as a casualty loss. The loss is measured as the lesser of the basis of the television, \$2,400 or the reduction in the fair market value of the television \$900 (\$2,400 - \$1,500). Goodson's is allowed a casualty loss of \$900. *Instructors Note:* In practice, an "immaterial" casualty loss similar to this would probably be netted in the cost of goods sold calculation of the business.

- b. The company replaces its inventory system. The old system cost \$45,000 and has a basis of \$16,000. The company sells the old system for \$7,500. The new system costs \$75,000.

The sale of a business asset results in an ordinary loss. The loss on the sale of the computer system is \$8,500 (\$7,500 - \$16,000).

- c. A flood damages one of Goodson's retail stores. The building suffers extensive water damage. The basis of the building is \$60,000 and the cost of repairing the damage is \$72,000. The insurance company reimburses Goodson \$50,000.

The loss from the flood damage is measured as the lesser of the decline in the value of the property or the property's basis. The cost of repairing the building (\$72,000) can be used as an estimate of the decline in market value. The basis of the property is increased by the repair cost of \$72,000 to \$132,000. The \$72,000 loss is reduced by the \$50,000 of insurance proceeds to determine the net casualty loss of \$22,000 (\$72,000 - \$50,000).

- d. The owner of Goodson sells a complete home entertainment center (e.g., projection TV, DVD, stereo system) to his sister for \$7,000. The normal sales price is \$8,500. The system costs \$6,300.

Although the \$7,000 charged to his sister, a related party, for the entertainment center is less than the normal sales price (\$8,500) the price is greater than the owner of Goodson's cost (\$6,300). Therefore, Goodson would recognize \$7,000 from the sale of the entertainment center and deduct its cost of \$6,300 (a gain of \$700 on sale).

- e. Assume the same facts as in part d, except that the owner of sells the home entertainment center to his sister for \$5,500.

Unlike in the previous example, the owner of Goodson sold the entertainment center to a related party, his sister, for an amount (\$5,500) which is less than its cost. Because the transaction is with a related party, Goodson's deduction for the cost of the system is limited to the amount paid by his sister \$5,500. The \$800 difference between the amount received (\$5,500) and the cost (\$6,300) is considered a disallowed loss between a related party and is not deductible. *Instructors Note:* Goodson's sister has a basis in the entertainment system of \$5,500. If she sold the system for more than \$5,500 but less than \$6,300, she would not have to recognize a gain.

- f. The owner of Goodson finds that the controller has embezzled \$10,000 from the company. Before the owner can confront the controller, the controller leaves town and cannot be found.

An embezzlement loss is considered a theft. The basis of the property (cash) stolen is used in measuring a theft. Goodson is allowed to deduct the \$10,000 cash embezzled as a business casualty loss.

- g. Upon arriving at the company headquarters, the vice-president of sales finds that someone has broken in and stolen 3 computers. The damage to the outside door is extensive. The cost of repairing the door is \$1,500, and the cost of replacing the 3 computers is \$9,500. The original cost of the computers totals \$10,500. Goodson's basis in the computers is \$5,000. The thieves also stole \$350 from the petty cash fund. Goodson files a claim with its insurance company and receives \$4,800.

Goodson has incurred both a theft loss and a casualty loss. The basis of business property is used to measure the amount of a theft. The theft loss is \$5,350 (\$350 petty cash + \$5,000 computers) and the casualty loss is \$1,500 (cost to repair the door). The casualty and theft loss must be reduced by the \$4,800 it receives from its insurance company. Goodson's casualty and theft loss is \$2,050 [(\$5,350 + \$1,500) - \$4,800].

47. Gordon is the sole proprietor of Fashion Flowers & Florals (FFF). During the current year, one of FFF's delivery vans is involved in an automobile accident. The van has a basis of \$6,000. What is FFF's allowable casualty loss deduction under each of the following situations?

- a. A comparable van sells for \$4,000. FFF's van was totally destroyed in the accident. FFF's insurance pays \$2,200 on the casualty.

The loss on business property totally destroyed is the property's basis. The \$6,000 basis is reduced by the \$2,200 insurance reimbursement for a deductible loss of \$3,800.

- b. A comparable van sells for \$8,400. FFF's van was totally destroyed in the accident. FFF's insurance pays \$6,400 on the casualty.

The \$6,000 basis is the measure of loss. Because the \$6,400 of insurance proceeds exceeds the \$6,000 basis, FFF has a gain of \$400 on the casualty.

48. Assume the same facts as in problem 47. What is FFF's allowable casualty loss deduction under each of the following situations?

- a. A comparable van sells for \$4,000. After the accident, the insurance adjuster estimates the van was worth \$1,500. The insurance company pays FFF \$1,200 on the casualty.

The loss on partially destroyed business property is measured as the lesser of the decline in the value of the property, \$2,500 (\$4,000 - \$1,500), or the property's basis, \$6,000. FFF's loss is the \$2,500 decline in value. This is reduced by the \$1,200 insurance reimbursement for a net casualty loss deduction of \$1,300 (\$2,500 - \$1,200).

- b. A comparable van sells for \$8,400. After the accident, the insurance adjuster estimates the value of the van at \$1,500. The insurance company pays FFF \$1,200 on the casualty.

The loss on partially destroyed business property is measured as the lesser of the decline in the value of the property, \$6,900 (\$8,400 - \$1,500), or the property's basis, \$6,000. The loss is limited to the \$6,000 basis. This is reduced by the \$1,200 insurance reimbursement for a net casualty loss deduction of \$4,800 (\$6,000 - \$1,200).

49. Stella owns a taxicab company. During the year, two of her cabs are involved in accidents. One is totally destroyed; the other is heavily damaged. Stella is able to replace the destroyed cab with an identical model for \$5,500. Her adjusted basis in the destroyed cab is \$3,750, and the insurance company pays her \$2,800. The adjusted basis of the damaged cab is \$3,800. The insurance adjuster estimates that the damaged cab is worth \$3,600. Although a comparable cab sells for \$7,800, the insurance company gives Stella only \$2,900. Write a letter to Stella explaining the amount of her deductible casualty loss.

The loss on business property totally destroyed is the property's basis. The loss on partially destroyed business property is measured as the lesser of the decline in the value of the property or the property's basis. Whether the property is totally destroyed or only partially destroyed, the measured loss is reduced by any insurance reimbursement.

Stella's loss for the cab that is totally destroyed is its basis of \$3,750. The \$3,750 is reduced by the insurance reimbursement of \$2,800 for a deductible loss of \$950. The loss on partially destroyed business property is the lesser of the decline in the value of the property, \$4,200 (\$7,800 - \$3,600) or the property's basis, \$3,800. Stella's loss is the cab's basis, \$3,800 and is reduced by the \$2,900 insurance reimbursement for a net casualty loss deduction of \$900. Stella's total casualty loss on the two accidents is \$1,850 (\$950 + \$900).

	<u>Destroyed Cab</u>		<u>Damaged Cab</u>	
Lower of:				
Adjusted basis	\$3,750		\$3,800	
or				
Reduction in FMV	5,500	\$ 3,750	4,200	\$ 3,800
Insurance reimbursement		(2,800)		(2,900)
Casualty loss		<u>\$ 950</u>		<u>\$ 900</u>

50. Rhoda owns an electronics store that is burglarized during the current year. The burglars destroy the point-of-sale terminal and steal \$380 from the cash drawer. The point-of-sale terminal was purchased for \$7,500, and its adjusted basis is \$3,700. The insurance adjuster estimates that the fair market value of a similar point-of-sale terminal is \$6,000. The burglars also steal stereo equipment costing \$4,200 that has a retail value of \$7,000. In breaking into the store, the burglars break a large glass door that costs Rhoda \$540 to replace. What is Rhoda's deductible loss if the insurance company reimburses her \$5,000?

Rhoda's deductible casualty loss is \$3,820:

Amount of Loss:

Cash	\$ 380
Point of sale terminal (basis)	3,700
Stereo equipment (basis)	4,200
Broken glass door	540
Total loss	<u>\$ 8,820</u>
Less: Insurance	(5,000)
Deductible theft loss	<u><u>\$ 3,820</u></u>

The loss on business property that is stolen is the property's basis. The loss on the broken glass is the cost to replace it.

51. Wilbur owns a 25% interest in the Talking Horse Corporation, which is organized as an S corporation. His basis in the property is \$15,000. For the year, Talking Horse reports an operating loss of \$28,000 and a capital loss of \$6,000. Wilbur's adjusted gross income is \$72,000

- a. What effect would these losses have on Wilbur's adjusted gross income if he does not materially participate in Talking Horse? Explain.

As a 25% owner of Talking Horse, Wilbur's share of the ordinary loss is \$7,000 ($\$28,000 \times 25\%$) and his share of the capital loss is \$1,500 ($\$6,000 \times 25\%$). If Wilbur is not a material participant in the activity, the \$7,000 loss cannot be deducted because the loss is incurred in a passive activity. However, assuming Wilbur's \$1,500 share of the capital loss is not from the sale of an asset used in a passive activity, but from the sale of an investment (i.e., stock) of the passive activity, he can reduce his adjusted gross income by \$1,500. Therefore, if Wilbur has no other capital gains or losses for the year his adjusted gross income is \$70,500 ($\$72,000 - \$1,500$).

- b. What effect would these losses have on Wilbur's adjusted gross income if he materially participates in Talking Horse? Explain.

As a 25% owner of Talking Horse, Wilbur's share of the ordinary loss is \$7,000 ($\$28,000 \times 25\%$) and his share of the capital loss is \$1,500 ($\$6,000 \times 25\%$). At the beginning of the year, Wilbur's basis and the amount he has at-risk in Talking Horse is \$15,000. Therefore, he is allowed to deduct the \$7,000 loss. Wilbur can also use the \$1,500 of capital loss to reduce his adjusted gross income. As a material participant, Wilbur's adjusted gross income is \$63,500 ($\$72,000 - \$7,000 - \$1,500$). Wilbur's basis and his at-risk amount in Talking Horse at the end of the year is \$6,500 ($\$15,000 - \$7,000 - \$1,500$).

52. During 2016, Yoko has total capital gains of \$8,000 and total capital losses of \$16,000.
- a. What is the effect of the capital gains and losses on Yoko's 2016 taxable income? Explain.

The capital gains and losses are netted together to determine the net capital gain/loss position for the year. Yoko has a net capital loss of \$8,000:

Total capital gains	\$ 8,000
Total capital losses	(16,000)
Net capital loss	<u>\$ (8,000)</u>
2016 Deduction	<u>\$ 3,000</u>
Loss carryforward to 2017	<u>\$ (5,000)</u>

The deduction for capital losses is limited to \$3,000 per year, with any excess capital loss carried forward for netting in subsequent years. Yoko has a \$5,000 capital loss carryforward.

- b. Assume that in 2017 Yoko has total capital gains of \$10,000 and total capital losses of \$7,500. What is the effect of the capital gains and losses on Yoko's taxable income in 2017? Explain.

The 2017 capital gains and losses are netted with the \$5,000 capital loss carryforward. This results in a net capital loss of \$2,500. Because it is under the \$3,000 maximum deduction limit, the entire \$2,500 net capital loss is deductible in 2017.

Total capital gains	\$ 10,000
Total capital losses	(7,500)
2016 Loss carryforward	(5,000)
Net capital loss	<u>\$ (2,500)</u>
2017 Deduction	<u>\$ (2,500)</u>

- c. How would your answer change if Yoko's total capital losses are \$14,000 in 2017?

The netting of the 2017 gains and losses with the \$5,000 capital loss carryforward results in a net capital loss of \$9,000. Only \$3,000 of the loss is deductible in 2017, with a \$6,000 loss carryforward to 2018.

Total capital gains	\$ 10,000
Total capital losses	(14,000)
2016 Loss carryforward	(5,000)
Net capital loss	<u>\$ (9,000)</u>
2017 Deduction	<u>\$ 3,000</u>
Loss carryforward to 2018	<u>\$ (6,000)</u>

53. Goldie sells 600 shares of Bear Corporation stock for \$9,000 on December 14, 2016. She paid \$27,000 for the stock in February 2013.

- a. Assuming that Goldie has no other capital asset transactions in 2016, what is the effect of the sale on her 2016 income?

Goldie realizes a long-term capital loss of \$18,000 (\$9,000 - \$27,000) on the sale. However, because she has no other capital asset transactions during 2016, she can only deduct \$3,000 of the loss in 2016. The remaining \$15,000 of loss is carried forward to 2017.

- b. Assume that Goldie has no capital asset transactions in 2017. What is the effect of the Bear Corporation stock sale on her 2017 income?

Goldie can deduct \$3,000 of the \$15,000 of loss carried forward from 2016 in 2017. The remaining \$12,000 of loss is carried forward to 2018.

- c. On July 2, 2018, Goldie sells 100 shares of Panda common stock for \$12,400. Goldie purchased the stock on September 4, 2016, for \$7,500. What is the effect of the sale on Goldie's 2018 income?

The sale of the stock results in a long-term capital gain of \$4,900 (\$12,400 - \$7,500) that is netted against the \$12,000 capital loss carryforward from 2017, resulting in a net long-term capital loss of \$7,100 for the year. Goldie can deduct \$3,000 of the \$7,100 loss in 2018. The remaining \$4,100 of loss is carried forward to 2019.

2018 Capital gain	\$ 4,900
Loss carryforward	(12,000)
Net long-term capital loss	<u>\$ (7,100)</u>
2018 Deduction	<u>\$ 3,000</u>
Loss carryforward to 2018	<u>\$ (4,100)</u>

54. Labrador Corporation has total capital gains of \$18,000 and total capital losses of \$35,000 in 2016. Randy owns 25% of Labrador's outstanding stock. What is the effect on Labrador's and Randy's 2016 taxable incomes if
- a. Labrador is a corporation? Explain how Labrador and Randy would treat the capital gains and losses.

A corporation is a taxable entity. It nets its capital losses against its capital gains. In this case, Labrador Corporation has a \$17,000 (\$18,000 - \$35,000) net capital loss in 2016. Corporations can only deduct capital losses against capital gains. Labrador is allowed to carryback the \$17,000 capital loss from 2016 to 2013, 2014, and 2015 and use it to offset any net capital gains it paid tax on in those years. If there is insufficient capital gain income in the three carryback years, Labrador may carryforward any remaining loss for five years and use it to offset future capital gains.

- b. Labrador is an S corporation? Explain how Labrador and Randy would treat the capital gains and losses.

An S corporation is a conduit entity. Labrador is not taxed on any income it earns. The income flows to the shareholders for taxation. As a shareholder, Randy receives his share of the gains and losses and reports them on his individual tax return, subject to the limits imposed on individuals. Randy receives capital gains of \$4,500 (25% x \$18,000) and capital losses of \$8,750 (25% x \$35,000). These are combined with any other capital gains and losses Randy incurs during the year. If Randy has no other capital gains and losses, his net capital loss would be \$4,250 (\$4,500 - \$8,750) and he is allowed to deduct \$3,000 of the loss in the current year, with the remaining \$1,250 carried forward to 2017.

55. Bongo Corporation is incorporated in 2014. It has no capital asset transactions in 2014. From 2015 through 2018, Bongo has the following capital gains and losses:

	2015	2016	2017	2018
Capital Gains	\$ 14,000	\$ 12,000	\$ 9,000	\$ 30,000
Capital Losses	(8,000)	(26,000)	(22,000)	(11,000)

Assuming that Bongo's marginal tax rate during each of these years is 34%, what is the effect of Bongo's capital gains and losses on the amount of tax due each year?

The gains and losses must be netted together. Net capital gains are subject to the corporate tax. Net capital losses cannot be deducted in the year of the loss. Losses are carried back three years and forward five years and used to offset net capital gains in the carryover period. Carrybacks result in a tax refund. Carryforwards reduce the tax paid in future periods on net capital gains. For Bongo:

	2015	2016	2017	2018
Net gain (loss)	\$ 6,000	\$ (14,000)	\$ (13,000)	\$ 19,000

The 2016 loss is carried back to 2015 and a \$2,040 (\$6,000 x 34%) refund is obtained. The remaining 2016 loss of \$8,000 (\$6,000 - \$14,000) is carried forward to 2018 and is used to reduce the \$19,000 capital gain to \$11,000 (\$19,000 - \$8,000). The 2017 loss of \$13,000 is carried forward to offset the remaining \$11,000 of net capital gain. The remaining \$2,000 (\$11,000 - \$13,000) of net capital loss is carried forward and used to reduce capital gains for a maximum of four more years.

	2015	2016	2017	2018
Capital gain (loss)	\$ 6,000	\$ (14,000)	\$ (13,000)	\$ 19,000
Tax rate	x 34%			
Tax paid	<u>\$ 2,040</u>			
Carryback loss to 2015	<u>(6,000)</u>	<u>6,000</u>		
Tax refund	<u>\$ 2,040</u>			
Carryforward loss to 2017		<u>\$ (8,000)</u>	<u>(8,000)</u>	
Carryforward loss to 2018			<u>\$ (21,000)</u>	<u>(21,000)</u>
Carryforward loss to 2019				<u>\$ (2,000)</u>

56. Newcastle Corporation was incorporated in 2015. For the years 2015 through 2017, Newcastle has the following net capital gain or loss.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Net capital gain (loss)	6,000	(27,000)	18,000

If Newcastle is in the 34% marginal tax bracket for each of these years, what effect do the net capital gains (losses) have on its tax liability for 2015, 2016, and 2017?

Net capital gains are subject to the corporate tax at regular tax rates. Net capital losses cannot be deducted in the year of the loss. Losses are carried back three years and forward five years and used to offset net capital gains in the carryover period. Carrybacks result in a tax refund. Carryforwards reduce the tax paid in future periods on net capital gains. Part of the 2016 loss is carried back to 2015 and a \$2,040 (\$6,000 x 34%) refund is obtained. The remaining 2016 loss of \$21,000 (\$27,000 - \$6,000) is carried forward to 2017 to offset the entire capital gain in 2017. The remaining \$3,000 (\$21,000 - \$18,000) of 2016 capital loss can be carried forward for 4 more years.

	<u>2015</u>	<u>2016</u>	<u>2017</u>
Capital gain (loss)	\$ 6,000	\$ (27,000)	\$ 18,000
Tax rate	x 34%		
Tax paid	<u>\$ 2,040</u>		
Carryback 2016 capital loss to 2015	<u>(6,000)</u>	6,000	
Tax refund	<u>\$ 2,040</u>		
Carryforward 2016 capital loss to 2017		<u>21,000</u>	<u>(21,000)</u>
Remaining carryforward to 2018-2021			<u>\$ (3,000)</u>

57. Sonya, who is single, owns 20,000 shares of Malthouse Corporation stock. She acquired the stock in 2013 for \$75,000. On August 12, 2017, Sonya's father tells her of a rumor that Malthouse will file for bankruptcy within the next week. The next day, Sonya sells all her shares of Malthouse for \$20,000.

- a. How much of the loss can she deduct?

Stock is a capital asset and the \$55,000 loss (\$20,000 - \$75,000) is subject to the \$3,000 annual capital loss limitation. The remaining \$52,000 of loss is carried forward for use in subsequent years.

- b. Assume the same facts, except that the stock is qualifying small-business stock. How much of the loss can she deduct?

If the stock is qualifying small business stock, a single individual can deduct up to \$50,000 of loss per year as an ordinary loss. In this case, Sonya has an ordinary loss of \$50,000 with the remaining \$5,000 being a capital loss. Only \$3,000 of the capital loss is deductible. Thus, her total loss deduction is \$53,000. The remaining \$2,000 of capital loss is carried forward for use in subsequent years netting.

- c. Assume the same facts as in part a, except that Sonya is married. How much of the loss can she deduct?

Married couples are allowed to deduct up to \$100,000 of loss on qualifying small business stock. If Sonya is married, she is able to deduct the entire \$55,000 loss as an ordinary loss.

Note: Sonya being married has no impact on the answer to the initial question. The stock is a capital asset and the \$55,000 loss is subject to the \$3,000 annual capital loss limitation. The remaining \$52,000 of loss is carried forward for use in subsequent years.

58. Rick, a single taxpayer, owns 30,000 shares of qualifying small business stock that he had purchased for \$300,000. During the current year, he sells 10,000 of the shares for \$25,000.

- a. What are the tax effects for Rick from selling the shares?

Rick has realized a loss of \$75,000 on the sale of the stock:

Amount realized	\$ 25,000
Basis (\$300,000 ÷ 30,000 = \$10 x 10,000)	(100,000)
Realized loss	<u>\$ (75,000)</u>

Because the stock is qualifying small business stock, Rick is allowed to deduct \$50,000 of the loss as an ordinary loss. The remaining \$25,000 of loss is a capital loss. Rick can deduct \$3,000 of the loss and carryforward the remaining \$22,000 of loss.

- b. Assume that Rick also sells other capital assets at a gain of \$12,000. What are the tax effects of Rick's capital asset transactions?

The \$50,000 ordinary loss deduction is not affected. The remaining \$25,000 loss is netted against the \$12,000 of capital gains resulting in a net capital loss of \$13,000. Only \$3,000 of the loss is deductible. The remaining \$10,000 is carried forward to next year.

Remaining capital loss from small business stock	\$ (25,000)
Capital gain	12,000
Net capital loss	<u>\$ (13,000)</u>
Capital loss deduction	3,000
Loss carryforward	<u>\$ (10,000)</u>

- c. Assume the same facts as in part a. In the year after selling the 10,000 shares of qualified small business stock, Rick has total capital gains of \$16,000 and total capital losses of \$12,000. What are the effects of Rick's capital asset transactions on his taxable income?

The current year capital gains and losses are netted with the \$10,000 capital loss carryforward resulting in a net capital loss of \$6,000.

Capital gains	\$ 16,000
Capital losses	(12,000)
Capital loss carryforward	(10,000)
Net capital loss	<u>\$ (6,000)</u>

Only \$3,000 of the net capital loss is deductible with the remaining \$3,000 loss carried forward to the next year.

59. Evita sells 2 pieces of land during the current year. She had used the first piece as a parking lot for her pet store. (She owns the store as a sole proprietor.) The land cost Evita \$45,000, and she sells it for \$28,000. The second piece is a building she had purchased as a speculative investment. Evita paid \$45,000 for the lot and sells it for \$28,000. Assume that Evita has no other dispositions during the year. Write a letter to Evita explaining the deductible loss from her two land transactions.

Evita has realized a loss of \$17,000 (\$28,000 - \$45,000) on each piece of land. The type of activity the loss is incurred in determines the deductibility of the realized loss.

The loss on the sale of the first piece of land is a loss incurred in a trade or business and the \$17,000 loss is fully deductible. The second piece of land is held as an investment and is a capital asset. Therefore, the loss on the second piece of land is a capital loss. Because Evita had no other capital gain and loss transactions during the year, the loss is subject to the \$3,000 annual capital loss limitation.

Evita's loss deduction is \$20,000 (\$17,000 trade or business loss + \$3,000 capital loss). The remaining \$14,000 capital loss is carried forward to the next year.

60. Katelyn purchased 300 shares of Condine, Inc., stock in 2014 for \$9,000. During 2016, she sells 200 shares of Condine to her brother, Jon, for \$3,600 and the remaining 100 shares to an unrelated third party for \$2,000.

- a. Assuming that these are her only stock sales during the year, what impact do these sales have on her 2016 taxable income?

Katelyn's basis in the 200 shares she sells to her brother is \$6,000 [$\$9,000 \div 300 \text{ shares} = \$30 \times 200 \text{ shares}$] and her realized loss on the sale is \$2,400 ($\$3,600 - \$6,000$). Because Katelyn and her brother are related parties, she is not allowed to deduct any of the \$2,400 loss on the sale of the stock to her brother. Upon subsequent sale to an unrelated party, her brother can use the loss to reduce the gain on the sale (but not below zero). Katelyn can deduct the \$1,000 [$\$2,000 - \$3,000$ ($\$30 \times 100 \text{ shares}$)] loss she has on the sale to the unrelated party.

- b. Assume that Jon sells the Condine stock in 2017 for \$4,800. What impact does the sale have on his and Katelyn's 2017 taxable incomes?

The realized gain on sale by her brother is \$1,200, but he can reduce his realized gain by \$1,200 of Katelyn's disallowed loss of \$2,400. The remaining \$1,200 ($\$2,400 - \$1,200$) of Katelyn's loss is disallowed. Jon's recognized gain is \$0.

	2017 Katelyn	2017 Jon
Selling price	\$ 3,600	\$ 4,800
Less: Basis	(6,000)	(3,600)
Realized gain (Loss on sale)	<u>\$ (2,400)</u>	<u>\$ 1,200</u>
Deductible loss	- 0-	(1,200)
Recognized gain		<u>\$ -0-</u>

- c. Assume that Jon sells the shares in 2017 for \$6,200. What impact does the sale have on his and Katelyn's 2017 taxable incomes?

The realized gain on sale by Jon is \$2,600, but he can reduce his realized gain by Katelyn's disallowed loss of \$2,400. Jon's recognized gain is \$200.

	2017 Katelyn	2017 Jon
Selling price	\$ 3,600	\$ 6,200
Less: Basis	(6,000)	(3,600)
Realized gain (loss) on sale	<u>\$ (2,400)</u>	<u>\$ 2,600</u>
Deductible loss	- 0-	(2,400)
Recognized gain		<u>\$ 200</u>

- d. Assume that Jon sells the shares in 2017 for \$3,100. What impact does the sale have on his and Katelyn's 2017 taxable incomes?

In this case, the subsequent sale results in a loss of \$500 ($\$3,100 - \$3,600$). Katelyn's disallowed loss cannot be used to increase her brother's loss on the subsequent sale. Jon has a realized and recognized loss of \$500.

61. Elliot sells some stock to his sister, Nancy, for \$4,000. His basis in the stock is \$6,000. Several years later, Nancy sells the stock for \$7,000.

- a. What is the effect of the sales on Elliot and Nancy?

Elliot and Nancy are related parties. Elliot is not allowed to deduct any of the \$2,000 loss on the sale of the stock to his sister. Upon subsequent sale to an unrelated party, Nancy can use the loss to reduce gain on the sale but not below zero. The gain on sale by Nancy is \$3,000, which is reduced by Elliot's disallowed loss of \$2,000 and her recognized gain is \$1,000.

	Elliot	Nancy
Selling price	\$ 4,000	\$ 7,000
Less: Basis	(6,000)	(4,000)
Realized gain (Loss on sale)	\$ (2,000)	\$ 3,000
Deductible loss	-0-	(2,000)
Recognized gain		<u>\$ 1,000</u>

- b. Assume that the subsequent sale by Nancy is for \$5,000.

The gain on the subsequent sale is only \$1,000. Nancy may only use \$1,000 of Elliot's disallowed loss to offset her gain. A loss cannot be created on the subsequent sale by use of the disallowed loss. The remaining \$1,000 of the original loss is lost forever.

	Elliot	Nancy
Selling price	\$ 4,000	\$ 5,000
Less: Basis	(6,000)	(4,000)
Realized gain (Loss on sale)	\$ (2,000)	\$ 1,000
Deductible loss	-0-	(1,000)
Recognized gain		<u>\$ -0-</u>

- c. Assume that the subsequent sale by Nancy is for \$2,000.

In this case, the subsequent sale results in a loss of \$2,000 (\$2,000 - \$4,000). Elliot's disallowed loss cannot be used to increase Nancy's loss on the subsequent sale. Nancy recognizes a \$2,000 loss.

62. Howard Company is 100% owned by Rona. During the current year, Howard sells some land to Rona for \$50,000 that had cost Howard \$80,000 and that had a fair market value of \$100,000. Write a letter to Rona explaining the tax effects of the sale.

The bargain purchase by the related party shareholder is considered to be a dividend to Rona of \$50,000 (\$100,000 - \$50,000). The loss on the sale of the land by Howard Company is disallowed because it is sold to a related party. Rona's basis in the land is \$100,000 (\$50,000 cash paid + \$50,000 income recognized).

63. Darlene owns 500 shares of Sandmayor, Inc., common stock that she purchased several years ago for \$20,000. During the current year, the Sandmayor stock declines in value. Darlene decides to sell the stock to realize the tax loss. On December 17, she sells the 500 shares for \$12,000. Her investment adviser tells her she thinks the Sandmayor stock probably will begin to increase in value next year. On this advice, Darlene purchases 600 shares of Sandmayor common stock on January 10 of the next year for \$15,000. The adviser turns out to be right --- Darlene sells the 600 shares in May for \$22,000. What are the effects of the sales on Darlene's taxable income in each year? Explain.

The December 17 sale results in a realized loss of \$8,000. However, the loss cannot be recognized because it is a wash sale (the 500 shares sold are repurchased within 30 days). The disallowed loss on the wash sale is added to the basis of 500 of the shares purchased on January 10. The total basis of the January 10 shares is \$23,000 (\$20,500 + \$2,500).

Amount realized	\$ 12,000
Less: Basis	(20,000)
Realized loss	\$ (8,000)
Disallowed loss - wash sale	8,000
Deductible loss	<u>\$ -0-</u>

	500 Wash Sale Shares	100 New Shares
<u>Basis in shares:</u>		
January 10 purchase (\$25 per share)	\$ 12,500	\$ 2,500
Disallowed loss	8,000	-
Basis	<u>\$ 20,500</u>	<u>\$ 2,500</u>

The sale of the 600 shares in May results in a \$2,167 long-term loss (holding period began several years ago) on the 500 "wash sale" shares and a short-term gain \$1,167 (holding period began on January 10) on the "new" shares.

Amount realized (\$36.67 per share)	\$ 18,333	\$ 3,667
Less: Basis (\$15,000 + \$8,000)	(20,500)	(2,500)
Realized and recognized gain (loss)	<u>\$ (2,167)</u>	<u>\$ 1,167</u>

64. Ed owns 500 shares of Northern Company for which he paid \$15,000 several years ago. On November 24, he purchases an additional 350 shares for \$6,300. Ed sells the original 500 shares for \$10,000 on December 14. What are the effects of the December 14 sale? Explain.

The sale of the 500 shares results in a realized loss of \$5,000. However, 350 of the 500 shares sold are replaced within the 30 day period that defines a wash sale. Therefore, the loss on the 350 shares replaced is disallowed and added to the basis of the 350 replacement shares purchased on November 24. The loss on the 150 shares that are not replaced is allowed as a capital loss. The disallowed loss is \$3,500 and the allowable loss is \$1,500:

Amount realized	\$ 10,000
Less: Basis	(15,000)
Realized loss	\$ (5,000)
Disallowed loss on 350 shares (350 ÷ 500) x \$5,000	3,500
Allowable loss on 150 shares not replaced	<u>\$ (1,500)</u>

The basis of the 350 shares purchased on November 24 is \$9,800 (\$6,300 cost + \$3,500 disallowed loss on wash sale).

65. Leona owns 300 shares of Ross Industries. She acquired the shares on February 17, 2014, for \$6,500. On September 17, 2016, she acquires another 200 shares of Ross for \$4,800. Two weeks later, a lawsuit is filed against Ross for patent infringement, and its stock price drops to \$19 per share. Unsure of the outcome of the lawsuit, Leona sells 300 shares of the stock for \$5,400 on October 12, 2016. What is her recognized gain or loss on the sale of the Ross stock?

Leona has a realized loss of \$1,100 on the sale of the 300 shares of stock. Unless the taxpayer specifies differently, the first shares acquired are considered the first shares sold. Because she acquired 200 shares within the 30 day period that defines a wash sale, the loss on 200 shares of the stock sold cannot be recognized. Therefore, Leona has a disallowed loss of \$733 ($\$1,100 \times (200 \text{ shares} \div 300 \text{ shares})$) on the sale of the stock and a recognized loss of \$367 ($\$1,100 - \733). The disallowed loss of \$733 is added to her basis in the 200 shares she acquired on September 17, 2016. Her basis in the September 17, 2016 stock is \$5,533 ($\$4,800 + \733).

October 12 Sale:

Amount realized	\$ 5,400
Less: Basis	(6,500)
Realized loss	<u>\$ (1,100)</u>
Disallowed loss	<u>\$ 733</u>
Recognized loss	<u>\$ 367</u>

66. Jorge and his wife own a beachfront vacation home in Savannah, Georgia. During the year, high winds from a tropical storm shatter a sliding glass door and rain from the storm causes extensive water damage to the kitchen. Fortunately, during a calm in the storm, Jorge is able to board up the door, which limits the water damage to the kitchen. The items damaged in the storm are:

	Cost	Value Before	Value After	Insurance Proceeds
Kitchen Furniture	\$2,100	\$1,400	\$400	\$650
TV	\$ 250	\$ 200	\$ -0-	\$125
Refrigerator	\$1,000	\$ 950	\$100	\$800
Linoleum Flooring	\$1,600	\$ 900	\$ -0-	\$500

In addition, Jorge pays \$625 to replace the sliding glass door. The insurance company will not reimburse him for the cost of the new door because the old sliding glass door did not meet the company's standards for a hurricane area. What is the amount of Jorge's casualty loss before considering any annual limitations that may apply?

The measure of a personal casualty loss is the lesser of the decline in market value or the property's basis. In the case of a theft, the decline in market value is the market value of the property prior to the theft. The measured loss must be reduced by any insurance reimbursements and the \$100 statutory floor. Jorge's casualty loss is \$1,400 before considering the annual personal casualty loss limitation (i.e., 10% of adjusted gross income):

Kitchen furniture (decline in value)	\$ 1,000
Television (decline in value)	200
Refrigerator (decline in value)	850
Linoleum Flooring (decline in value)	900
Window damage (cost to repair)	625
Total loss before insurance reimbursement	\$ 3,575
Less: Insurance reimbursement (\$650 + \$125 + \$800 + \$500)	2,075)
Loss net of insurance	\$ 1,500
Less: statutory floor	(100)
Net casualty loss before annual limitation	<u>\$ 1,400</u>

67. Ghon and Li own a home on Lake Gibran. During a heavy rainstorm, the lake overflows and floods the basement, which is used as their family room. The entire contents of the basement (rug, furniture, stereo, and so on) are destroyed. The insurance adjuster estimates that the damage to the basement and its contents is \$13,500. Ghon and Li do not have flood insurance, so the insurance company will reimburse them only \$2,700 for the damage. If their adjusted gross income for the year is \$58,000, what is their deductible casualty loss?

The measure of a personal casualty loss is the lesser of the decline in market value or the property's basis. The measured loss must be reduced by any insurance reimbursements and the \$100 statutory floor. This amount is then further reduced by the annual personal casualty loss limitation of 10% of their adjusted gross income. Ghon and Li's casualty loss of \$13,500 must be reduced by the insurance reimbursement of \$2,700 and the \$100 statutory floor for a net casualty before the annual limitation of \$10,700. The annual 10% of AGI limitation results in a casualty loss of \$ 4,900 [\$10,700 - (\$58,000 x 10%)].

Loss per insurance adjuster (decline in value)	\$ 13,500
Less: insurance reimbursement	(2,700)
Loss net of insurance	<u>\$ 10,800</u>
Less: statutory floor	(100)
Net casualty loss before annual limitation	<u>\$ 10,700</u>
Annual limitation (\$58,000 x 10%)	(5,800)
Deductible casualty loss	<u><u>\$ 4,900</u></u>

Instructors Note: The adjuster's estimate of the damage should provide an accurate value of the property's decline in value and in virtually all cases will be less than the original basis of the property.

68. Kevin is the sole proprietor of Murph's Golf Shop. During the current year, a hurricane hits the beach near Kevin's shop. His business building, which has a basis of \$60,000, is damaged. In addition, his personal automobile, for which he paid \$22,000, is damaged. Fair market values (FMV) before and after the hurricane are

Case A	FMV Before	FMV After
Building	\$ 130,000	\$ 85,000
Automobile	12,000	3,000

Case B	FMV Before	FMV After
Building	\$ 130,000	-0-
Automobile	12,000	-0-

- a. What is Kevin's gross loss in each of the above cases?

The gross loss (i.e., the loss before any limitations) in case A is \$45,000 for the building and \$9,000 for the automobile. For business property that is partially destroyed, the gross loss is measured as the lesser of 1) the decrease in fair market value, \$45,000 (\$130,000 - \$85,000) or 2) the basis of the property, \$60,000. All personal casualty losses are measured using the same valuation rule - the lesser of \$22,000 basis versus \$9,000 (\$12,000 - \$3,000) decline in market value.

In case B, the gross loss is \$60,000 on the building and \$12,000 on the automobile. Business property fully destroyed is measured at the basis of the property. Personal casualty losses are always measured using the valuation rule of the lesser of basis or decline in market value.

- b. Assume that in case A, Kevin receives \$36,000 from his insurance company for the building and \$5,000 for his automobile. What is his allowable loss?

The allowable loss on the building is \$9,000 (\$36,000 - \$45,000). The loss on the automobile is \$3,900 (\$5,000 - \$9,000 - \$100). Personal casualty losses are reduced by the \$100 statutory floor per occurrence and then reduced by 10% of Kevin's adjusted gross income.

- c. Assume that the insurance proceeds are \$130,000 and \$5,000 in case B. What is the tax effect of the casualty for Kevin?

The receipt of insurance proceeds of \$130,000 results in a gain of \$70,000 (\$130,000 - \$60,000). The loss on the automobile is \$6,900 (\$5,000 - \$12,000 - \$100). The \$6,900 personal casualty loss is then reduced by 10% of Kevin's adjusted gross income.

69. Marsha owns a two-family condominium in southern California that she paid \$140,000 for in 2000. One unit has 2,400 square feet of space, and the other has 1,600 square feet. Marsha uses the 2,400-square-foot unit as a vacation home and rents the other unit to a retired couple. During the current year, an electrical fire destroys the condominium. Because part of it was used as rental property, Marsha's insurance company reimburses her only \$120,000. The fair market value of the condominium before the fire was \$160,000, and her adjusted basis in the rental unit is \$20,000. Assume that Marsha's adjusted gross income before considering the casualty is \$55,000. Write a letter to Marsha explaining the effect of the casualty on her taxable income.

Because the rental property is a mixed-purpose asset it must be accounted for as two assets - a business asset and a personal asset. The best method for allocating between the business and personal portion of the condominium is based on the total square footage of the two units. Based on the square footage 40% [$1,600 \div (2,400 + 1,600)$] of the casualty loss is business and the remaining 60% is personal. The gain or loss from the casualty must be computed separately and the appropriate rules for business and personal property applied to each portion:

	40% Business	60% Personal
Initial basis	<u>\$ 56,000</u>	<u>\$ 84,000</u>
Less: depreciation	<u>(36,000)</u>	<u>-0-</u>
Adjusted basis	<u>\$ 20,000</u>	<u>\$ 84,000</u>
Amount of loss:		
Business portion - adjusted basis	\$ (20,000)	
Personal portion - lesser of:		
Adjusted basis	\$84,000	
OR		
Decline in value ($\$160,000 \times 60\% = \$96,000$)		\$ (84,000)
Less: Insurance proceeds	<u>48,000</u>	<u>72,000</u>
Net casualty gain (loss)	<u>\$ 28,000</u>	<u>\$ (12,000)</u>

Marsha has a \$28,000 casualty gain on the business portion of condominium and a \$12,000 loss on the personal portion of the condominium. The \$28,000 gain is added to her \$55,000 adjusted gross income giving her an adjusted gross income of \$83,000 ($\$28,000 + \$55,000$). Assuming that Marsha itemizes her deductions, her deductible casualty loss is \$3,600:

Loss net of insurance	\$ 12,000
Less: statutory floor	(100)
Net casualty loss before annual limitation	\$ 11,900
Annual limitation ($\$83,000 \times 10\%$)	(8,300)
Deductible personal casualty loss	<u>\$ 3,600</u>

70. Jamila is involved in an auto accident during the current year that totally destroys her car. She purchased the car 2 years ago for \$28,000. Jamila used the car in her business 75% of the time over the past 2 years. She had properly deducted \$4,000 in depreciation for the business use of the car. The fair market value of the car before the accident is \$16,000. The insurance company reimburses her \$12,000. Assuming that Jamila has an adjusted gross income of \$45,000 during the current year before considering the effect of the auto accident, what is the effect of the accident on her taxable income?

Because the automobile is a mixed-use asset it must be accounted for as two assets - the business portion and the personal portion. The gain or loss from the casualty must be computed separately and the appropriate rules for business and personal property applied to each portion:

	75% Business	25% Personal
Initial basis	<u>\$ 21,000</u>	<u>\$ 7,000</u>
Less: depreciation	<u>(4,000)</u>	<u>-0-</u>
Adjusted basis	<u>\$ 17,000</u>	<u>\$ 7,000</u>
Amount of loss:		
Business portion - adjusted basis	\$ (17,000)	
Personal portion - lesser of:		
Adjusted basis	\$ 7,000	
OR		
Decline in value		(4,000)
(\$16,000 x 25% = \$4,000)	\$ 4,000	
Less: Insurance proceeds	9,000	3,000
Net loss	<u>\$ (8,000)</u>	<u>\$ (1,000)</u>

Jamila can deduct the \$8,000 loss on the business portion of the automobile. Assuming Jamila has no other casualty losses during the year, she is not entitled to a casualty loss on the personal portion of the automobile. The \$900 loss (\$1,000 - \$100 statutory floor) does not exceed 10% of her adjusted gross income [\$900 < \$4,500 (\$45,000 x 10%)].

71. Andy sells the following assets during the year.

	Gain (Loss)
Personal automobile	\$ (2,000)
ABC stock	4,800
Personal furniture	1,200
BCCI bonds	(9,600)

What is Andy's deductible loss? Explain.

The loss on the automobile is not an allowable capital loss because it is a personal use asset. The gain on the furniture is taxable under the all-inclusive income concept. The gain on the stock and the loss on the bonds are capital gains and losses. Andy's net capital loss for the year is \$3,600:

Gain on sale of stock	\$ 4,800
Gain on sale of furniture	1,200
Loss on BCCI bonds	(9,600)
Net capital loss	\$ (3,600)
Capital loss deduction	3,000
Capital loss carryforward	<u><u>\$ (600)</u></u>

Only \$3,000 of the net capital loss is deductible. The remaining \$600 is carried forward to subsequent years for use in those years.

72. Faith, who is single, sells the following assets during 2016:

- 20,000 shares of qualified small business stock at a loss of \$62,000. Faith bought the stock in 2011.
- 1,200 shares of Geelong Industries at a gain of \$4,500. Faith bought the stock in 2013.
- An XZ10 sailboat at a loss of \$3,500. Faith acquired the boat, which she used in her leisure hours, in 2012.
- A 1973 Holden Deluxe automobile at a gain of \$3,700. Faith never used the car for business.
- 50 shares of Fremantle, Inc., at a gain of \$1,300. Faith bought the stock in 2016 and sells it to her brother.
- 75 shares of Fitzroy Corporation at a loss of \$300. Faith bought the stock in 2012 and sells it to her sister.

Calculate Faith's net capital gain (loss) for 2016.

Faith can deduct \$50,000 as an ordinary loss on the qualifying small business stock. The remaining \$12,000 (\$50,000 - \$62,000) is a long-term capital loss. The loss on the XZ10 sailboat is not an allowable capital loss because it is a personal use asset. The \$3,700 gain on the automobile is taxable under the all-inclusive income concept. The \$1,300 gain on the sale of stock to her brother is taxable. Only sales at a loss to a related party are disallowed. The \$300 loss on the sale to her sister is disallowed -- related party sale. Faith's net capital loss for the year is \$2,500:

Short-term gain on sale of Fremantle stock		\$ 1,300
Long-term loss on small business stock	\$ (12,000)	
Long-term gain on sale of Geelong stock	4,500	
Long-term gain on sale of automobile	<u>3,700</u>	<u>\$ (3,800)</u>
Net long-term capital loss		<u>\$ (2,500)</u>
Capital loss deduction		<u>\$ 2,500</u>

Note: Faith also has an ordinary loss on the small business stock of \$50,000.

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.

73. The Readyhough Corporation was incorporated in 2008. During 2015, the corporation had operating income of \$80,000. Because of a strike at its major supplier, the corporation had an operating loss of \$60,000 in 2016. The corporation expects to rebound in 2017, forecasting operating income of \$140,000. The current interest rate is 6%.

The issue is whether Readyhough should elect not to carry the loss back or carry the loss forward. To determine the optimal choice, the present value of the tax savings of each option must be calculated. A carryback to 2015 will result in a refund of \$10,000 $[(\$50,000 \times 15\%) + (\$10,000 \times 25\%)]$.

If the loss carryforward option is elected, the tax savings on the carryforward to 2017 is \$22,850 (see below) and the present value of the tax savings is \$21,548 $(\$22,850 \times .943)$. Therefore, by foregoing the carryback, Readyhough realizes a present value tax savings of \$11,548 $(\$21,548 - \$10,000)$.

Corporate tax on \$140,000 =
 $\{\$22,250 + [(\$140,000 - \$100,000) \times 39\%]\} = \quad \$ 37,850$

Corporate tax on \$80,000 =
 $\{\$7,500 + [(\$80,000 - \$50,000) \times 25\%]\} = \quad (15,000)$
Tax savings from carrying forward \$60,000 loss **\$ 22,850**

74. Celine opens a jewelry store during the current year. She invests \$20,000 of her own money and receives a nonrecourse bank loan of \$80,000. During the current year, the store has a loss of \$24,000.

The issue is to determine the amount of Celine's deductible loss. The amount of her loss is limited to the amount she is at-risk. Celine is at risk for \$20,000 - the amount she invested in the jewelry store. She is not at-risk for the nonrecourse debt, because she is not personally liable to repay the debt. Nonrecourse debt only is considered at-risk if it is used to finance the holding of real estate. The \$4,000 loss that is not deductible is carried forward until Celine increases her at-risk amount.

75. Anton is single and a self-employed plumber. His net income from his business is \$56,000. He has dividend income of \$6,000 and an \$8,000 loss from a rental property in which he actively participates.

The issue is whether Anton can deduct the \$8,000 loss from his rental activity. Because Anton actively participates in the rental activity and his adjusted gross is less than \$100,000 he can deduct the entire \$8,000 loss against his active and portfolio income. His adjusted gross income is \$54,000.

76. Rita is the sole owner of Video Plus, a local store that rents video games, software, and movies. She works 40 hours a week managing the store.

The issue is whether Video Plus is a passive activity. A rental activity that includes significant services is not considered a rental activity under the passive activity rules. In addition, Rita must be a material participant in the business. Therefore, because the rental activity involves significant personal services and Rita materially participates in operating the store (i.e., works 40 hours per week > 500 hours per year), the store is not a passive activity.

77. Margery owns a passive activity with a basis of \$15,000. The activity has a \$9,000 suspended loss. Margery sells the passive activity for \$22,000.

There are two issues. The first is whether Margery has a gain or loss on the sale of the passive activity. The second issue is whether the suspended loss is deductible. Margery has a capital gain of \$7,000 (\$22,000 - \$15,000) on the sale of the activity and is allowed a deduction of \$9,000 for the suspended loss on the activity. Any suspended loss on a passive activity is deductible in full when the entire interest in the activity is disposed of through a sale of the activity. This results in a net deduction of \$2,000. However, the \$7,000 capital gain is netted with any other capital gains and losses that Margery has during the year. Long-term capital gains are taxed at 0%, 15%, or 20% depending on the taxpayers filing status and taxable income. Therefore, this further complicates the tax effect of Margery's net deduction of \$2,000.

78. Orlando owns a passive activity with a basis of \$13,000 and a \$6,000 suspended loss. He dies when the passive activity has a fair market value of \$17,000.

The issue is whether Orlando's suspended loss is deductible. A deduction is allowed for a suspended loss on a passive activity held at death, but only to the extent the suspended loss exceeds the unrealized gain on the passive activity. Orlando's suspended loss of \$6,000 exceeds his unrealized gain of \$4,000 (\$17,000 - \$13,000) by \$2,000 (\$6,000 - \$4,000). Therefore, he can deduct \$2,000 of his suspended loss.

79. Emma owns and operates Conway Camera. One night someone breaks into the store and steals cameras that cost \$2,200. The retail price of the cameras is \$3,500.

The issue is to determine the amount of Conway's theft loss. A theft of business property is measured at its basis, not its retail value. Conway's theft loss is the \$2,200 basis reduced by any insurance proceeds she receives.

80. Mike's Pizza decides to replace one of its delivery vehicles. The vehicle has a basis of \$2,700 and Mike's is able to sell it for \$2,100.

There are two issues. The first is whether Mike's has a gain or loss on the sale of its delivery vehicle. The second is whether the gain or loss is capital or ordinary. Mike has a loss of \$600 (\$2,100 - \$2,700) on the sale of the delivery vehicle. The sale of a business asset results in an ordinary loss. Therefore, Mike has an ordinary loss deduction of \$600.

81. Zoriana sells stock that she acquired in 2012 for \$7,500. Her basis in the stock is \$14,000. She has a \$2,000 long-term capital loss carryover from 2015.

The issue is what amount Zoriana can deduct as a capital loss. She has a long-term capital loss of \$6,500 (\$7,500 - \$14,000) that is added to her \$2,000 long-term capital loss carryover. However, only \$3,000 of her \$8,500 (\$6,500 + \$2,000) long-term capital loss can be deducted in the current year. The remaining \$5,500 (\$8,500 - \$3,000) is carried forward to the following year.

82. Alphonse sells stock with a basis of \$5,500 to his brother, Conner, for \$4,000. His brother sells it later in the year for \$5,100.

There are two issues. The first is whether Alphonse can deduct the \$1,500 loss on the sale of the stock. The second is what is the amount of Conner's gain on his subsequent sale of the stock. Alphonse and Conner are related parties. Therefore, Alphonse is not allowed to deduct any of the \$1,500 loss on the sale of the stock to his brother. However, upon the subsequent sale to an unrelated party, Conner can use \$1,100 of the loss to reduce his \$1,100 gain (\$5,100 - \$4,000) to zero. A loss cannot be created on the subsequent sale by use of the disallowed loss. The remaining \$400 (\$1,100 - \$1,500) of the original loss is lost forever.

	<u>Alphonse</u>	<u>Conner</u>
Selling price	\$ 4,000	\$ 5,100
Less: Basis	(5,500)	(4,000)
Realized gain (Loss on sale)	\$ (1,500)	\$ 1,100
Deductible loss	<u>-0-</u>	<u>(1,100)</u>
Recognized gain		<u>\$ -0-</u>

83. On January 1, 2016, Brenda acquires 200 shares of Disney stock for \$8,000. She sells 200 shares of the stock on September 2, 2016, for \$30 per share. On September 23, 2016, Brenda acquires 400 shares of Disney stock for \$10,400.

The issue is the amount of the loss Brenda can deduct on the sale of the Disney stock. The sale of the 200 shares on September 2 results in a realized loss of \$2,000 $[(200 \times \$30) - \$8,000]$. However, all 200 shares sold are replaced within the 30-day period that defines a wash sale. Therefore, the loss on the shares replaced is disallowed and added to the basis of 200 of the replacement shares purchased on September 23:

Amount realized	\$ 6,000
Less: Basis	(8,000)
Realized loss	\$ (2,000)
Disallowed loss	2,000
Allowable loss	<u>\$ -0-</u>

The cost of the 400 shares acquired on September 23 is \$26 per share $(\$10,400 \div 400)$. However, the basis of the shares must be split into two parts. The basis of 200 of the shares purchased on September 23 is \$7,200 $[(200 \times \$26) + \$2,000 \text{ disallowed loss on wash sale}]$. The basis of the other 200 shares acquired is \$5,200 $(200 \times \$26)$

84. George is single and has adjusted gross income of \$37,000. He discovers termites in the basement of his house and pays \$6,200 to fix the damage. His insurance company will not reimburse him for the damage.

The issue is whether George can claim a casualty loss for the damage caused by the termites. A casualty must be sudden, unexpected and unusual in nature. Although the damage is unexpected and unusual in nature, termite damage is not sudden and occurs over a substantial period of time. Therefore, the termite infestation is not a casualty and George cannot deduct the \$6,200 loss.

85. **Tax Simulation.** Alicia, Bob and Carol are equal partners in, Dunning Law Associates. In 2010, Alicia, in an attempt to maximize the firm's return on its investment portfolio, encourages her partners to acquire \$90,000 of stock in a local Internet provider. The stock was acquired by the partnership from the issuing corporation and the corporation that issued the stock meets all the tests for the stock to be treated as small business stock. In 2016, when the stock is worth \$20,000, Bob and Carol, who are upset with Alicia's investment choice, distribute all the shares of the small business stock to Alicia as part of her partnership distribution. The following year, Alicia sells the stock for \$15,000.

Required: Determine the tax treatment of Alicia's loss on the sale of the stock. Search a tax research database and find the relevant authority (ies) that forms 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 Alicia's facts. If there is any uncertainty about the validity of your answer, indicate the cause for the uncertainty.

Sec. 1244 (a) allows an individual taxpayer or a partnership to deduct the loss on the sale of Sec. 1244 stock (i.e., small business stock) as an ordinary loss.

Sec. 1244 (a) General rule — In the case of an individual, a loss on section 1244 stock issued to such individual or to a partnership which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as an ordinary loss.

Sec. 1244 (b) limits the amount an individual taxpayer can deduct on the sale of the stock to \$50,000 if the taxpayer is a single individual and \$100,000 if the taxpayer files a joint tax return

Sec. 1244 (b) Maximum amount for any taxable year. For any taxable year the aggregate amount treated by the taxpayer by reason of this section as an ordinary loss shall not exceed— (1) \$50,000, or (2) \$100,000, in the case of a husband and wife filing a joint return for such year under section 6013.

Although the stock is considered to be small business stock to the partnership, the question to be resolved is whether it is still considered to be small business stock when Alicia sells it. Reg. Sec. 1.1244(a)-1(b) provides that only two classes of taxpayers are allowed an ordinary loss deduction on the sale of small business stock. The first is an individual who originally was issued the stock and the second, is an individual who was a partner in a partnership at the time the partnership acquired the stock and whose share of the partnership distribution reflects the loss sustained by the partnership on its sale of the stock (*emphasis added*).

Reg. Sec. 1.1244(a)-1(b) Taxpayers entitled to ordinary loss. The allowance of an ordinary loss deduction for a loss of section 1244 stock is permitted only to the following two classes of taxpayers: (1) An individual sustaining the loss to whom the stock was issued by a small business corporation, or (2) An individual who is a partner in a partnership at the time the partnership acquired the stock in an issuance from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership.

Reg. Sec. 1.1244(a)-1(b) goes on to state that ordinary loss treatment is not available to a partner if the partner receives Sec. 1244 stock in a distribution from the partnership because the stock is not considered small business stock when the partner sells the stock. For a partner to receive the benefit from Sec. 1244, the partnership must sell the stock at a loss and have the loss flow-through to the partner.

(b) Taxpayers entitled to ordinary loss. The allowance of an ordinary loss deduction for a loss of section 1244 stock is permitted only to the following two classes of taxpayers:

- (1) An individual sustaining the loss to whom the stock was issued by a small business corporation, or*
- (2) An individual who is a partner in a partnership at the time the partnership acquired the stock in an issuance from a small business corporation and whose distributive share of partnership items reflects the loss sustained by the partnership. The ordinary loss deduction is limited to the lesser of the partner's distributive share at the time of the issuance of the stock or the partner's distributive share at the time the loss is sustained. In order to claim a deduction under section 1244 the individual, or the partnership, sustaining the loss must have continuously held the stock from the date of issuance. A corporation, trust, or estate is not entitled to ordinary loss treatment under section 1244 regardless of how the stock was acquired. An individual who acquires stock from a shareholder by purchase, gift, devise, or in any other manner is not entitled to an ordinary loss under section 1244 with respect to this stock.*

Thus, ordinary loss treatment is not available to a partner to whom the stock is distributed by the partnership. Stock acquired through an investment banking firm, or other person, participating in the sale of an issue may qualify for ordinary loss treatment only if the stock is not first issued to the firm or person. Thus, for example, if the firm acts as a selling agent for the issuing corporation the stock may qualify. On the other hand, stock purchased by an investment firm and subsequently resold does not qualify as section 1244 stock in the hands of the person acquiring the stock from the firm.

Reg. Sec. 1.1244(a)-1(c) provides an example which illustrates this point.

Example 3 - A and B, both individuals, and C, a trust, are equal partners in a partnership to which a small business corporation issues section 1244 stock. The partnership distributes section 1244 stock to partner A and he subsequently sells the stock at a loss. Section 1244 is not applicable to the loss since A did not acquire the stock by issuance from the small business corporation.

In conclusion, the stock is not considered qualified small business stock to Alicia. Therefore, the loss on the sale of the stock is treated as a capital loss and her loss deduction is limited to \$3,000. Note: The \$3,000 loss assumes she has no other sales of capital assets during the year.

86. **INTERNET ASSIGNMENT** Articles on tax topics are often useful in understanding the income tax law. CPA firms and other organizations publish tax articles on the Internet. Using the "Guides-Tips-Help" section of the Tax and Accounting Sites Directory (<http://www.taxsites.com/>) find an article, tax tip, or other information discussing passive activities and write a summary of what you found.

Clicking on Guides-Tips-Help within Tax Sites, one possible selection is Fairmark Press: Tax Guide for Investors (<http://fairmark.com/>). At this page, use the site search engine and the words "passive activities" and you will find an assortment of forum discussions on issues with passive activities.

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.

87. **INTERNET ASSIGNMENT** The Internal Revenue Service provides information on a variety of tax issues in its publication series. These publications can be found on the IRS world wide web site (<http://www.irs.gov/>). Go to the IRS World Wide Web site and find publications with information on casualties. Describe the process you used to obtain this information and provide the title(s) of the publication(s) with relevant information.

At the IRS homepage, click on Forms and Publications. Then click on "Current Forms and Publications". At the following screen, type in the find box the word "casualties" and in the drop down menu next to the word "in" change the search focus from Product Number to Title, then hit find. You will see Publication 547 "Casualties Disasters and Thefts (Business and Nonbusiness)" in the results. You will need Adobe Acrobat to read the PDF file "Publication 547." If you do not have Adobe Acrobat, you can download it from the IRS website.

Alternatively, on the main IRS page you can type in casualties and it will be the first item selected.

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.

88. **RESEARCH PROBLEM** Carla is an engineer for Synder Corporation and travels frequently. On a recent business trip to Indianapolis, she checks into her hotel room early on Sunday afternoon and then spends the rest of the day touring the city. When she goes to put on her emerald bracelet the next morning, she cannot find it. She is almost certain that she packed the bracelet and saw it in her jewelry box when she unpacked her clothes Sunday afternoon. Upon notifying hotel security, she learns that two other guests have reported jewelry stolen in the past month. When Carla returns home, she cannot find the bracelet in her house. It had been given to her by her grandmother and had a fair market value of \$5,000. Unfortunately, the bracelet was not insured. Is Carla allowed a casualty deduction for the loss of her emerald bracelet?

The Tax Court in *Campbell, Ira Est*, (1964) TC Memo 1964-53, found that, if it is just as likely that the property was mislaid or lost as that it was stolen, there will be no deduction. Specifically, the court found that where the taxpayer saw her emerald bracelet in her luggage at the hotel upon arrival and the next day discovered that her bracelet is missing is not allowed a theft deduction for the bracelet. The fact that other hotel guests had jewelry stolen did not prove that Carla's bracelet was stolen. If it is just as likely that the property is mislaid or lost as it is stolen, the taxpayer is not allowed a theft deduction. Since the research problem is based on the facts of Campbell, Carla is not entitled to a casualty loss deduction for her bracelet.

89. **RESEARCH PROBLEM** Suzanne is married and the sole owner of Laidlaw Corporation. When the corporation was established in 2005, she received 10,000 shares of qualified small business stock in exchange for her \$100,000 investment. On four occasions, Suzanne made loans totaling \$50,000 to the corporation when it had trouble paying its bills. In March 2016, Suzanne cancels the debt of \$50,000 and receives 5,000 shares of qualified small business stock. In May, she sells all her stock in the corporation. Is Suzanne allowed ordinary loss treatment on the sale of her small business stock?

The question is whether the stock Suzanne receives in exchange for the cancellation of the debt qualifies as small business corporation stock. The Tax Court in *John Toney Sr.*, TC Memo 1986-69 stated that Congress' intention in enacting the Section 1244 stock rules (i.e., qualified small business stock) was to encourage small business development by the infusion of new funds into small businesses. Therefore, if a taxpayer had their 100% owned corporation issue stock to him in exchange for canceling the debt the taxpayer owes the corporation and then he immediately sells all of their stock in the corporation, the taxpayer is subverting Congress' intent. As a result, the stock exchanged for the cancellation of debt would not be treated as qualified small business stock.

Since the research problem is based on the facts of *Toney*, Suzanne is not entitled to an ordinary loss on the portion of the stock sale that relates to debt. In their decision, the Tax Court viewed the debt equity other than small business stock. Therefore, only a portion of the sale would qualify for ordinary loss treatment. Suzanne would have an ordinary loss as calculated below.

Amount realized	$[\$60,000 \times (10,000 \div 15,000 \text{ shares})]$	\$ 40,000
Basis		(100,000)
Ordinary loss on small business stock		<u>\$ (60,000)</u>

Because Suzanne is married, she can deduct the entire \$60,000 (\$100,000 limit for married taxpayers) as an ordinary loss. The remaining \$20,000 (\$60,000 - \$40,000) of the sale proceeds would be used to calculate her loss on the sale of her recently acquired shares of stock.

Amount realized	$[\$60,000 \times (5,000 \div 15,000 \text{ shares})]$	\$ 20,000
Basis		(50,000)
Capital loss on stock		<u>\$ (30,000)</u>

If Suzanne has no other capital gains or losses she can deduct only \$3,000 of the loss in the current year.

90. Adela owns rental real estate that generated a \$27,000 loss during the current year. Using the information below as a guide, prepare a spreadsheet calculating her adjusted gross income. It should be flexible enough to calculate Adela's adjusted gross income if she meets either the real estate professional exception or the active participant test. A template to assist the student in solving this problem can be found at www.cengagebrain.com.

Salary	\$80,000
Dividends	22,000
Interest	12,500

Note: The solution below assumes that the taxpayer meets the active participant test. However, the excel formulas are flexible enough to provide a solution to the problem if the taxpayer is a material participant.

Input Area:

Spend > 50% in Real Estate Activity	Yes
Spend > 750 hours in Real Estate Activity	Yes
Spend > 500 Hours on Rental or 100-hour Test	No

Material Participant	No
-----------------------------	-----------

Own > 10% of Property	Yes
Have significant and bona fide involvement	Yes
Active Participant	Yes

	\$
Rental Loss	27,000
Maximum Allowable Rental Loss If Active Participant	\$ 25,000
	\$
Salary	80,000
	\$
Interest	12,500
	\$
Dividends	22,000
	\$
AGI Before Rental Loss	114,500
	\$
Allowable Rental Loss	17,750
	\$
Adjusted Gross Income	96,750

Input Area:

Spend > 50% in Real Estate Activity	Yes
Spend > 750 hours in Real Estate Activity	Yes
Spend > 500 Hours on Rental or 100-hour Test	No

Material Participant	=IF(AND((B2="Yes"),(B3="Yes"),(B4="Yes")),"Yes", "No")
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Own > 10% of Property	Yes
Have significant and bona fide involvement	Yes
Active Participant	=IF((B5="Yes"), "Not Applicable", IF(AND((B7="Yes"), (B8="Yes")), "Yes", "NO"))

Rental Loss	27000
Maximum Allowable Rental Loss If Active Participant	=IF((B9="Not Applicable"),B11,IF(B11>25000,25000,B11))
Salary	80000
Interest	12500
Dividends	22000
AGI Before Rental Loss	=SUM(B14:B16) =IF(B9="Not applicable",B11,IF(B17>150000,0,IF((150000>B17>10 0000),(25000-(B17-100000)*0.5),-B12)))
Allowable Rental Loss	
Adjusted Gross Income	=(B17-B18)

91. **TAX FORM PROBLEM** Rick and Debbie Siravo own a beachfront home in Wrightsville Beach, NC. During the year, they rent it for 20 weeks (140 days) at \$1,100 per week and use it 10 days for personal purposes. Rick actively participates in the management of the property, but does not qualify as a real estate professional. Their adjusted gross income for the year is \$137,200 and the costs of maintaining the home for the year are:

Mortgage interest	\$ 15,500
Real property taxes	4,500
Management fee	1,085
Insurance	1,200
Utilities	2,200
Cleaning service (only for rental period)	1,500
Repairs and maintenance	700
Depreciation (unallocated)	8,500

Complete Form 1040 Schedule E and Form 8582 using the above information. Rick's Social Security number is 036-87-1458, Debbie's Social Security number is 035-11-4856, and the address of the home is 435 Beachway Lane, Wrightsville Beach, NC 28480. Forms and instructions can be downloaded from the IRS web site (<http://www.irs.ustreas.gov/fromspubs/index.html>).

The total number of days that Rick and Debbie use the beachfront home is 150 days (10 personal days + 140 rental days). Therefore, with the exception of the management fee and the cleaning fee, which is 100% rental, 6.67% of the expenses are personal and the remaining 93.33% (100% - 6.67%) of the expenses are rental

	Total	Rental	Personal
Mortgage interest	\$ 15,500	\$14,467	\$ 533
Real property taxes	4,500	4,200	300
Management fee	1,085	1,085	-0-
Insurance	1,200	1,120	80
Utilities	2,200	2,053	47
Cleaning service (only for rental period)	1,500	1,500	-0-
Repairs and maintenance	700	653	47
Depreciation (unallocated)	8,500	7,933	567

Instructor's Note: Complete tax form solution included separately in file *SM_Ch_07_Problem_91.pdf* located on the Instructor's Resource CD with the folder 'Solutions Manual' and also on the companion website www.cengagebrain.com

92. **Integrative Tax Return Problem** This is the fifth part of a six part problem that will 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. The following basic information is provided for preparing their 2015 tax return:

- Laurie inherited two limited partnerships when her grandfather passed away on October 10, 2013. The first, Towers Brothers, is a real estate venture. The K-1 she received indicated that her share of the income is \$3,400. Her suspended loss in the partnership is \$2,200. The second limited partnership, DrillTech, is an oil and gas business. Her loss for the year is \$2,700. Laurie's suspended loss in DrillTech is \$5,600.
- On July 1, 2013, Lynn invested \$4,000 in his brother's corporation, PutterPlus, a training device to help golfers putt better. The corporation qualified as a small business corporation and went out of business on February 2, 2015.
- On April 22, 2010, the Norris' acquire 1,000 shares of NFG Inc. for \$11,000. On August 10, they sell 400 shares for \$2,000. On September 5, Lynn is watching Mad Money and based on Kramer's advice, he buys 300 shares of NFG for \$7 a share.
- **Required:** Based on the information provided above, only fill out the appropriate portions of Form 1040, Form 8582, and finish Form 1040 Schedule D.

The bankruptcy of Putter Plus results in a loss of their \$4,000 investment.

The sale of the 400 shares of NFG Inc. results in a realized loss of \$2,400. Because 300 of the 400 shares sold are replaced within 30 days (August 10 to September 5) the repurchase of the 300 shares on September 5 creates a wash sale. Therefore, the loss on the 300 shares replaced is disallowed and added to the basis of the 300 replacement shares purchased on September 5. The loss on the 100 shares that are not replaced is allowed as a capital loss. The disallowed loss is \$1,800 and the allowable loss is \$600.

Amount realized	\$ 2,000
Less: Basis	(4,400)
Realized loss	<u>\$ (2,400)</u>
Disallowed loss on 300 shares	
(300 ÷ 400) x \$2,400	1,800
Allowable loss on 100 shares not replaced	<u><u>\$ (600)</u></u>

The basis of the 300 shares purchased on September 5 is \$3,900 (\$2,100 cost + \$1,800 disallowed loss on wash sale).

Instructor's Note: The solution to the tax form problem is included separately in files **SM_Ch_07_Problem_92A.pdf**, **SM_Ch_07_Problem_92B.pdf**, **SM_Ch_07_Problem_92C.pdf** and **SM_Ch_07_Problem_92D.pdf**, located on the Instructor's Resource CD with the folder 'Solutions Manual' and also on the companion website, <http://www.cengagebrain.com>.

COMPREHENSIVE PROBLEM

93. Calculate Calzone Trucking's 2016 taxable income. Indicate the amount and the effect of any carryforwards or carrybacks on Calzone Trucking's current, past, or future income.

Calzone's 2016 taxable income is \$5,300:

Operating income			\$ 43,300
Less:			
Casualty loss from hail storm			
Roof damage	\$ 13,200		
Truck damage			
Decline in FMV - \$62,000 - \$37,000	<u>25,000</u>		
Amount of loss	<u>\$ 38,200</u>		
Insurance proceeds - \$16,600 + \$9,700	<u>(26,300)</u>	(11,900)	
Casualty loss - truck accident			
Basis of truck	\$ 24,000		
Insurance proceeds	<u>(13,700)</u>	(10,300)	
Loss on sale of equipment			
Amount realized	\$ 10,800		
Adjusted basis - \$28,000 - \$15,400	<u>(12,600)</u>	(1,800)	
Capital gains and losses			
Retro stock			
Amount realized	\$ 36,200		
Adjusted basis	<u>21,400</u>	\$ 14,800	
Tread stock			
Amount realized	\$ 31,700		
Adjusted basis	<u>62,100</u>	(30,400)	
Net capital loss		<u>\$ (15,600)</u>	-0-
Loss on sale of truck to son			
Amount realized	\$ 8,000		
Adjusted basis	<u>(10,100)</u>		
Realized loss	<u>\$ 2,100</u>		
Disallowed loss - related party sale	<u>(2,100)</u>	-0-	
Taxable income before NOL		<u>\$ 19,300</u>	
Net operating loss carryforward			
\$64,000 - \$32,000 - \$18,000		<u>(14,000)</u>	
Taxable income		<u><u>\$ 5,300</u></u>	

The 2014 net operating loss is carried back to 2013, reducing the 2015 carryforward to \$14,000 (\$64,000 - \$32,000 - \$18,000). The entire net operating loss carryforward is used up in 2016.

The repairs to the roof of \$13,200 are used to measure the loss from the hail storm damage (lower of the cost of repairs -- decline in fair market value or basis). The loss to the truck when the roof collapsed during the hail storm is the lesser of the \$35,000 adjusted basis or the decline in the value of the truck, \$25,000 (\$62,000 - \$37,000).

The loss on the truck totally destroyed is the truck's adjusted basis, \$24,000.

The \$1,800 (10,800 - \$12,600) loss on the sale of the equipment is an ordinary loss. The fine is not deductible.

The sale of the 2 stocks result in capital gains and losses, which are netted together to determine their tax effect. The net capital loss is not deductible by a corporation; it may only be used to offset net capital gains in the 3-year carryback and 5 year carryforward period. Because Calzone used the net operating loss to reduce 2015 income to zero, the \$15,600 capital loss is carried forward and used to offset net capital gains for 5 years.

The \$2,100 loss on the sale of the truck is not deductible by Calzone because the sale to his son is a related party transaction.

DISCUSSION CASES

94. The enactment of the passive loss rules has generally diminished the attractiveness of tax shelters as investments. However, rental real estate continues to provide a viable tax shelter for certain taxpayers. Explain why this is true.

Although individuals are not allowed to deduct net passive losses against other forms of income, two exceptions to this general rule are provided for rental real estate activities. The first is for individuals who meet the real estate professional exception. If a taxpayer meets this test, the activity is not passive and the loss from the rental activity is deductible. To meet this exception, the taxpayer must:

- **spend more than 50 percent of their total personal services time (work) in real property trades or businesses in which the taxpayer materially participates,**
- **perform more than 750 hours a year of service in real property trades or businesses in which the taxpayer materially participates and,**
- **materially participate in the rental activity.**

A taxpayer is considered to materially participate in an activity if the taxpayer spends more than 500 hours a year working on the rental activity or spend more than 100 hours a year in the activity, and the time spent in the activity is more hours than any other owner or non-owner spends in the activity (known as the 100-hour test). A real property trade or business is any real property redevelopment, construction, acquisition, conversion, rental operation, management, leasing, or brokerage trade or business. In addition, an individual who is an employee of a business engaged in a real property trade or business qualifies for this exception only if the employee has an ownership interest in the business that is greater than 5 percent.

The second exception is for individuals who are active participants in rental real estate. To meet the active participant test, the taxpayer must own at least a 10% interest in the property and have significant and bonafide involvement in the activity. This exception allows individuals to deduct up to \$25,000 of losses each year against active and portfolio income. However, the maximum allowable deduction is reduced when an individual's adjusted gross income is greater than \$100,000. The phase-out of the special deduction ends at an adjusted gross income of \$150,000. Thus, high-income taxpayers cannot take advantage of this special provision.

95. Exeter Savings and Loan is located in a two-story building in downtown Exeter. The building has a basement in which the heating system for the bank is located. The bank also uses the basement to store records and photocopying equipment. Last fall, the Saugutuxet River overflowed and flooded the basement. The flood destroyed all the bank's records and damaged all the equipment. The building suffered no serious structural damage.

This is the second time in ten years that the basement has been flooded. The state and county conducted a flood control study after the first flood but adopted no formal flood control plans. Fearful of another flood, the bank now stores all its records on the first and second floors.

The bank has claimed a casualty loss for the damaged records and equipment, and the decline in the market value of the building. It contends that because the basement of the building can no longer be used for storage, it is entitled to a casualty loss equal to the difference between the fair market value of the building before the casualty and the fair market value after the casualty. Explain whether Exeter Savings and Loan can deduct as a casualty loss the building's decline in fair market value.

The bank cannot claim a casualty loss for the decline in the market value of the building because the flooding did not cause any physical damage to the building. In measuring a casualty loss, the bank is required to use the lower of the building's basis or the decline in fair market value of the building. The cost of repairs to the asset can be used to approximate the decline in the building's fair market value. However, because the bank did not incur any repair expense to fix the basement, the amount of the casualty loss is zero. The perceived decline in market value due to losing storage space cannot be used in place of the cost of repairs.

Instructor's Note: In a similar case, *The Citizens Bank of Weston v. Commissioner* 252 F.2d 425 (4th Cir., 1958), the court found that the taxpayer was only entitled to a casualty loss for the damage to the equipment and records. Although the value of the basement might have declined in value, the amount of the decline can only be determined when and if the bank sells the building. There is nothing to preclude the bank from using this space in the future.

96. Jordan and her brother Jason agree to purchase a hardware store from a local bank, which acquired it through foreclosure. Because the bank wants to sell the business, Jordan and Jason can buy it for only \$160,000. Jordan will invest \$42,000 and own 70% of the business, and Jason will invest \$18,000 and own the remaining 30%. The bank is financing the remaining \$100,000 with a nonrecourse loan secured by the building (\$40,000), inventory (\$45,000), and equipment (\$15,000). Although Jordan and Jason believe that the store will prove to be an excellent investment within a few years, they expect losses of \$35,000, \$20,000, and \$14,000 in the first three years of operation. They anticipate turning a profit of \$16,000 in the fourth year. Jason and Jordan are unsure whether to operate the business as a corporation or an S corporation. Both will materially participate in running the hardware store. Explain to Jordan and Jason how the store's operating results will be taxed if they operate as a corporation versus an S corporation.

If Jordan and Jason operate the business as a corporation the corporation is subject to tax. During the first three years operating the business, the entity will report a loss. Therefore, the entity will not pay tax and have a net operating loss (NOL) carryforward. Because the corporation is a separate tax entity, Jordan and Jason will not receive any benefit from the NOL on their individual tax return and will report their salary, if any, on their individual return. In year four, the corporation will report income but can use the \$69,000 net operating loss carryforward from the first three years to offset the \$16,000 of income. The remaining \$53,000 (\$69,000 - \$16,000) NOL can be carried forward and used to offset income in future years.

If the business is operated as an S corporation, the income or loss will flow-through to Jordan and Jason and they will report their share of the income or loss on their respective tax returns. As material participants of an S corporation, Jordan and Jason can deduct their share of the losses only to the extent they are at-risk for the loss. As the table below indicates, the loss in year 1 is less than the amount that Jordan and Jason are at-risk. Therefore, they can deduct their pro rata share, \$24,500 and \$10,500 respectively, of the loss in year 1. The amount they have at risk at the end of year 1 is \$17,500 and \$7,500 respectively.

Since the amount they have at-risk in the S corporation exceeds their pro rata share of the loss in year 2, they can deduct \$14,000 and \$6,000 respectively. In year 3, their pro rata share of the loss, \$9,800 and \$4,200 respectively, exceeds their respective at-risk amount in the entity. Therefore, the amount Jordan can deduct in year 3 is limited to his remaining at-risk amount of \$3,500 and Jason's deductible loss is limited to \$1,500 that is at-risk. In year 4, the S corporation reports income of \$16,000. This increases their basis in the entity by \$11,200 and \$4,800 respectively. Jordan can now deduct the loss of \$6,300 from year 3 that was suspended due to the at-risk rules. He will report income in year 4 of \$4,900 (\$11,200 - \$6,300). Jason can also deduct his suspended loss of \$2,700 from year 3. He will report income in year 4 of \$2,100 (\$4,800 - \$2,700). Jordan's amount at-risk at the end of year 4 is \$4,900 and Jason's is \$2,100.

Jordan and Jason should operate as an S corporation because they will receive an immediate tax benefit (reduced tax liability) from the losses incurred during the early years of the business.

	(70%) Jordan	(30%) Jason
Initial amount at risk (amount invested)	\$ 42,000	\$ 18,000
Loss year 1 (\$35,000)	(24,500)	(10,500)
Amount at-risk end of year 1	<u>\$ 17,500</u>	<u>\$ 7,500</u>
Amount at-risk beginning year 2	\$ 17,500	\$ 7,500
Loss year 2 (\$20,000)	(14,000)	(6,000)
Amount at-risk end of year 2	<u>\$ 3,500</u>	<u>\$ 1,500</u>
Amount at-risk beginning year 3	\$ 3,500	\$ 1,500
Loss year 3 (\$14,000)	(9,800)	(4,200)
Loss suspended due to at-risk rules	<u>\$ (6,300)</u>	<u>\$ (2,700)</u>
Loss suspended due to at-risk rules	\$ (6,300)	\$ (2,700)
Income year 4 (\$16,000)	11,200	4,800
Amount at-risk end of year 4	<u>\$ 4,900</u>	<u>\$ 2,100</u>

TAX PLANNING CASES

97. Jay is single and works as a salesman. In December of the current year, he is selected as the company's outstanding salesperson. In recognition of this honor, he receives a \$75,000 bonus, which puts him in the 39.6% tax bracket. Jay owns 2,400 shares of stock in Amtrav corporation, which qualifies as small business stock. His broker has advised him to sell most, if not all, of his Amtrav stock. If he sells all his shares in the current year, he will recognize a \$25 per share loss on the stock. Unfortunately, even if he sells all his stock, he will remain in the 39.6% tax bracket. He expects his marginal tax rate will drop to 25% next year but will be 28% and 33% respectively, for the years after that. He does not anticipate any other capital gains or losses during the next three years. If Jay's goal is to minimize his taxes, develop a strategy for how many shares and in what year(s) he should sell his Amtrav stock. Assume that if he does not sell all his stock in the current year, that his loss per share will remain constant and that the time value of money is 8%.

Because the shares of Amtrav qualify as small business stock, Jay is allowed to deduct \$50,000 as an ordinary loss on the sale of the stock. Any loss in excess of \$50,000 is treated as a capital loss and is limited to \$3,000 per year. If Jay sells all his stock (2,400 shares) in the current year he will realize a loss of \$60,000. The first \$50,000 of the loss is treated as an ordinary loss and the remaining \$10,000 is considered a capital loss. However, only \$3,000 of the loss can be deducted in the current year and the remaining \$7,000 is carried forward. In the first year, he will save \$20,488 in taxes (\$53,000 x 39.6%) and over the next three years, he will save an additional \$1,920 (\$22,908 - \$20,988) in taxes. The present value of the tax savings over the period is \$22,665:

	Current Year	1 Year Later	2 Years Later	3 Years Later	Total
Ordinary loss	\$50,000	0	0	0	\$50,000
Capital loss	3,000	\$3,000	\$3,000	\$1,000	10,000
Total Loss	\$53,000	\$3,000	\$3,000	\$1,000	\$60,000
Marginal tax rate	x 39.6%	x 25%	x 28%	x 33%	
Tax savings	\$20,988	\$750	\$840	\$330	\$22,988
PV factor	1.000	.926	.857	.794	
Net tax benefit	\$20,988	\$695	\$720	\$262	\$22,665

Because Jay's marginal tax rate changes over the period, he needs to determine whether selling all of his shares in the current year is better than selling enough shares to generate the maximum deductible loss (\$53,000 = \$50,000 ordinary loss + \$3,000 capital loss). To determine which is the better option, Jay needs to compute the present value of saving \$1 in taxes for each of tax year. The chart below indicates that the present value of saving a \$1 in taxes is highest (.2620) three years later when Jay is in the 33% tax bracket.

1 year later	\$1 x 25% = 25% x .926 = .2315
2 years later	\$1 x 28% = 28% x .857 = .2400
3 years later	\$1 x 33% = 33% x .794 = .2620

Therefore, Jay will maximize his tax savings by selling enough shares to generate a \$53,000 loss in the current period. As a result, Jay should sell 2,120 ($\$53,000 \div \25 loss per share) shares in the current year and the remaining 280 ($2,400 - 2,120$) shares three years later. The table below verifies this conclusion. Jay's saves an additional \$390 ($\$23,298 - \$22,908$) by selling 2,120 shares in the current year and the remaining 280 shares three years later. The present value of his tax savings is \$22,822, an increase of \$157 ($\$22,822 - \$22,665$) over selling all the shares in the current year.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Total</u>
Ordinary loss	\$ 50,000	\$ -0-	\$ -0-	\$ 7,000	\$ 57,000
Capital loss	3,000	-0-	-0-	-0-	3,000
Total Loss	<u>\$ 53,000</u>	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ 7,000</u>	<u>\$ 60,000</u>
Marginal tax rate	x 39.6%	x 25%	x 28%	x 33%	
Tax savings	\$ 20,988	\$ -0-	\$ -0-	\$ 2,310	\$ 23,298
PV factor	1.000	.926	.857	.794	
Net tax benefit	<u>\$ 20,988</u>	<u>\$ -0-</u>	<u>\$ -0-</u>	<u>\$ 1,834</u>	<u>\$ 22,822</u>

Instructor's Note: By splitting the sale over the four year period, \$50,000 of each year's loss is treated as an ordinary loss.

98. Tom has \$40,000 to invest and seeks your advice. A partner at Global Investments has proposed two investment opportunities: a real estate limited partnership or a five-year investment contract that will pay interest of 8% annually and return his original investment at the end of the fifth year. Tom will invest the interest he receives from the annuity each year in a savings account that will pay 5% per year. The limited partnership expects losses in the first two years of \$8,000 and \$6,000 but expects that its income in years three through five will be \$4,000, \$10,000, and \$12,000. At the end of year five, Tom believes, he will be able to sell the limited partnership at a gain of \$5,000. He expects that his marginal tax rate over the five-year period will be 28%. Write a letter to Tom explaining whether he should invest in the limited partnership or the annuity contract. In your letter, also discuss any other factors he should consider concerning the two investments.

Tom will earn \$3,200 (\$40,000 x 8%) per year from the investment contract. However, the \$3,200 is subject to tax, so Tom will only have \$2,304 [\$3,200 x (1 - .28)] each year to reinvest in a savings account. Assuming the after-tax interest proceeds are reinvested each year along with the new proceeds from the annuity (i.e., \$2,304 per year), Tom's total earnings net of tax are \$12,380 [(\$2,304 x 5) + \$860].

Earnings on money received and reinvested:

Year 2:	\$2,304	x 5%	= \$115	x (1 - 28%)	=	83
Year 3:	\$4,691	x 5%	= \$235	x (1 - 28%)	=	169*
Year 4:	\$7,164	x 5%	= \$358	x (1 - 28%)	=	258
Year 5:	\$9,726	x 5%	= \$486	x (1 - 28%)	=	350
Total earnings						<u>860</u>

* The \$4,691 consists of the \$2,304 (net of tax) from year 1 that was invested in the beginning of year, plus the interest (net of tax) earned on the investment in year 2, plus the additional (net of tax) proceeds from the investment contract from year 2.

Year	After-tax income	PV factor	PV
1	\$2,304 + 0 = \$ 2,304	.926	\$2,134
2	\$2,304 + 83 = \$ 2,387	.857	\$2,046
3	\$2,304 + 169 = \$ 2,473	.794	\$1,964
4	\$2,304 + 258 = \$ 2,562	.735	\$1,883
5	\$2,304 + 350 = \$ 2,654	.681	\$1,807
Total	<u>\$12,380</u>		<u>\$9,834</u>

If Tom invests in the limited partnership, he cannot deduct his losses because the limited partnership is a passive activity. Tom reports \$12,000 of income in year 5 since he will be able to offset his income from years' three and four against his losses from years' one and two. Therefore, the income he receives in years' 3 and 4 is tax-free. The \$12,000 of income will yield Tom \$8,640 [\$12,000 x (1 - 28%)] after tax. Tom will have a long-term gain on the sale of the limited partnership. His after tax proceeds from the sale are \$4,250 [\$5,000 x (1 - 15%)]. Assuming the limited partnership distributes his share of the income, his total after-tax cash proceeds from the limited partnership are \$26,890 (\$4,000 + \$10,000 + \$8,640 + \$4,250).

Tom's after-tax yield from the limited partnership is \$14,510 (\$26,890 - \$12,380) greater than with the investment contract. However, Tom must also consider the time value of money. Using a discount rate (i.e., present value rate) of 8%, the net present value of the investment contract is \$9,834.

The net present value of the proceeds from the partnership is \$19,304.

Year	After-tax income	PV factor	PV
3	\$ 4,000	.794	\$ 3,176
4	\$10,000	.735	\$ 7,350
5	\$12,890	.681	\$ 8,778
Total	<u>\$26,890</u>		<u>\$19,304</u>

Therefore, Tom's net proceeds will be \$9,470 greater (\$19,304 - \$9,834), if he invests in the limited partnership than if he chooses the investment contract.

Other factors Tom should consider is the risk associated with the income streams from the investments and the risk of losing part or all of his initial investment. The income stream from the limited partnership is much more subjective than the income stream from the investment contract. In addition, the probability of Tom losing his initial investment (or a portion of it) in the limited partnership is much greater than with the investment contract.

ETHICS DISCUSSION CASE

99. Anthony owned a 2014 Luxuro automobile that had a fair market value of \$18,000. His son James, who is 19, borrows the car without his father's knowledge and totals it in 2015. James has been involved in two car accidents, and his father is afraid that James will not be able to get insurance. Therefore, Anthony decides not to file an insurance claim and deducts the loss on his 2015 tax return. In 2016, Anthony decides to have his friend Brigid, a local CPA, prepare his tax return. In preparing his 2016 return, Brigid reviews Anthony's 2015 return and finds that Anthony took a casualty loss on the Luxuro. Aware that Anthony has insurance, she is perplexed as to why he deducted the loss. Anthony tells her of his son's fearsome driving record and his worry that James could not get insurance. What are Brigid's responsibilities (refer to the Statements on Standards for Tax Services which can be found at www.cengagebrain.com), if any, concerning Anthony's 2015 tax return? What effect does the issue have on Brigid's preparation of Anthony's 2016 return?

Based on the facts set forth in the case, the client improperly deducted the casualty loss on his car. A casualty loss deduction cannot be taken if the taxpayer does not file an insurance claim. Brigid is required by SSTS #6 to inform the client of the error in the prior years' tax return. Paragraph (.03) states that upon becoming aware of an error in a client's previously filed return, the CPA should recommend appropriate measures to correct the error. In this case, Anthony (or Brigid on Anthony's behalf) should file an amended return for 2015. If the client amends the return (or Brigid upon Anthony's request), then Brigid can prepare the 2016 return. If the client does not agree to file an amended return, then paragraph (.04) of SSTS #6 requires the CPA to consider whether to withdraw from the engagement. Brigid should consider consulting her own legal counsel before deciding whether to withdraw from the engagement. The potential exists for her to violate Rule 301 of The Professional Code of Conduct (relating to her confidential client relationship). Under this rule, conversations between Brigid and her client are privileged communication and cannot be disclosed without the client's permission. However, because Brigid has only reviewed the prior years' tax return and has yet to prepare the current year's tax return, she probably has not violated Rule 301. She should probably consult a lawyer if she has any doubts whether she is in violation of Rule 301. Also, SSTS #6 requires that if the CPA prepares the return, the CPA should insure that the error is not repeated. Since the error occurred when the client prepared the return, it is unlikely that the error will occur again.

Chapter 7

Check Figures

17. \$9,000 carryforward to 2017
18. \$44,500 tax refund
19. carryforward loss - \$7,267 greater savings
20. a. \$90,000 b. \$67,000
21. Ending amount at-risk - \$16,000
22. Loss limited to at-risk - \$16,000
23. a. \$30,000 b. no effect
24. a. \$14,000 b. \$31,000
c. \$49,000 d. \$14,000
e. \$24,000
25. a. \$72,000 b. \$45,000
c. \$47,000
26. a. Yes b. No
c. No d. No
e. No f. Yes
27. a. Yes b. No
c. No d. Yes
e. No f. Yes
28. a. 2015 – At-risk \$0; \$1,000 suspended at-risk rules
b. 2015 – At risk \$0; \$20,000 suspended passive loss rules
c. 2015 – Allowable loss \$3,800; \$1,000 suspended at-risk rules
29. a. Betina \$9,600; Aretha \$0 b. Betina \$9,600; Aretha \$2,500
c. Betina \$9,600; Aretha \$14,400
30. a. \$18,500
b. \$16,000
c. \$16,000
d. \$16,000
31. a. 2015 - \$102,000; 2016 - \$120,000; 2017 - \$96,000
b. 2015 - \$105,000; 2016 - \$135,000; 2017 - \$78,000
32. a. 2015 - \$97,000; 2016 - \$115,000; 2017 - \$97,000
b. 2015 - \$97,500; 2016 - \$130,500; 2017 - \$81,000
33. a. \$15,000 deduction b. \$0
c. \$14,000 deduction d. \$5,500 deduction

34. a. \$12,900 deduction
c. \$0
- b. \$10,500 deduction
d. \$12,900 deduction
35. a. No effect
- b. PA2 - \$10,000
36. a. No effect
- c. PA2 - \$7,200
37. No deduction in any year
38. a. \$12,000 long-term capital gain
- b. \$5,000 long-term capital loss
39. a. \$ 7,000 capital gain
\$16,000 suspended loss deduction
- b. \$ 5,000 capital loss
\$16,000 suspended loss deduction
40. \$9,000 deduction
41. No suspended loss allowed
42. No effect; Felipe's basis is \$46,000
43. a. \$1,000 increase
c. \$5,000 decrease
e. No effect
- b. \$6,000 capital loss;
\$13,000 suspended loss deduction
d. No effect
44. N/A
45. a. \$135,000 ordinary loss
c. \$3,100 loss
e. \$37,300 loss
- b. \$27,000 casualty loss
d. \$0 casualty loss
46. a. \$900 loss
c. \$22,000 casualty loss
e. \$5,500
g. \$2,050
- b. \$8,500 ordinary loss
d. \$700 income
f. \$10,000 casualty loss
47. \$3,800 loss
- b. \$400 gain
48. \$1,300 loss
- b. \$4,800 loss
49. \$1,850 total loss
50. \$3,820 loss
51. a. \$70,500 AGI
- b. \$63,500 AGI
52. a. \$5,000 carryforward
b. \$2,500 deduction
- c. \$3,000 deduction; \$6,000 carryforward
53. a. \$15,000 carryforward
b. \$12,000 carryforward
- c. \$4,100 carryforward
54. a. \$17,000 loss carryback
- b. \$4,500 capital gain; \$8,750 capital loss
55. 2016 carryback generates \$2,040 refund

56. 2016 carryback generates \$2,040 refund; \$3,000 carryforward to 2018
57. a. \$52,000 loss carryforward
b. \$50,000 ordinary loss, \$3,000 capital loss, \$52,000 carryforward c. \$55,000 ordinary loss
58. a. \$22,000 loss carryforward
b. \$10,000 loss carryforward c. \$3,000 loss carryforward
59. \$17,000 business loss; \$3,000 capital loss deduction
60. a. Katelyn: \$2,400 loss disallowed
b. Jon: no gain recognized
c. Jon: \$200 recognized gain
d. Jon: \$500 recognized loss
61. a. Elliot: \$2,000 loss disallowed; Nancy: \$1,000 gain recognized
b. Nancy: No recognized gain
c. Nancy: \$2,000 recognized loss
62. \$30,000 disallowed loss; \$50,000 dividend income
63. \$8,000 disallowed loss; \$2,167 realized loss; \$1,167 realized gain
64. \$1,500 recognized loss
65. \$367 recognized loss
66. \$1,400 casualty loss
67. \$4,900 casualty loss
68. a. \$45,000 loss; \$ 9,000 loss b. \$9,000 loss; \$3,900 loss
c. \$70,000 gain; \$6,900 loss
69. \$28,000 business gain; \$3,600 personal casualty loss
70. \$8,000 business loss; \$900 personal casualty loss (\$0 deductible)
71. \$600 loss carryforward
72. \$2,500 long-term capital loss