

Solutions to Develop Research Skills

Note to Instructor: No research aids or “hints” are provided in the textbook for problems in this chapter. Before the solution to each problem, however, suggested research aids are provided. This allows you to choose whether or not to provide any hints to your students for a particular problem. For problems that can be solved using free Internet sources, you must provide students with the citations in these hints and refer students to Figure 2.2 of Chapter 2 in the text for the URLs to enable them to solve these problems using free Internet sources. Some of the problems require access to *Checkpoint®* or a similar service. The research process for solving a sample problem is illustrated in Appendix A through screen captures for *RIA Checkpoint®*.

59. *Repaying Creditors of Prior Business (can be solved using Checkpoint® or a similar service)*

Gary Sanders owns his own real estate business. He has developed a reputation within the community for honesty and integrity. He believes that this is one of the reasons his firm has been so successful. Gary was a 30 percent shareholder in an unsuccessful fast-food restaurant, Escargot-to-go. Although he personally thought the business had great food and was well run, escargot never appealed to the local community. Early this year the corporation filed for bankruptcy.

Many of the creditors of Escargot were also clients of Gary’s real estate business. After Escargot declared bankruptcy, Gary’s real estate business began to suffer. Gary felt that the decline in his real estate business was related to the bankruptcy of Escargot so Gary used the earnings of his real estate business to repay all the creditors of Escargot-to-Go. Within a few months, Gary’s real estate business began to pick up. Gary has asked you to determine if his real estate business can deduct the expenses of repaying Escargot-to-Go’s creditors.

Hint: *William A. Thompson* TC Memo 1983-487, 46 TCM 1109, 1983 PH T.C. Memo ¶83,487

Issue: Can Gary deduct the amount he paid to the bankrupt corporation’s creditors?

Conclusion: Gary should be permitted to deduct the amount paid to those creditors who are also customers of his real estate business. However, Gary may not deduct the amount paid to the other creditors who are not customers of his real estate business.

Discussion of Reasoning and Authorities: Business expenses are deductible under Section 162 if they are ordinary, necessary and reasonable in amount. The general payment of another’s debts is not usually considered an ordinary and necessary business expense. The determination of whether a particular payment is ordinary and necessary, however, can be difficult.

In the landmark case of *Welch v. Helvering*, 3, USTC ¶1164, 12 AFTR 1456 (UCCS, 1953), the Supreme Court discussed the meaning of the term “ordinary and necessary”. The court stated that while the payments to the corporation’s creditors were necessary (in that they were appropriate and helpful) for the development of Welch’s business, they were not ordinary. The court held that no deduction was allowed when the payments were made to build goodwill in the taxpayer’s new job instead of preserving his existing business reputation. However, expenditures incurred by a taxpayer to protect his business reputation or avoid unfavorable business or commercial publicity have been regarded as deductible. A payment made to merely protect personal reputation is not deductible.

In *William A. Thompson* 46 TCM 1109, 1983 PH T.C. Memo ¶83,487, the taxpayer was allowed a deduction for the payments made to creditors of a defunct corporation providing these creditors

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were also clients of his engineering firm. Other payments made by Thompson to creditors whom he felt morally obligated to repay were not deductible.

Based on these cases, Gary should be permitted to deduct the payments he made to the creditors who were also clients of his real estate business. These payments were made to preserve his current professional reputation and to maintain the business relationship with the clients of his real estate business. However, payments made to the creditors who were not also current real estate clients will probably not be deductible.

60. *Travel Away from Home (can be solved using free Internet sources)*

Ben is the chief executive officer of a restaurant chain based in Maine. Ben began the business 15 years ago and it has grown into a multimillion-dollar company, franchising restaurants all over the country. Ben has a new interest, however, in horse breeding. He previously raised horses with some success over the years but has only recently decided to pursue this new business with the same intensity he originally pursued the restaurant business. Ben has always liked South Florida and sets up his new horse breeding business there. He purchased a fully operating breeding farm and leased a nearby condominium for six months so he can oversee the business. Ben plans to continue to spend about six months each year in Florida for the next three years overseeing his horse business, which should provide about 30 percent of his total income. Ultimately, Ben would like to sell his interest in his restaurant business and retire to Florida to devote all of his time to his horses. Ben wants to know if he can deduct any of the costs associated with his travel to Florida.

Hints: *Andrews, Edward v. Comm.*, 67 AFTR 2d 91-881, 931 F2d 132, 91-1 USTC ¶50,211; *Markey v. Comm.*, 33 AFTR 2d 74-595, 490 F2d 1249, 74-1 USTC ¶9192; and Revenue Ruling 54-147, 1954-1 C.B. 51.

Issue: What expenses, if any, can Ben deduct relating to his travel between Maine and Florida?

Conclusion: Since Ben will be traveling away from home on business, he can deduct his travel expenses between Maine and Florida, his Florida condominium lease expenses, and the allowable portion of meal costs.

Discussion of Reasoning and Authorities: As a general rule, living expenses are nondeductible personal expenses under Section 262. However, Ben may be able to deduct these costs as travel expenses. Section 162(b) specifically allows the deductions for traveling expenses, including the costs of meals and lodging, while away from home in the pursuit of business. If this rule applies, Ben would be permitted to deduct his travel expenses to and from Florida, his lease payments and the allowable portion of meal costs.

In the Supreme Court case, *Commissioner v. Flowers*, 326 U.S. 465 (34 AFTR 301) 1946, the Court stated that travel expenses are deductible only if (1) reasonable and necessary; (2) incurred while away from home; and (3) incurred in the pursuit of business.

The case of *Andrews, Edward v. Comm.*, 67 AFTR 2d 91-881, 931 F2d 132, 91-1 USTC ¶50,211 (CA-1, 1991), vacg. TC Memo 1990-391, PH TCM ¶90,391, 60 CCH TCM 277 provides similar facts to the case at hand. In the lower court case of *Andrews*, the Tax Court found that Andrews had two tax homes. Its decision was based on an observation that Andrews' business in Florida for 6 months was recurrent each year, rather than temporary. However, the Appellate Court found that Andrews had only one tax home and that the duplicate living expenses while on business at the other house were a cost of producing income and therefore, deductible as travel expenses. The Appellate Court left it up to the Tax Court to determine which of the two homes would be considered the tax home.

In this case, Ben meets the travel expense requirements provided in the *Flowers* case. He has substantial business activity in both locations. Ben would be considered away from his tax home when in Florida or in Maine, depending on where his tax home is located. Consideration should be given to how the tax home is determined.

It may behoove Ben to take steps to ensure that the place yielding the greatest tax benefits is ultimately considered his tax home. For example, if living costs in Florida would be greater than the costs of living in Maine, steps might be taken to ensure that Maine is the tax home so that the taxpayer would be in a travel status while in Florida.

Rev. Rul. 54-147 addressed the situation in which a taxpayer has two or more geographically separated places of business. In this ruling, the IRS indicated that a taxpayer would be away from home while at the location of the minor or secondary business. To determine which business is the principal and which is secondary, the IRS considered the following factors: (1) total time spent working in each area; (2) degree of business activity in each area; and (3) the relative amount of income from each area. The Sixth Circuit also held in *Markey v. Comm.* (33 AFTR 2d 74-595, 490 F2d 1249, 74-1 USTC ¶9192, rev'g TC Memo 1972-154) that when a taxpayer has two places of business at a considerable distance from one another, the tax home will generally be the one where the taxpayer: (1) spends more of his time, (2) engages in greater business activity, and (3) derives a greater proportion of his income. Based on the facts provided, it would appear that Maine will be considered Ben's tax home since 70% of his income is derived from his business there.

61. *Deductibility of Skybox Rental (can be solved using free Internet sources)*

Marino Corporation pays \$6,500 to rent a 10-seat skybox for three football games to use for business entertainment at each game. The price for a regular nonluxury box seat at each game is \$45. How much can Marino Corporation deduct for this entertainment expense?

Hint: Sections 274(l)(2) and 274(n).

Issue: How much can Marino Corporation deduct for the skybox rental?

Conclusion: Marino will only be permitted to deduct \$675 as an entertainment expense.

Discussion of Reasoning and Authorities: When a skybox or other private luxury box is leased for more than one event, Section 274(l)(2) limits the amount allowable as a deduction to the sum of the face value of non-luxury box seat tickets for the number of seats in the box. Section 274(n) further reduces this amount by 50 percent to determine the amount that can be deducted as an entertainment expense. Therefore, Marino can deduct \$675 as an entertainment expense [(\$45 FMV of nonluxury seats x 10 seats in the skybox) x 3 games) = \$1,350, then reduced by 50% = \$675].

62. *Allocation of Vacation Home Expenses (can be solved using Checkpoint® or a similar service)*

Suzanne owns a vacation home at the beach in which she lived for 30 days and rented out for 61 days during the current year. Her gross rental income is \$2,600. Her total expenses for the vacation home are as follows:

Mortgage interest	\$1,500
Property taxes	900
Utilities	700
Maintenance	300
Depreciation for entire house	1,100

- Compute Suzanne's net rental income using the IRS method for allocating expenses.
- Compute Suzanne's net rental income using the Tax Court method (also known as the Bolton method) for allocating expenses.
- Which method results in less taxable income? Explain.

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Hint: Prop. Reg. Section 1.280A-3(c) and *Bolton*, 77 TC 104, aff'd 694 F2d 556 (1982).

- a. Net rental income under the IRS method is zero. Section 280A(e)(1) specifies that the rental allocation of each expense should use a fraction "which bears the same relationship to such expenses as the number of days during each year that the unit (or portion thereof) is rental at a fair rental bears to the total number of days during such year that the unit (or portion thereof) is used." However, Section 280A(e)(2) specifies that this provision does not apply to "any deduction that would be allowable under this chapter for the taxable year whether such unit (or portion thereof) was rented" and is generally considered to mean deductions such as interest and taxes. Prop. Reg. Section 1.280A-3(c) states that the IRS applies the Section 280A(e)(1) allocation procedures to all expenses that are otherwise allowable. Thus, the IRS interprets this to mean that interest and taxes should be apportioned between rental and personal days based on a ratio of the rental days (as the numerator) to the total number of days the vacation rental home was actually used for rental and personal purposes during the year (as the denominator). Under this method, 61/91 would be the fraction used to allocate all categories of expenses to rental use as follows:

<u>Type of expense</u>	<u>Rental Expenses</u>	<u>Itemized Deductions</u>
Interest (\$1,500 x 61/91)	\$1,005	
Interest – personal portion (\$1,500 - \$1,005)		\$495
Taxes (\$900 x 61/91)	603	
Taxes – personal portion (\$900 - \$603)		297
Utilities (\$700 x 61/91)	469	
Maintenance (\$300 x 61/91)	<u>201</u>	
Subtotal before depreciation	\$2,278	\$792
Depreciation (\$1,100 x 61/91 = \$737) but limited to remaining income of \$322 (\$2,600 - \$2,278)	322	
Net rental income (\$2,600 - \$2,278 - \$322)	-0-	

- b. Net rental income under the Tax Court method is \$792. The Tax Court in *Bolton*, 77 TC 104 (affirmed by the 9th circuit in 694 F2d 556) stated that Section 280(e)(2) prohibits applying the Section 280(e)(1) limit to the otherwise deductible items of interest and taxes. The Court approved the taxpayer's allocation of interest and taxes based on the entire year (365 days) and not just the total number of days the vacation home was actually used during the year. The Court reasoned that the vacation homeowner paid interest and taxes based on 365 days a year and not the actual number of days the property was used. The IRS, however, refused to accept this allocation method. Thus, the Tax Court (or *Bolton*) method allocates interest and taxes based on the number of days in the year. Expenses other than interest and taxes are allocated in the same manner under both methods. Under the Tax Court method, expenses would be allocated as follows:

<u>Type of expense</u>	<u>Rental Expenses</u>	<u>Itemized Deductions</u>
Interest (\$1,500 x 61/365)	\$251	
Interest – personal portion (\$1,500 - \$251)		\$1,249
Taxes (\$900 x 61/365)	150	
Taxes – personal portion (\$900 - \$150)		750
Utilities (\$700 x 61/91)	469	
Maintenance (\$300 x 61/91)	<u>201</u>	
Subtotal before depreciation	\$1,071	\$1,999
Depreciation (\$1,100 x 61/91)	737	
Net rental income (\$2,600 - \$1,071 - \$737)	\$792	

- c. The Tax Court method usually results in more deductions and less overall taxable income. Under the Tax Court method, total deductions are \$3,807 (\$1,808 rental expenses + \$1,999 itemized deductions) and gross rental income is \$2,600, resulting in \$1,207 ($\$3,807 - \$2,600$) expenses in excess of income. Under the IRS method, total deductions are \$3,392 (\$2,600 rental expenses + \$792 itemized deductions) and gross rental income is \$2,600, resulting in only \$792 expenses in excess of income. Under the Tax Court method, \$415 ($\$1,207 - \792) more in expenses are allowed than under the IRS method if the taxpayer has enough other itemized deductions to make itemizing worthwhile and if the itemized deductions are not phased out.