35. In 2007, RayeAnn acquires a car for $14,000. She uses the car in her advertising business and for personal purposes. Her records indicate the car is used 70% for business and that the total operating expenses, including depreciation, are $3,800.

a. How should RayeAnn treat the operating costs of the car for tax purposes?

The car is considered a mixed-use asset. The expenses associated with a mixed-use asset must be allocated between the business portion and the personal portion. In this case, 70% of RayeAnn's expenses are treated as a business expense. She can deduct $2,660 ($3,800 x 70%) of the cost of operating the car. The remaining $1,140 is a personal expense and is not deductible.

b. In 2010, RayeAnn sells the car for $6,500. Her business use for 2008 through 2010 remains at 70%, and she properly deducted $5,880 in depreciation. What is her taxable gain or loss from the sale of the car?

RayeAnn must treat the sale of the car as the sale of two assets - a business asset and a personal asset. The $6,500 sales price and the $14,000 purchase price is allocated between her business and personal use:

<table>
<thead>
<tr>
<th></th>
<th>Business</th>
<th>Personal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$4,550</td>
<td>$1,950</td>
</tr>
<tr>
<td>- $6,500 x 70%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- $6,500 x 30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Adjusted basis</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Original cost</td>
<td>$9,800</td>
<td>$4,200</td>
</tr>
<tr>
<td>- $14,000 x 70%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- $14,000 x 30%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Depreciation</td>
<td>(5,880)</td>
<td>(3,920)</td>
</tr>
<tr>
<td>Gain (loss) on sale</td>
<td>$630</td>
<td>$(2,250)</td>
</tr>
</tbody>
</table>

The gain on the sale of the business portion of the asset is considered a Section 1231 gain (discussed in Chapter 11). The loss on the personal portion of the asset is a nondeductible personal use loss.

37. Discuss whether the following expenditures meet the ordinary, necessary, and reasonable requirements.

a. Sadie owns 5 shares of Megaconglomerate stock. She spent $4,000 to attend the annual shareholders' meeting.

The expenditure of $4,000 to attend the shareholders' meeting would not be considered ordinary, nor would it be reasonable. It would not be ordinary because a prudent business person in the same situation would not make such a large expenditure on such a small investment. In addition, it is likely that the $4,000 cost is greater than the amount invested, making it an unreasonable amount.
b. Sam runs a successful medical practice. Because he has a substantial investment portfolio, he spent $3,000 to attend a seminar on investing strategies.

The expenditure meets the ordinary, necessary, and reasonable test if Sam's investment portfolio is large in relation to the expenditure. However, the costs of attending seminars are deductible only if they are related to the trade or business of the taxpayer (discussed in Chapter 6).

c. Alana is a self-employed tax attorney. She spent $3,000 to attend the American Institute of Certified Public Accountants' annual conference on income tax developments.

The cost of attending the seminar would meet the ordinary, necessary, and reasonable tests. The purpose of the expenditure is directly related to Alana's trade or business as a tax attorney and would be a deductible education expense.

d. Kevin owns a large ranching operation. He is deeply religious and feels it is important that his employees have access to religious counseling. He hired an ordained minister to live on the ranch and be available to counsel his employees on any religious problems they might have.

The expenditure would not be considered ordinary because it is not a common business practice in the ranching business. The necessity of the expenditure is also questionable because it does not directly benefit Kevin's business. The primary benefit is personal - Kevin gets the satisfaction of having a minister available for himself and his employees.

39. For each of the following situations, discuss whether the expense is currently deductible or must be capitalized:

a. The Mickleham Hotel installs a $125,000 sprinkler system to comply with recently enacted fire regulations.

The cost of installing the sprinkler system is a capital expenditure. The sprinkler system has a useful life that extends substantially beyond the end of the tax year. The expense also increases the value of the building by reducing the chances of it being destroyed by fire and by making it safer for the occupants. The fact that the expenditure is required to conform the building to the new fire regulations does not make the expense immediately deductible.

b. The Healesville Corporation pays a real estate commission of $35,000 in acquiring its new office building.
The $35,000 real estate commission is a capital expenditure that must be added to the cost of the building. The fee is considered a cost of acquiring the building.

c. The Doverson Company pays $25,000 to repave its parking lot.

The cost of repaving the parking lot is deductible in the current year as a repair expense. The repaving does not extend the useful life of the parking lot, but returns the lot to its original condition. Note: If the expenditure is to convert a dirt parking into an asphalt parking lot, the cost is considered a capital expenditure, because Doverson has more than maintained the parking lot — it has substantially improved and increased the value of the parking lot.

d. The Watsonia Company pays $56,000 to add an air-conditioning system to its warehouse. The company had agreed to air condition the warehouse as part of a three-year labor agreement with its employees.

The cost of installing the air-conditioning system is a capital expenditure. The air conditioning system has a useful life that extends substantially beyond the end of the tax year and increases the value of the warehouse. The fact that the expenditure is required under the current labor agreement does not change the treatment of the expense.

e. Hua pays $600 to repair the walls and ceiling of his rental property after his tenant moves out.

The $600 cost of repairing the walls and ceiling are a current period expense. The expense is a repair expense because it does not extend the useful life of the rental property, but rather restores the property to its original condition.

41. Neal and Ned spend $25,000 on travel, surveys, and financial forecasts to investigate the possibility of opening a bagel shop in the city. Because their suburban bagel shop has been so successful, they would like to expand their operations. What is the proper treatment of their expenditures if

a. They open a bagel shop in the city?

Because they are investigating the expansion of an existing business, they may deduct the $25,000 as a current expense. The investigation is considered to be an ordinary and necessary business expense.

b. They decide not to open a bagel shop in the city?

The $25,000 is deductible even if they don’t open a business in the new location. The expenses are related to expanding the existing active business, which is an ordinary and necessary business activity.

c. Answer a and b assuming they are investigating opening a computer store in the city and they operate a bagel shop in the suburbs.
A taxpayer who incurs less than $50,000 of start-up costs can deduct up to $5,000 of the start-up costs in the year the new business. Any amount in excess of $5,000 must be amortized over 180 months. For taxpayers, with start-up costs in excess of $50,000, the $5,000 amount is phased-out on a dollar-by-dollar basis. Therefore, the deduction for start-up costs can be viewed as consisting of two parts. The first is a $5,000 current deduction and a second part that amortizes the remaining start-up costs over 180 months.

Because they are investigating a "new" business, the $25,000 is a capital expenditure and is not currently deductible. If they open the computer store, they can deduct $5,000 and amortize the remaining $20,000 ($25,000 - $5,000) over 180 months [i.e., ($20,000 ÷ 180 = $111.11) per month]. Therefore, assuming the restaurant is open for 6 months, her deduction in the current year would be $5,667 [$5,000 + (6 x $111.11)].

If they do not open the computer store, the investigation expenses are nondeductible personal expenditures. That is, they have no trade or business to write the expenses against and there is no personal deduction allowed for such expenses.

43. What is the proper tax treatment for each of the following expenses?

   a. Bernilyn, a commercial real estate broker, is late for a meeting with her boss when she is stopped and ticketed $150 for speeding. She is using a company car when she receives the ticket.

      The $150 speeding ticket is a fine. Fines are not deductible business expenses because it is neither ordinary nor necessary to violate the law.

   b. Russell is an employee of the Dinsmore Corporation, a small plumbing repair business. He learns that his boss Simon, the sole owner of the business, was arrested twenty years ago for burglary. Because Simon needs access to homes and businesses to do his work, he pays Russell $100 per month for his silence.

      The $1,200 ($100 x 12) Simon paid Russell is not deductible. The payment to Russell is probably illegal under local or state law. The tax law explicitly states that illegal bribes are not deductible.

   c. Anastasia owns a travel agency. The daughter of the president of her largest corporate client is getting married, and Anastasia insists on paying for her bridal shower at a local restaurant.

      The payment of the cost of a bridal shower for her largest client’s daughter is not an ordinary or necessary business expense. The function is primarily personal in nature.
d. The San Martin Construction Company pays local union officers $20,000 to ensure that San Martin continues to receive construction contracts. The payments are standard practice in the area.

The payment of $20,000 as a kickback is not considered a valid business expense because it violates public policy. This is true even though the payments are considered standard practice in the area. Instructors Note: If the payments are not illegal under state law (i.e., it is standard practice), the payment may be an ordinary and necessary business expense.

50. Determine the current tax deduction allowed in each of the following situations:

a. Sam owns and operates SoftPro, a software programming business. In June, the firm files for bankruptcy. Eighteen months earlier, Karl, had recommended SoftPro as a good investment to his clients. Three of Karl’s clients each loaned SoftPro $40,000 at 12% interest. To avoid losing his three clients, Karl repaid the $40,000 each client had loaned to SoftPro.

Karl is not allowed a deduction for the amount he paid to each of his clients. Although the expense might be necessary for Karl to maintain his business reputation, the expense would not be considered ordinary. For the expense to be considered ordinary, the expense must be commonly incurred in the taxpayer’s business. In addition, the expense must be customary or usual in the taxpayer’s business. Karl’s payment to the clients does not meet either of these requirements.

b. During the year, Susan’s mother is hospitalized for 3 weeks and incurs $36,000 of medical costs. Her mother’s insurance company pays only $22,000 of the medical expenses. Because her mother could pay only $4,000 of the remaining medical costs, Susan pays the remaining $10,000. Susan’s mother does not qualify as her dependent.

To be deductible, an expenditure must be for the taxpayer’s benefit or be the payment of a taxpayer’s obligation. A payment of another person’s obligation does not result in a tax deduction for either person. An exception to this is for medical expenses paid on behalf of a taxpayer’s dependent. However, since Susan’s mother does not qualify as a dependent this exception does not apply. Therefore, Susan cannot deduct the $10,000 she pays for her mother’s medical costs.

Instructor’s Note: As discussed in Chapter 8, if Susan’s mother did not qualify as a dependent because she fails to meet either the gross income or the joint return test (i.e., she meets the support test), then her mother is considered a dependent for purposes of deducting the $10,000 in medical expenses.
51. As a hobby, Jane creates and sells oil paintings. During the current year, her sales total $8,000. How is the tax treatment of her hobby different from the treatment of a trade or business, if

a. Her business expenses total $5,600?

Because Jane’s activity is a hobby, her sales must be reported as gross income and her expenses are allowed as a miscellaneous itemized deduction. Her deductions will be subject to the general limitation (2% of adjusted gross income) on miscellaneous itemized deductions. Jane should report:

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>$ 8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous Itemized Deductions</td>
<td>$ 5,600</td>
</tr>
</tbody>
</table>

Instructor’s Note: The solution in part a, b and c assumes that the expenses related to Jane’s hobby are not for interest and taxes that could otherwise be deducted as itemized deductions.

b. Her business expenses total $10,000?

Because Jane’s expenses exceed her gross income, her hobby expenses are limited to the $8,000 of income from the hobby. She should report:

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>$ 8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Miscellaneous Itemized Deductions</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>Nondeductible Personal Expense</td>
<td>$ 2,000</td>
</tr>
</tbody>
</table>


c. Assume that Jane itemizes her deductions and that she has an adjusted gross income of $42,000 before considering the effect of the hobby. Discuss the actual amount of the deduction Jane would receive in parts a and b.

Hobby expenses are deductible as miscellaneous itemized deductions, which are subject to a 2% of adjusted gross income limitation. The $8,000 of hobby income will increase her adjusted gross income to $50,000. Assuming that Jane has no other miscellaneous itemized deductions, the allowable hobby deductions must be reduced by $1,000 ($50,000 x 2%). This will leave her with an actual deduction of $4,600 ($5,600 - $1,000) in part a and $7,000 ($8,000 - $1,000) in part b.

<table>
<thead>
<tr>
<th>Gross Income</th>
<th>Part a</th>
<th>Part b</th>
</tr>
</thead>
<tbody>
<tr>
<td>8,000</td>
<td>$ 8,000</td>
<td>$</td>
</tr>
<tr>
<td>Hobby expenses</td>
<td>$ 5,600</td>
<td>$ 8,000</td>
</tr>
</tbody>
</table>
54. Mel and Helen own a beachfront home in Myrtle Beach, S.C. During the year, they rented the house for 5 weeks (35 days) at $800 per week and used the house for personal purposes 65 days. The costs of maintaining the house for the year were:

- Mortgage interest: $5,500
- Real property taxes: 4,500
- Insurance: 650
- Utilities: 1,000
- Repairs and maintenance: 480
- Depreciation (unallocated): 3,500

a. What is the proper tax treatment of this information on their tax return?

Because the personal use of the home exceeds 14 days, the home is a vacation home and deductions are limited to rental income. Deductions must be taken in a specified order: interest and taxes first, expenses other than depreciation second, and depreciation last. The expenses are allocated based on actual days the vacation home is rented to total days used for either rental or personal use. Thus, 35% \[\left(\frac{35}{100} \times 35 + 65\right)\] of the expenses are related to the rental activity.

Rent ($800 x 5 weeks): $4,000
Interest and taxes ($10,000 x 35%): (3,500)
Balance of income: $500
Operating expenses ($2,130 x 35% = $746): (500)*
Balance of income: $-500*
Depreciation ($3,500 x 35% = $1,225): -500**
Income from rental: $-500

* Limited to the balance of income, remaining amount is carried forward.
** Allocated amount is carried forward.

The adjusted gross income from rents would be reported as zero. The remaining $246 ($746 - $500) of expenses and the allocated depreciation of $1,225 that is not allowed because of the income limit can be carried forward and deducted in a year when income is large enough to absorb the deductions.

The interest and taxes $6,500 ($10,000 - $3,500) allocated to the personal use of the dwelling are allowed as an itemized deduction. Thus, if Mel and Helen itemize their deductions, the rental will decrease their taxable income by the $6,500 of itemized deductions.

b. What is the proper tax treatment if Helen and Mel rented the house for only 2 weeks (14 days)?
If the dwelling is rented 14 days or less, the $1,600 of rental income ($800 x 2 weeks) is not reported and expenses related to rental use are not deducted. The interest and taxes ($10,000) are allowed as an itemized deduction.

Chapter 6

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

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

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

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

<table>
<thead>
<tr>
<th>Miles</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home to office</td>
</tr>
<tr>
<td>Office to home</td>
</tr>
<tr>
<td>Home to local clients to home</td>
</tr>
<tr>
<td>Home to out of town clients to home</td>
</tr>
</tbody>
</table>

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

   Pablo's deductible business expense is $6,441 (13,280 miles x 48.5 cents). The standard mileage rate for 2007 is 48.5 cents per mile. In computing his deduction, Pablo may deduct the mileage from home to his clients and back home (10,630), and the miles (2,650) to and from his out of town clients. The miles from home to his office and back are considered commuting and cannot be used to determined his allowable business expense.

35. Mario owns his own business and drives his car 15,000 miles a year for business and 7,500 miles a year for commuting and personal use. He wants to claim the largest tax deduction possible for business use of his car. His total auto expenses for 2007 are as follows:

   - Gas, oil, and maintenance: $6,700
   - Insurance: $500
   - Interest on car loan: $480
   - Depreciation: $2,960
   - License: $180
a. What is Mario's 2007 deduction using the standard mileage rate?

Under the standard mileage rate method Mario can deduct $7,565. He can deduct 48.5 cents for each mile he uses his car for business. Parking and tolls are added separately because these expenses are all business related. Interest expense is not considered a cost incurred to operate or maintain the vehicle and is deductible under either method if the taxpayer is self-employed. Because Mario is self-employed, he can deduct the business portion (66.7%) of the interest expense.

**Standard Mileage Deduction:**
15,000 miles × 48.5 cents $ 7,275
Add: Parking and tolls 290
Total deduction $ 7,565

Interest expense ($480 × 66.7%) 320

b. What is Mario's 2007 deduction using the actual cost method?

Under the actual cost method, Mario can deduct $7,187. Based on the business use of his car he can deduct 66.7% (15,000 mi. ÷ 22,500 mi.) of the cost (other than parking, tolls) of operating the vehicle. Parking and tolls are added separately because these expenses are all business related. Interest expense is not considered a cost incurred to operate or maintain the vehicle and is deductible under either method if the taxpayer is self-employed. Because Mario is self-employed, he can deduct the business portion (66.7%) of the interest expense.

**Actual Cost Deduction:**
Total actual expenses (other than parking, tolls and interest) $10,340
Business usage percentage (15,000 mi. ÷ 22,500 mi.) × 66.7% $ 6,897
Allocated actual cost $ 6,897
Add: parking and tolls 290
Total deduction $ 7,187

Interest expense ($480 × 66.7%) 320

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

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

a. If she spends 4 days on business and 3 days sightseeing, what amount may she deduct as travel expense?
Based on time spent on business and personal activities, the trip was primarily for business. As a result, transportation is fully deductible. Other expenses are deducted as follows:

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airfare</td>
<td>$475</td>
</tr>
<tr>
<td>Hotel ($175 x 4)</td>
<td>700</td>
</tr>
<tr>
<td>Meals ($40 x 4 x 50%)</td>
<td>80</td>
</tr>
<tr>
<td>Incidentals ($25 x 4)</td>
<td>100</td>
</tr>
<tr>
<td>Total deduction</td>
<td>$1,355</td>
</tr>
</tbody>
</table>

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

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

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

<table>
<thead>
<tr>
<th>Expense</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Airfare</td>
<td>$0</td>
</tr>
<tr>
<td>Hotel ($175 x 2)</td>
<td>350</td>
</tr>
<tr>
<td>Meals ($40 x 2 x 50%)</td>
<td>40</td>
</tr>
<tr>
<td>Incidentals ($25 x 2)</td>
<td>50</td>
</tr>
<tr>
<td>Total deduction</td>
<td>$440</td>
</tr>
</tbody>
</table>

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

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

Jan may deduct the full $1,600 cost of the Christmas party. Employee recreational expenses, such as a Christmas party are not subject to the 50% limitation on meals and entertainment. Unless the $50 gift certificate is considered a de minimus fringe, the gift certificate will be compensation to the employee. It cannot be considered an employee award because it is given to all employees and is not based on length of service or safety. Whether it is a de minimus fringe or compensation Jan can deduct $1,000 ($50 x 20 employees) and his total deduction is $2,600 ($1,600 entertainment + $1,000 business gift). Instructor's Note: The employees would like the gift certificate to be treated as a de minimus fringe benefit since it would not be subject to tax.
a. Assume that the party is attended by 10 employees and 10 of the Mews major suppliers. At the party each receives a holiday cheese basket that costs $30. How much can Jan deduct?

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

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

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

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

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

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

In 2007 a taxpayer with adjusted gross income less than $65,000 ($130,000 for a married couple filing a joint return) is allowed to deduct for adjusted gross income a maximum of $4,000 of qualified higher education expenses. If a taxpayer’s adjusted gross income exceeds $65,000 ($130,000 for a married couple filing a joint return) but does not exceed $80,000 ($160,000 for a married couple filing a joint return), the taxpayer can deduct a maximum of $2,000 of qualified higher education expenses. If the taxpayer’s adjusted gross income exceeds these amounts $80,000 ($160,000 for a married taxpayer filing jointly), then the taxpayer is not allowed a deduction for adjusted gross income. Therefore, in 2007, some taxpayers can deduct qualified higher education expenses even if the expenses are not incurred as a
requirement for the taxpayer to continue employment or do not maintain or improve the skills required in their job. Qualified higher education expenses are limited to tuition and fees paid to attend the institution.

Note: If the expense is considered an itemized deduction due to AGI limitations, then the expense would only qualify as an itemized deduction if the course is not part of a program of study that qualifies Forest for a new trade or business.

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

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

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

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

a. Related to Howard's business?

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total debt</td>
<td>$8,000</td>
</tr>
<tr>
<td>Amount of bad debt previously deducted</td>
<td>(4,800)</td>
</tr>
<tr>
<td>Amount received in payment of bad debt</td>
<td>(2,700)</td>
</tr>
<tr>
<td>Current year bad debt</td>
<td>$500</td>
</tr>
</tbody>
</table>

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

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

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

<table>
<thead>
<tr>
<th>Total debt</th>
<th>$ 8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount of bad debt previously deducted</td>
<td>(4,800)</td>
</tr>
<tr>
<td>Amount received in payment of bad debt</td>
<td>(3,300)</td>
</tr>
<tr>
<td>Current year gross income</td>
<td>($100)</td>
</tr>
</tbody>
</table>

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

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

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

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

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

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

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

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

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

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

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

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

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

a. Angela earns $18,000, and their adjusted gross income is $91,000.

Both taxpayers have earned income. Because neither Carlos nor Angela is covered by a pension plan, they each can contribute and deduct up to $4,000. Thus, they may contribute and deduct a total of $8,000 for adjusted gross income.

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

Even though Angela does not have earned income, they are allowed to contribute and deduct a maximum of $8,000 for adjusted gross income because their total earned income exceeds $8,000. However, they must establish separate IRA accounts and the total amount contributed to each account cannot exceed $4,000.

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

Angela is allowed to contribute $4,000 to her IRA. Because Carlos is at least 50 years of age, he is allowed to contribute $5,000 to an IRA account. Because both are covered by an employer-sponsored pension plan, the amount of the IRA deduction is reduced when their adjusted gross income reaches $83,000. The deduction is fully phased out when adjusted gross income exceeds $103,000. The maximum contribution amount is not affected by this limitation, only the deductible amount of the contribution. Angela’s $4,000 deduction must be reduced by 40% \([($91,000 - $83,000) ÷ $20,000]\) and leaves
her with an allowable deduction for adjusted gross income of $2,400 \[($4,000 - ($4,000 \times 40\%))\]. Carlos’s $5,000 deduction is also reduced by 40\% \[(($91,000 - $83,000) \div $20,000)\] and leaves him with an allowable deduction for adjusted gross income of $3,000 \[($5,000 - ($5,000 \times 40\%))\]. Their total deduction for AGI is $5,400 ($2,400 + $3,000).

Chapter 7

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

<table>
<thead>
<tr>
<th>Active Income</th>
<th>Portfolio Income</th>
<th>Passive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$43,000</td>
<td>$29,000</td>
<td>$(27,000)</td>
</tr>
</tbody>
</table>

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. Howard owns an apartment complex that meets federal guidelines qualifying it as low-income housing.

Investments in low-income housing are generally not considered to be passive activities. Howard's investment is not a passive activity.

e. 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.

f. Assume the same facts as in part e, 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.

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:

<table>
<thead>
<tr>
<th>Amount of Loss:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
</tr>
</tbody>
</table>
Point of sale terminal (basis) 3,700
Stereo equipment (basis) 4,200
Broken glass door 540

Total loss $8,820
Less: Insurance (5,000)
Deductible theft loss $3,820

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.

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. 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 | $(75,000) |

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.

a. 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 | $(13,000) |
| Capital loss deduction | 3,000 |
| Loss carryforward | $(10,000) |

b. 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

$ (6,000)

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

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. 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.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Elliot</th>
<th>Nancy</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 4,000</td>
<td>$ 7,000</td>
<td></td>
</tr>
<tr>
<td>Less: Basis</td>
<td>(6,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Realized gain (Loss on sale)</td>
<td>$(2,000)</td>
<td>$ 3,000</td>
</tr>
<tr>
<td>Deductible loss</td>
<td>-0-</td>
<td>(2,000)</td>
</tr>
<tr>
<td>Recognized gain</td>
<td></td>
<td>$ 1,000</td>
</tr>
</tbody>
</table>

a. 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.

<table>
<thead>
<tr>
<th>Selling price</th>
<th>Elliot</th>
<th>Nancy</th>
</tr>
</thead>
<tbody>
<tr>
<td>$ 4,000</td>
<td>$ 5,000</td>
<td></td>
</tr>
<tr>
<td>Less: Basis</td>
<td>(6,000)</td>
<td>(4,000)</td>
</tr>
<tr>
<td>Realized gain (Loss on sale)</td>
<td>$(2,000)</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Deductible loss</td>
<td>-0-</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Recognized gain</td>
<td></td>
<td>$ -0-</td>
</tr>
</tbody>
</table>

b. 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.

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

<table>
<thead>
<tr>
<th>Case A</th>
<th>FMV Before</th>
<th>FMV After</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$130,000</td>
<td>$85,000</td>
</tr>
<tr>
<td>Automobile</td>
<td>12,000</td>
<td>3,000</td>
</tr>
</tbody>
</table>
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.

70. Jamila is involved in an auto accident during the current year that totally destroyed 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:

<table>
<thead>
<tr>
<th></th>
<th>Business</th>
<th>25%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial basis</td>
<td>$21,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>Less: depreciation</td>
<td>(4,000)</td>
<td>-0-</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$17,000</td>
<td>$7,000</td>
</tr>
</tbody>
</table>

Amount of loss:

Business portion - adjusted basis: $17,000

Personal portion - lesser of:

Adjusted basis: $7,000

OR

Decline in value: $(16,000 \times 0.25) = $4,000

Less: Insurance proceeds: $9,000

Net loss: $(8,000) $(1,000)

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 \times 10%)].

Chapter 10

28. During 2007, Belk Corporation purchases $70,000-worth of equipment for use in its business. Belk's current taxable income before considering the Section 179 deduction is $26,000.


The taxable income limitation applies to this scenario. That is, the maximum Section 179 deduction is limited to the taxpayer's taxable income calculated before the Section 179 deduction. Although Belk purchased $70,000 of qualifying Section 179 property, it can deduct only $26,000, the amount of taxable income from the business. The $44,000 ($70,000 - $26,000) excess may be carried forward to 2008. Note: If Belk elects to expense only $26,000, no carryforward results. However, its basis in the property is $44,000 instead of zero.
b. Belk's 2008 business taxable income—before a Section 179 deduction—is $50,000. What is Belk's maximum Section 179 deduction in 2008? Explain.

Assuming that Belk elected to expense $70,000 in 2007, under the taxable income limitation, a maximum of $44,000 can be deducted. Since Belk's carryforward of $44,000 is less than its taxable income, the full amount of the carryforward can be deducted in 2008. If Belk only expenses $26,000 in 2007, then there is no deduction in 2008 but its depreciable basis in the property is $44,000 instead of zero.

32. In each of the following situations, determine the depreciable basis of each asset.

a. Melissa purchases furniture and fixtures from the estate of the owner of a business for $45,000. She plans to use these assets in her business.

The entire $45,000 of the furniture and fixtures cost is depreciable. Note: The furniture and fixtures are eligible for the Section 179 election. If the election to expense is made, the depreciable basis in the asset is zero ($45,000 - $45,000). The property would not have been eligible for additional first year depreciation since the property is used property.

b. Quang purchases a computer from his employer for $4,000. He plans to use it in his consulting practice, which he conducts in the evenings and on weekends. The fair market value of the computer is $7,000.

The basis in the computer is $7,000. The bargain purchase rules apply. The computer's basis is the amount paid, $4,000, plus the $3,000 ($7,000 FMV - $4,000 selling price) Quang recognizes from the bargain purchase. Note: The computer is eligible for the Section 179 election. If the election to expense is made, the depreciable basis in the asset is zero.

c. Jenny begins using her personal automobile as a delivery vehicle for her florist business. She purchased the car for $19,000 in 2005 and it is currently worth $13,000.

The depreciable basis is $13,000. The split-basis rule for property converted from personal to business use are applicable because the fair market value is less than the adjusted basis on the conversion date ($13,000 < $19,000). The fair market value becomes the basis of the business use asset for depreciation purposes. Note: The automobile is eligible for the Section 179 election. If the election to expense is made, the maximum amount, assuming 100% business use, which can be expensed for a vehicle is limited to depreciation maximum in 2006 and 2007 of $3,060.
d. Fletcher inherits a collectible car from his grandfather's estate. The grandfather's basis in the car was $5,000. The executor of the estate does not make any special elections and values the care at its appraised fair market value of $25,000. Fletcher plans to use the car in his business.

The depreciable basis of the car becomes the fair market value of $25,000. The property is inherited, and the rules for inherited property are used. Note: The automobile is eligible for the Section 179 election. If the election to expense is made, the maximum amount, assuming 100% business use, which can be expensed for a vehicle is limited to a maximum of $3,060.

37. The United Express Company begins business in August 2006 by purchasing the assets listed in the table below. Calculate the maximum MACRS depreciation on the assets.

<table>
<thead>
<tr>
<th>Asset</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trucks</td>
<td>$98,000</td>
</tr>
<tr>
<td>Tractor units</td>
<td>55,000</td>
</tr>
<tr>
<td>Office equipment</td>
<td>84,000</td>
</tr>
</tbody>
</table>

To claim the maximum MACRS depreciation, the company should elect to expense the maximum $112,000 allowed under Section 179 for 2007. In addition, the company should elect to expense the assets with the longest useful life. United's cost recovery deduction is $144,333.

Office Equipment (7-year life):
- Election to expense $84,000

Trucks (5-year life):
- Election to expense ($112,000 - $84,000) $28,000
- Depreciable basis ($98,000 - $28,000) $70,000
- First-year depreciation (Table A10-2) x 20% $14,000

Tractor Units (3-year life):
- Depreciable basis $55,000
- First-year depreciation (Table A10-2) x 33.33% $18,333

Total 2007 cost recovery $144,333

39. The Browser Company purchases a mainframe computer in August 2007 for $100,000. The company does not elect to expense the asset but wants to claim the maximum depreciation. In May 2010, the company sells the computer. Calculate the adjusted basis of the computer at the date of sale.

The adjusted basis of the computer is $23,040, calculated by computing depreciation for each year using Table A10-2 (useful life of 5 years). Under the mid-year convention, only half a year's depreciation is allowed in the year of sale.
52. Guadalupe purchases an office building to use in her business at a cost of $520,000. She properly allocates $20,000 of the cost to the land and $500,000 to the building. Assuming that Guadalupe would like to deduct the maximum depreciation on the building, what is her first-year depreciation on the building if she purchases the building on

a. June 30, 1992?

The property is classified as 31.5-year nonresidential real estate because it is placed into service after 1986 and before May 13, 1994. The depreciation rate for month 6 and year one of Table A10-8, is 1.720%. Multiplying this rate by the depreciable basis of $500,000 results in the first-year depreciation on the building of $8,600.

\[
\text{First-year depreciation} = \frac{500,000 \text{ basis of the building} \times 1.720\%}{100} = 8,600
\]

b. June 30, 1994?

Because the property is placed into service after May 12, 1994, the classification is 39-year nonresidential real estate. The depreciation rate for month 6 and year 1 of Table A10-9 is 1.391%. Accordingly, the first-year depreciation on the building is $6,955:

\[
\text{First-year depreciation} = \frac{500,000 \text{ basis of the building} \times 1.391\%}{100} = 6,955
\]

56. On June 1, 2006, Kirsten buys an automobile for $42,000. Her mileage log for the year reveals the following: 20,000 miles for business purposes; 7,000 miles for personal reasons; and 3,000 miles commuting to and from work. What is Kirsten’s maximum cost-recovery deduction for 2006?

Kristen’s depreciation deduction on the automobile is limited in two ways. First, only the business portion of the basis may be depreciated. Therefore, only $28,000 \([42,000 \times (20,000 \div 30,000)\)] of the basis is depreciable. The 3,000 miles she travels commuting are considered personal miles. Because the automobile is used more than 50% for business use, regular MACRS depreciation may be used, but the deduction each year is limited. Using regular MACRS (Table A10-2 for 5-year property), Kristen’s first-year depreciation deduction is limited to $1,973.

\[
\begin{align*}
\text{Initial basis} & \quad 42,000 \\
\text{Business use percentage} & \quad \times 66.67\% \\
\text{Business depreciable basis} & \quad 28,000
\end{align*}
\]
MACRS % (Table A10-2) \( \times \) 20% 
Total MACRS depreciation \( \$ \text{ } 5,600 \)

Annual depreciation limit for auto (Table A10-10) \( \$ \text{ } 2,960 \)
Kristen’s business use percentage \( \times \) 66.67%
Kristen’s maximum depreciation on auto in 2006 \( \text{ } \$ \text{ } 1,973 \)

Instructor's Note: After the book went to press the 2007 maximum deduction limitations were released. The 2007 maximum deduction remained at $3,060. However, the limit for minivans and SUV’s is $3,260.

Chapter 11

58. In 2007, Sondra Corporation recognizes $18,000 in Section 1231 gains and $10,000 in Section 1231 losses. In 2002, Sondra reported $12,000 in Section 1231 losses and no Section 1231 gains. No other Section 1231 gains or losses were recognized by Sondra during the 2002-2006 period. What is the tax treatment of Sondra’s 2007 Section 1231 gains and losses?

The Section 1231 netting results in 2007 ordinary income of $8,000 due to the $12,000 of nonrecaptured net Section 1231 losses from 2002.

**Step 1 Netting:**
No casualty gains or losses. Go to Step 2.

**Step 2 Netting:**
\[
\begin{align*}
\text{Section 1231 gains} & \quad \text{\( \$ \text{ } 18,000 \)} \\
\text{Section 1231 losses} & \quad \text{\( (10,000) \)} \\
\text{Net Section 1231 gain} & \quad \text{\( \$ \text{ } 8,000 \)}
\end{align*}
\]

**Step 3 Netting:**
The net Section 1231 gain from 2007 is recaptured as ordinary income due to the 2002 net Section 1231 loss of $12,000. The remaining 2002 Section 1231 loss of $4,000 ($12,000 - $8,000) will never be recaptured because 2002 is not part of the preceding 5-year period for the tax year 2008.

60. Rhinelander Corporation has the following net Section 1231 gains and losses for 2002 through 2006:

<table>
<thead>
<tr>
<th>Year</th>
<th>Gain/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$ 8,000</td>
</tr>
<tr>
<td>2003</td>
<td>( (6,000) )</td>
</tr>
<tr>
<td>2004</td>
<td>( (13,000) )</td>
</tr>
<tr>
<td>2005</td>
<td>11,000</td>
</tr>
<tr>
<td>2006</td>
<td>15,000</td>
</tr>
</tbody>
</table>

a. What is the proper characterization of the net Section 1231 gains and losses for 2002 - 2006 for Rhinelander Corporation?
The Section 1231 gain in 2002 is a long-term capital gain (there are no prior year losses to apply the lookback rule). The losses in 2003 and 2004 are deducted in those years as ordinary losses.

In 2005, the $11,000 Section 1231 gain is ordinary income under the lookback rule. The $6,000 ordinary loss deduction in 2003 and $5,000 of the ordinary loss deduction in 2004 is recaptured as ordinary income. This leaves a net Section 1231 loss of $8,000 ($13,000 - $5,000) remaining from 2004 which is still subject to recapture.

In 2006, $8,000 of the $15,000 gain is ordinary income under the lookback rule. Because the 2004 ordinary loss is fully recaptured, the remaining $7,000 gain is a long-term capital gain.

b. Assume that in 2007, Rhinelander has a net Section 1231 gain of $9,000. What is the proper characterization of the $9,000 gain?

The $9,000 gain is a long-term capital gain. All ordinary loss deductions in the previous 5 years have been recaptured.

62. Avalon Inc., buys equipment costing $150,000 in 2004 and sells it in 2007. Avalon deducts $94,000 in depreciation on the equipment before the sale. What is the character of the gain or loss on the sale of the equipment if the selling price is

Equipment is Section 1231 property. It is also subject to recapture under Section 1245. Any gain on the sale must be recaptured as ordinary income to the extent of the $94,000 in depreciation that has been deducted on the equipment. The adjusted basis of the equipment is $56,000 ($150,000 - $94,000) at the date of sale.

a. $90,000?

Avalon realizes a $34,000 gain on the sale. The entire gain is recaptured as ordinary income:

\[
\begin{align*}
\text{Amount realized} & \quad \$90,000 \\
\text{Adjusted basis} (\$150,000 - \$94,000) & \quad (56,000) \\
\text{Gain on sale} & \quad 34,000 \\
\text{Section 1245 - Ordinary income} & \quad 34,000 \\
\text{Section 1231 gain} & \quad 0 \\
\end{align*}
\]

b. $155,000?

Avalon realizes a $99,000 gain on the sale. The $94,000 of depreciation is recaptured as ordinary income, leaving a $5,000 Section 1231 gain:

\[
\begin{align*}
\text{Amount realized} & \quad \$155,000 \\
\text{Adjusted basis} (\$150,000 - \$94,000) & \quad (56,000) \\
\text{Gain on sale} & \quad 99,000 \\
\text{Section 1245 - Ordinary income} & \quad 94,000 \\
\end{align*}
\]
<table>
<thead>
<tr>
<th>Section 1231 gain</th>
<th>$ 5,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>c. $40,000?</td>
<td></td>
</tr>
</tbody>
</table>

Avalon realizes a $16,000 loss on the sale. The $16,000 loss is a Section 1231 loss — depreciation recapture applies only to gains:

| Amount realized   | $ 40,000 |
| Adjusted basis ($150,000 - $94,000) | (56,000) |
| Loss on sale      | $(16,000) |