

Chapter I8

Losses and Bad Debts

Discussion Questions

I8-1 The closed transaction doctrine states that a realized loss must be evidenced by a completed transaction or identifiable event. This doctrine exists to prevent taxpayers from recognizing a loss as a result of fluctuating prices prior to the disposition of the property. This is, of course, different from the economic concept for realized loss. p. I8-2.

I8-2 The amount of the deductible loss when property is disposed depends on (1) the type of property, (2) the manner in which the property is used, (3) the basis in the property, (4) the amount realized upon disposition, and (5) the way the property is disposed of. pp. I8-2 and I8-3.

I8-3 In order to deduct a loss on worthless securities, the taxpayer must first establish when the security actually became worthless. The deduction is only available in the year the security becomes worthless. Once this is determined, Sec. 165(g) provides that the loss incurred is treated as a loss from the sale of a capital asset on the last day of the taxable year. Because of the limitations imposed on the deductibility of capital losses, this may severely restrict the current tax benefit to the taxpayer. Under certain circumstances, if a domestic corporation holds worthless securities in an affiliated corporation, the loss to the domestic corporation is treated as having arisen from a sale of a noncapital asset. This makes the loss an ordinary loss. In order for this exception to apply, two requirements must be met: (1) the domestic corporation must own at least 80% of the voting power of all classes of the affiliated corporation's stock, and (2) more than 90% of the affiliated corporation's gross receipts for all its taxable years must be from nonpassive income. pp. I8-3 and I8-4.

I8-4 If the worthless securities consist of securities of an affiliated corporation held by a domestic corporation, the loss is treated as an ordinary loss rather than a capital loss. For this exception to apply, the domestic corporation must own at least 80% of the voting power of all classes of the affiliated corporation's stock and more than 90% of the affiliated corporation's gross receipts for all its taxable years must be from nonpassive income. (i.e., sources other than dividends, interest royalties, rents, annuities, and gains from the sale or exchange of stock and securities.) pp. I8-3 and I8-4.

I8-5 To have a capital loss, (1) there must be a sale or exchange and (2) the transaction must involve a capital asset. For example, the loss from the destruction of a capital asset is an ordinary loss and not a capital loss because there has not been a sale or exchange. Furthermore, a loss on the sale of inventory is ordinary because inventory is not a capital asset. pp. I8-4 and I8-5.

I8-6 In order for stock to be considered Sec. 1244 stock, the following requirements must be met:

1. The stock must be owned by an individual or a partnership.
2. The stock must have been originally issued to the individual or to a partnership in which the individual is a partner.
3. The stock must be stock in a domestic corporation.
4. The stock must have been issued for cash or property other than stock or securities.
5. The corporation may not have derived over 50% of its gross receipts from passive income sources (i.e., sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stock and securities) during the immediately preceding five taxable years.
6. At the time the stock is issued, the amount of money and property contributed to both capital and paid-in surplus may not exceed \$1 million. p. I8-5.

I8-7 Losses on the sale or worthlessness of Sec. 1244 stock are deductible as ordinary losses up to a maximum of \$50,000 per taxable year (\$100,000 for married taxpayers filing a joint return). Any excess loss for the year is a capital loss. Gains on the sale of Sec. 1244 stock are capital gains. p. I8-5.

I8-8 A loss on the sale of investment property between an individual and a controlled partnership or corporation (the individual owns more than 50% of the partnership or corporation) is disallowed. The individual and the controlled entity are deemed to be related parties, and therefore, the loss is disallowed. If the loss were not disallowed, the individual would be able to create a tax loss and still retain economic control of the property. The same reasoning applies to the wash sale provisions where losses on the sale of stock or securities are disallowed if substantially identical stock or securities are purchased within 30 days before or 30 days after the sale. A loss realized on property transferred to a controlled corporation in exchange for stock or securities of the corporation is deferred. Furthermore, losses realized on exchanges of like-kind property are also deferred. p. I8-6.

I8-9 a. A passive activity is any trade or business in which the taxpayer does not materially participate. A passive activity also includes any rental activity that is not a trade or business.
b. Individuals, estates, trusts, closely held C corporations, personal service corporations, and certain publicly traded partnerships, are subject to the passive loss limitation rules. The purpose of the passive loss rules is to prevent certain taxpayers from offsetting their portfolio and active income with losses generated in passive activities. pp. I8-9 through I8-11.

I8-10 a. A closely-held C corporation is a C corporation where more than 50% of the stock is owned by five or fewer individuals at any time during the last half of the corporation's taxable year.
b. A closely-held C corporation may offset its passive losses against its active business income but not its portfolio income. Individuals and personal service corporations may not offset either their active or portfolio income with passive losses. p. I8-12.

I8-11 A taxpayer's material participation in an activity is determined separately for each activity. Furthermore, suspended losses are deductible only upon the complete disposition of the passive activity. Also, the rental losses allowed under the special real estate exceptions must not be mixed in

with losses from other types of passive activities. For these reasons, it is critical to identify exactly what constitutes an activity. p. I8-11.

I8-12 a. Under the Regulations, different business operations may constitute one or more activities, depending upon all the pertinent facts and circumstances. The facts that are given more weight in this determination include:

- Similarities and differences in the types of business
- The extent of common control
- The extent of common ownership
- The geographical location, and
- Any interdependencies between the operations (i.e., the extent to which they purchase or sell goods between themselves, have the same customers, are accounted for with a single set of books, etc.).

Generally, taxpayers have a good deal of flexibility in identifying how operations are to be combined into activities based on these facts. However, once this determination is made, taxpayers must be consistent from year to year.

b. In general, a business operation and a rental operation cannot be combined into the same activity for purposes of the passive activity loss rules. However, if the business operation and the rental operation are situated at the same location and the business operation is insubstantial in comparison to the rental operation, or visa versa, the two may be combined into one activity. The Regulations do not define what constitutes insubstantial. p. I8-10.

I8-13 a. No. The rental unit qualifies as a real property trade or business with respect to Laura. This is the case because she meets the following requirements:

1. The rental unit is Laura's only business and she spends over 750 hours during the year managing and caring for the rental unit.
2. Because Laura is the sole manager of the unit, she meets the material participation requirements.
3. More than 50% of Laura's personal services for the year is spent in this real estate business.

b. Yes. The lab is a passive activity with respect to Kami. A business activity is passive with respect to a taxpayer if the taxpayer does not materially participate in the activity. In order to materially participate, the taxpayer must meet one of several tests:

1. The individual participates in the activity for more than 500 hours during the year.
2. The individual's participation in the activity for the year constitutes substantially all of the participation in the activity by all individuals, including individuals who do not own any interest in the activity.
3. The individual participates in the activity for more than 100 hours during the year, and that participation is more than any other individual's participation for the year.
4. Under the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.

The only test Kami possibly could meet is the fourth one. However, her participation probably is not continuous and substantial. Since Kami does not meet any of these tests, she does not materially participate, and the activity is passive.

c. There is a possibility that under the Regulations, the three operations (the lab, the medical supply company, and the medical services partnership) could be combined into one activity. If this is the case, Kami will have materially participated (over 500 hours) in the activity and the activity would not be passive with respect to her. If the three operations are treated as separate activities, she probably does not materially participate in any of them, based upon the tests mentioned in part b above. However, since she has participated over 100 hours in each of them, they are considered "significant participation" activities. Taxpayers can aggregate participation in these significant participation activities for purposes of determining material participation. This aggregation causes her participation to exceed the 500 hour test. Thus, none of the activities is passive with respect to Kami. pp. I8-13 and I8-14.

I8-14 A taxpayer materially participates in an activity if he or she meets one of the following tests.

1. The individual participates in the activity for more than 500 hours during the year.
2. The individual's participation in the activity for the year constitutes substantially all of the participation in the activity by all individuals, including individuals who do not own any interest in the activity.
3. The individual participates in the activity for more than 100 hours during the year, and that participation is not less than any other individual's participation for the year (including participation by individuals who do not own any interest in the activity).
4. The individual participates in "significant participation activities" for an aggregate of more than 500 hours during the year. A significant participation activity is one in which the taxpayer participates for more than 100 hours during the year but which does not meet the material participation test alone. An individual who spends over 100 hours each in several separate significant participation activities may aggregate the time spent in these activities in order to meet the 500 hour test.
5. The individual has materially participated in the activity in any five years during the immediately preceding ten taxable years. These five years need not be consecutive.
6. The individual materially participated in the activity for any three years preceding the year in question, and the activity is a personal service activity.
7. Taking into account all the relevant facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.

Active participation, on the other hand, is a less strict test. The taxpayer need not be involved on a regular or continuous basis. However, he or she still must be involved in management decisions or in the arranging for others to provide services. The active participation test is used in the case of rental real estate activities. pp. I8-11 and I8-12.

I8-15 a. Individual taxpayers who have actively participated in the rental of real estate may deduct losses from that passive activity of up to \$25,000 against their active and portfolio income. However,

this deduction is reduced by 50% of the taxpayer's AGI in excess of \$100,000. Thus, the requirements are (1) the taxpayer must be an individual, (2) the taxpayer must have actively participated in the management of the rental activity, (3) the activity generating the loss must be a real estate rental activity, and (4) the taxpayer must not have AGI in excess of \$150,000 (the loss is phased out at a 50% rate for AGI between \$100,000 and \$150,000).

b. To be excepted from the passive activity loss rules, an individual's rental activity must qualify as a real property trade or business. For individuals, more than one-half of the personal services performed in trades or businesses by the taxpayer during the year must be performed in real property trades or businesses in which the taxpayer materially participates. Additionally, the taxpayer must perform more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates. pp. I8-14 and I8-15.

I8-16 Suspended losses under the passive loss rules are not lost forever. The suspended losses are carried over indefinitely and are treated as losses allowable to the activity in the following taxable years. Any suspended losses that still exist when the property or activity is disposed of may be deducted in the year of disposal. pp. I8-7 and I8-8.

I8-17 A deductible casualty loss is a loss that (1) occurs in an identifiable event and (2) is sudden, unexpected, or unusual. For a loss to be a deductible casualty loss, the taxpayer must be able to determine or identify the event that caused or resulted in the loss. For example, the taxpayer will have a deductible casualty loss if he can show that a storm caused damage to his property. A sudden event is one that is swift, not gradual or progressive. An unexpected event is one that is ordinarily unanticipated and which the taxpayer did not intend. An unusual event is one that is not a day-to-day occurrence and that is not typical of the activity in which the taxpayer is engaged. For example, damage to property as a result of years of stormy weather will not qualify as a casualty loss. pp. I8-16 through I8-18.

I8-18 A casualty gain is realized when the insurance proceeds received exceed the property's adjusted basis. For personal-use property, all the casualty gains and losses realized during the year are netted together. If the losses exceed the gains, the excess is reduced by 10% of the taxpayer's AGI and the remainder is deductible as a from AGI deduction. However, if the casualty gains exceed the casualty losses for the year, the gain is treated as a long-term capital gain. p. I8-20.

I8-19 Under Sec. 165(h)(4)(E), no casualty loss deduction may be taken on personal-use property to the extent it is covered by insurance if a timely insurance claim is not filed. Since the insurance deductible is not covered by the insurance policy, Bill may make an argument that the deductible is eligible to be taken as a casualty loss. However, the deductible probably is not large enough to exceed the 10% of AGI limitation. Thus, Bill probably won't be able to deduct any of the casualty loss. p. I8-21.

I8-20 The casualty loss deduction on personal-use property is limited to the lesser of (1) basis, or (2) the reduction in fair market value. This is the case whether the property is totally or partially destroyed.

The casualty loss deduction on partially destroyed business or investment property is limited to the lesser of (1) basis, or (2) reduction in FMV. The amount of the casualty loss deduction for the total destruction of business or investment property is equal to the basis of the property. Casualty losses on personal-use property are reduced by \$100 per casualty and then are further reduced by 10% of AGI. Casualty losses on business property are not subject to these limits and floors. Casualty losses on business property and investment property that produce rents or royalties are for AGI deductions. Casualty losses on other types of investment property are not subject to the 2% of AGI reduction or the 3% overall limit on itemized deductions. pp. I8-19 and I8-20.

I8-21 Theft losses are deducted in the tax year in which the theft is discovered. Also, if the insurance reimbursement is less than anticipated, the unrecovered portion can be deducted in the subsequent year. Another situation in which the casualty loss can be deducted other than in the year in which the loss occurred is if the taxpayer sustains a loss in a location that the president of the United States declares a disaster area. In this case, an election can be made to deduct the loss in the year just prior to the year in which the loss occurred. Casualty losses on personal use property are reduced by \$100 per casualty and then are further reduced by 10% of AGI. Casualty losses on business and investment property are not subject to these limits and floors. pp. I8-21 and I8-22.

I8-22 Casualty losses are first reported on Form 4684 (Casualties and Thefts). Casualty losses on personal-use property then flow to Schedule A where they are reported as itemized deductions. Casualty losses on business property flow from Schedule 4684 to Form 4797 and then to line 14 on Form 1040. p. I8-20.

I8-23 The floor on personal-use casualty losses is \$100 per casualty. The \$100 floor is not imposed upon each individual item if more than one item is destroyed in a single casualty. The \$100 floor reduces the amount of the casualty loss before the loss is netted against the casualty gains. p. I8-19.

I8-24 Steve must treat the loan as a nonbusiness bad debt (assuming that the loan is bonafide and is not a gift) even though John used the money in a business. Thus, the \$15,000 bad debt is treated as a short-term capital loss. If Steve has no capital gains for the year, he may take a capital loss deduction of \$3,000, carrying the remainder over to subsequent years. On the other hand, if Steve were in the business of lending money, then Steve could treat the loan as a business bad debt and deduct the entire loss as an ordinary loss in the current year. p. I8-25.

I8-25 Dana may not take any deduction with respect to this bad debt. Although it is a bad debt that had been incurred in her business, she has no basis in the debt because she is a cash basis taxpayer and did not report the receivable in income. pp. I8-25 and I8-26.

I8-26 A third party guarantor of a loan who is required to repay the debt is entitled to a bad debt deduction under certain circumstances. To obtain the bad debt deduction, the guarantee must not be considered a gift. p. I8-24.

18-27 A nonbusiness bad debt is defined as any debt other than: (a) a debt created or acquired in connection with a trade or business of the taxpayer; or (b) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. Nonbusiness bad debts are deductible as short-term capital losses. p. 18-25.

18-28 a. In deducting a loss on a deposit in a qualified financial institution a taxpayer may elect to treat the loss as a personal casualty loss in the year in which the loss can be reasonably estimated. The taxpayer may also elect to treat the loss as incurred in a transaction entered into for profit (but not a trade or business). The amount treated as such under this election is limited to \$20,000 per institution per year and is subject to the 2% AGI reduction. If no election is made, the loss is a nonbusiness bad debt in the year of worthlessness or partial recovery, whichever comes last.

b. If a taxpayer would benefit more in the current year from a loss deduction, the election to treat the loss as a personal casualty loss may be desirable. This is true in the case of partial worthlessness since no deduction is available for partially worthless nonbusiness debts. Also, since the election effectively converts a short-term capital loss into an ordinary loss, the taxpayer may use the election to minimize taxable income. This may be so because of the \$3,000 limit on the deductibility of capital losses after netting against any capital gains. However, by treating the loss as a personal casualty loss, the total loss is reduced by 10% of the taxpayer's AGI. The second election might be made if the loss is less than the \$20,000 limit and the taxpayer has other miscellaneous itemized deductions in excess of 2% of AGI. Otherwise, under this election a taxpayer may lose more tax benefits than if the election had not been made. p. 18-27.

18-29 When a taxpayer collects a bad debt that was previously written off, the recovery must be reported in income to the extent the taxpayer received a tax benefit from the write-off in the prior year. p. 18-27.

18-30 An NOL deduction is a deduction taken against the income of a year either preceding or following the year in which the NOL is incurred. The NOL arises when the taxpayer's business deductions (and personal casualty loss deductions) exceed the taxpayer's business and other income. Generally the deduction is first carried back to the two immediately prior years (in chronological order) and then to the 20 succeeding years (again in chronological order). The statute allows the deduction in an attempt to equalize the federal income tax burden imposed on taxpayers with business income that fluctuates from year to year, with the tax burden imposed on taxpayers with business income that is relatively stable from year to year. p. 18-28.

18-31 An individual taxpayer's net tax loss is adjusted by the following items in computing a NOL: (1) any NOL deduction; (2) any capital loss deduction; (3) deductions for personal exemptions; and (4) the excess of nonbusiness deductions over nonbusiness income. These adjustments are made either in an attempt to measure only the economic loss that occurs when business expenses exceed business income or to prevent a possible double benefit from the deduction. For example, the deduction for personal exemptions does not reflect a true economic loss. Since capital losses have their own carryover provisions, allowing them to create or increase a net operating loss would create a double benefit for the same loss. pp. 18-28 and 18-29.

I8-32 a. Generally an NOL is carried back 2 years and carried forward for 20 years. For NOL's arising in a farming business, in a qualified small business attributable to a Presidentially declared disaster, or in a casualty or theft sustained by an individual, the carryback period is extended to 3 years.

b. A taxpayer may elect not to carry back the NOL and to carry the loss forward. If the taxpayer anticipates higher income in the subsequent years, thus pushing the taxpayer into higher marginal tax rates, it may be advantageous to forego the carryback and carry the NOL forward in order to reduce taxable income. p. I8-31.

I8-33 Yes. For purposes of the NOL computation, casualty losses on personal-use assets are treated as business losses. Therefore, casualty losses on personal-use assets are excluded in making the adjustment for excess nonbusiness deductions over nonbusiness income and can create or increase an NOL. p. I8-28.

I8-34 An NOL deduction is a deduction for AGI. Thus, the prior year's AGI is reduced. Because of this reduction, other from AGI deductions taken in the year of the carry back may also have to be reduced since the amount of these deductions is dependent upon the taxpayer's AGI. For example, the taxpayer will have to recompute the medical expense deductions (these are deductible only if they exceed 7.5% of AGI), personal casualty losses (these are deductible only if they exceed 10% of AGI), and miscellaneous itemized deductions (these are deductible only if they exceed 2% of AGI). Although the deduction for charitable contributions is limited to a certain percentage of the taxpayer's AGI (the general limit is 50% of AGI), the charitable contribution does not need to be recomputed. pp. I8-28 and I8-29.

Issue Identification Questions

I8-35 The primary tax issues are (1) whether the stock is worthless, (2) when it became worthless, and (3) the character of the loss. Since stock held for investment is a capital asset, the loss, if allowed, should receive capital loss treatment. Under Sec. 165(g), a security that becomes worthless during the taxable year is treated as having been sold on the last day of the taxable year. In this case, Sheryl must determine exactly when the stock became worthless. Although bankruptcy is one indication of worthlessness, the stock may, in fact, have become worthless in a prior year. Thus, if Sheryl can demonstrate that the stock became worthless in the prior year, she can report a short-term capital loss in that year. If it is determined that the stock became worthless in the current year, Sheryl will report a long-term capital loss in the current year. p. I8-3.

I8-36 The primary tax issue is the character of the \$75,000 loss (i.e., ordinary or capital). The Gold stock should qualify as Sec. 1244 stock since (1) Cora (an individual) received the stock in exchange for cash or property that she contributed directly to the corporation, (2) at the time the stock was issued, Gold, Inc.'s capital was less than \$1,000,000 and (3) for the last five years, more than 50% of its aggregate gross receipts were from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities. Thus, of the total \$75,000 loss, Cora will

report \$50,000 as ordinary loss and \$25,000 as a long-term capital loss. The capital loss, of course, is first netted against any capital gains. The current year deduction for any excess capital loss is limited to \$3,000. p. I8-5.

I8-37 The primary tax issue is whether the accident qualifies as a personal-use casualty loss. If qualified, Evan must apply the \$100 and 10% of AGI limits to the personal-use casualty loss. A corollary issue is whether the failure to file an insurance claim will invalidate the deduction. Although automobile accidents in general have been held to qualify for casualty loss treatment, an exception is made if the accident is caused by the taxpayer's willful negligence or willful act. Even if this accident qualifies as a casualty, no deduction is available if the taxpayer doesn't file an insurance claim to the extent that the loss is covered by insurance. Thus, if Evan does not file a claim, the casualty loss should be limited to the deductible amount of the insurance. However, Evan should also consider that the loss is subject to the \$100 and the 10% of AGI limits. p. I8-19.

I8-38 The principal tax issue is the character of the bad debt (i.e., business or nonbusiness). Since a nonbusiness bad debt is treated as a short-term capital loss, whereas a business bad debt is an ordinary loss, the determination of what kind of loan Dan has made to Beta, Inc. becomes critical. In order to show that this loss is a business bad debt, Dan must demonstrate that his motivation in making the loan was to protect his job rather than to protect his stock ownership. In cases where the loan was made to protect the taxpayer's job, the courts have held that the loss is a business bad debt. On the other hand, if the loan was made to protect the taxpayer's investment, the loss is a nonbusiness bad debt. pp. I8-25 through I8-27.

Problems

I8-39 a.	Amount realized	\$ 10,000
	Minus: Basis	(80,000)
	Loss recognized	<u>\$(70,000)</u>

Since the stock qualifies as Sec. 1244 stock, the first \$50,000 of the loss is ordinary loss. The remainder is a long-term capital loss.

b. A \$70,000 ordinary loss is recognized. The yearly limit on the ordinary loss deduction for Sec. 1244 stock by a taxpayer who is married and filing a joint return is \$100,000.

c. To qualify the loss as ordinary under Sec. 1244, the stock must have been originally issued to the individual or to a partnership in which the individual is a partner. Therefore, under this revised fact pattern the sale of the stock would result in a \$70,000 long-term capital loss. Sec. 1244 does not apply.

d. By selling a portion of the stock in one year and the remaining stock in another year the taxpayer could convert all \$70,000 to an ordinary loss. The \$50,000 maximum is per taxable year. This would avoid the annual \$3,000 limit on the deductibility of capital losses. p. I8-5.

I8-40 a. Since Madison is insolvent, all of its assets will go towards its debts, leaving nothing for Barry. Barry will not recover any of his basis in the stock. Thus Barry suffers a \$300,000 long-term capital loss.

b. The stock is qualified Sec. 1244 stock. Since Barry is married and files a joint return, the loss will consist of \$100,000 ordinary loss and \$200,000 capital loss.

c. Since (1) at least 80% of the voting power of Madison's stock is owned by Barry Corporation, and (2) more than 90% of Madison's gross receipts is from its mining operations, the \$300,000 loss is all ordinary. See Sec. 165(g).

d. Same as part (c). pp. I8-5 and I8-6.

I8-41

Short-Term		Long-Term	
Item	Gain or Loss	Item	Gain or Loss
Delta	(\$ 8,000)	Acme	\$ 6,000
Echo	2,000	Beta	(3,000)
Nonbusiness bad debt	(4,000)	Canary	25,000
		Foxtrot	(5,000)
Net STCL	<u>(\$10,000)</u>	Net LTCG	<u>\$23,000</u>

Thus, Joe has a \$13,000 (\$23,000 - \$10,000) net long-term capital gain. pp. I8-4 and I8-5.

I8-42 Activity X	\$ 20,000
Activity Y	(35,000)
Activity Z	<u>(15,000)</u>
Net passive loss carryover	<u>(\$30,000)</u>

$$\text{Activity Y: } \$30,000 \times \frac{\$35,000}{\$50,000} = \$21,000$$

$$\text{Activity Z: } \$30,000 \times \frac{\$20,000}{\$50,000} = \$12,000$$

These losses carry over to subsequent years and may be used to offset any income from passive activities. Additionally, any remaining loss attributable to an activity that is disposed of may be deducted in the year of disposal. This is why it is important to allocate the portion of the total net passive loss carryover to each individual activity. pp. I8-7 through I8-9.

I8-43 When a passive activity is disposed of the suspended losses of that activity may offset other than passive income.

Loss from Z for the year	(\$20,000)	
Suspended losses from Z	(40,000)	
Gain from the sale of Z	<u>30,000</u>	(\$30,000)
Income from X	\$25,000	<u>15,000</u>
Loss from Y	(10,000)	
Loss deductible against active business and portfolio income		<u>(\$15,000)</u>

pp. I8-7 through I8-9.

I8-44 a.	Salary Income	\$130,000
	Minus: maximum rental real estate loss	\$ 25,000
	Reduced by phase out:	
	(\$130,000 - \$100,000) x 0.50	<u>(15,000)</u>
	Deductible amount (not to exceed actual loss of \$50,000)	<u>(10,000)</u>
	AGI	<u>\$120,000</u>

b. \$40,000 - \$10,000 = \$30,000 suspended loss attributed to:

$$\text{Activity Y: } \$30,000 \times \frac{\$30,000}{\$50,000} = \$18,000$$

$$\text{Activity Z: } \$30,000 \times \frac{\$20,000}{\$50,000} = \$12,000$$

pp. I8-14 and I8-15.

I8-45 Although in 2000, activity A is not a passive activity, it is treated as a former passive activity. Thus, the suspended losses of \$24,000 for activity A are first offset against the current income of activity A, leaving a remainder of \$14,000 (\$24,000 - \$10,000). This \$14,000 excess is still treated as a passive activity suspended loss and is only deductible against passive income. Passive activity B has income of \$20,000 in 2000. This income is first reduced by the \$8,000 suspended loss from activity B, leaving a remainder of \$12,000 of passive income. Thus, \$12,000 of the remaining suspended loss from activity A is used to offset this income. \$2,000 of the suspended loss from activity A is carried over to 2001. pp. I8-7 through I8-9.

I8-46 Since Juan is in the 31% tax bracket, the credits equal \$9,677 (\$3,000 ÷ 0.31) in deduction equivalents. This amount, plus the \$6,000 in losses equals a total of \$15,677 in deductions and deduction equivalents. Since this amount is less than the \$25,000 real estate exemption amount,

normally Juan would be able to use all of the loss deductions and credits against his active business income. However, because Juan has AGI in excess of \$100,000, the real estate exemption is reduced to \$12,500 $\{ \$25,000 - [(\$125,000 - \$100,000) \times 0.50] \}$, and the maximum that Juan may use is \$12,500 in deductions and deduction equivalents. The deductions are taken first. Thus, Juan deducts the total of the \$6,000 losses, leaving \$6,500 in deduction equivalents available to be used in the current year. This translates to \$2,015 $(\$6,500 \times 0.31)$ in credits. Therefore, the suspended losses and credits carried over to next year are:

$$\text{Losses: } \$6,000 - \$6,000 = \$0$$

$$\text{Credits: } \$3,000 - \$2,015 = \$985$$

pp. I8-14 through I8-15.

I8-47 The first step is to compute AGI. This step consists of a two-step process. First the limit on the deduction of the \$25,000 real estate exemption for passive losses is computed as follows:

Salary	\$117,000
Dividend income	14,000
Net long-term capital gains	<u>5,000</u>
Tentative AGI (for passive loss)	<u>\$136,000</u>

Thus, the passive loss exemption for real estate is reduced to \$7,000 $[\$25,000 - (\$136,000 - \$100,000) \times 0.50]$. Since this amount is less than the \$20,000 loss from the passive real estate activity, Julie is limited to a current deduction of \$7,000. The remaining \$13,000 is a suspended loss attributable to the real estate activity. This deduction is a for AGI deduction since it is incurred in generating rental income. AGI now is \$129,000 $(\$136,000 - \$7,000)$.

AGI	\$129,000
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The next step is to compute the deductions from AGI.

Property taxes on residence				\$ 5,000	
Interest:					
Qualified residence			\$12,000		
Investment Interest (limited to investment inc.)		\$21,000			
Dividends	\$14,000				
LTCG	22,000				
STCL	<u>(17,000)</u>	19,000	<u>19,000</u>	31,000	
Charitable Contributions:				8,000	
Miscellaneous Itemized:					
Tax return preparation fees		\$ 2,500			
Unreimbursed employee expenses		<u>2,000</u>	4,500		
Minus: 2% AGI (0.02 x \$129,000)			<u>(2,580)</u>	<u>1,920</u>	
Total Itemized deductions (No reduction Reduction .03 (\$129,000-128,950))				\$45,920	(\$45,918)
				<u>(2)</u>	
Personal Exemption: (No reduction because AGI is less than threshold)					(\$ 2,800)
Taxable Income					<u>\$80,282</u>

Note: Since Juan used the net LTCG to compute net investment income, he may not use the maximum 20% rate for LTCG when computing his tax. pp. I8-14 through I8-15.

I8-48

	Business		Personal Use
	Asset A	Asset B	Asset C
Amount of loss	\$18,000	\$8,000	\$9,000
Minus: Insurance recovery	<u>(12,000)</u>	<u>(7,000)</u>	<u>(1,000)</u>
Net loss	<u>\$ 6,000</u>	<u>\$1,000</u>	<u>\$8,000</u>

Since A is a business asset and is totally destroyed, Antonio is allowed to deduct the property's basis of \$18,000 even though the decline in value was only \$15,000. The total loss on business assets A and B is \$7,000 and deductible as an ordinary loss in the taxpayer's business. The loss of \$10,000 income is not a casualty loss. The \$8,000 loss on asset C is reduced by \$100, and then is further reduced by 10% of AGI in computing the amount of itemized deductions. Thus the personal casualty loss that is deductible from AGI is \$1,600, computed as follows:

Loss	\$8,000
\$100 floor	(100)
10% of AGI [0.10 x (\$40,000 - \$7,000)]	<u>(3,300)</u>
	<u>\$4,600</u>

Note that the AGI is reduced by the \$7,000 casualty loss on the business property. pp. I8-18 through I8-22.

I8-49 a. The \$3,000 cash is a business asset and is deductible without reduction or netting with other items. The ring and necklace are both personal-use items. Thus, the loss on the ring must be netted against the gain on the necklace.

Necklace (\$6,000 insurance - \$2,300 basis)	\$3,700
Minus: Ring (\$3,000 - 100)	<u>(2,900)</u>
Net gain	<u>\$ 800</u>

Since Kelly has a \$800 net personal casualty gain, the \$3,700 gain on the necklace is reported as a long-term capital gain and the \$2,900 loss on the ring is reported as a short-term capital loss. Since a net gain was reported, there is no reduction for the 10% of AGI floor.

b. \$0. Theft losses are deductible in the year of discovery. pp. I8-19 through I18-21.

I8-50 a. The loss and reimbursement should not be reported since Jerry has a reasonable expectation of full recovery.

b. A \$2,700 loss should be reported in 2000.	
Amount of loss (\$15,000 - \$1,500)	\$13,500
Minus: \$100 floor	<u>(100)</u>
	\$13,400
Minus: 10% of AGI	<u>(4,200)</u>
Deductible loss	<u>\$ 9,200</u>

c. Assuming the loss was deducted on the 200 return, an amended return is not filed. The 2001 return should include in income an amount equal to the tax benefit the taxpayer received for the previous deduction. pp. I8-19 and I8-20.

I8-51 Automobile - lesser of basis or reduction for FMV decline	\$18,000
Minus: Insurance reimbursement	(14,000)
Loss before limitation	\$ 4,000
Minus: \$100 floor	(100)
Net loss	<u>\$ 3,900</u>
Theft of antiques	\$ 8,000
Minus: \$100 floor	(100)
Net loss	<u>\$ 7,900</u>
Antiques	\$ 7,900
Auto	<u>3,900</u>
Total loss	\$11,800
Minus: 10% of AGI	(6,000)
Deductible loss	<u>\$ 5,800</u>

p. I8-21.

I8-52 Since the losses on the business property exceed the gains, they are all ordinary losses for AGI. Thus Pam's AGI is \$65,000 (\$80,000 - \$15,000). Pam's net loss on the personal-use property is \$11,000. This is first reduced by \$100 because the losses were all suffered in the same casualty. The net \$10,900 is then reduced by 10% of AGI for a deductible personal casualty loss of \$4,400 (\$10,900 - [0.10 x \$65,000])

Asset	Loss	Insurance	Net
Business 1	(\$15,000)	\$ 4,000	(\$11,000)
Business 2	(8,000)	3,000	(5,000)
Business 3	(18,000)	19,000	<u>1,000</u>
Net loss on business property			<u>(\$15,000)</u>
Personal 1	(\$12,000)	\$ 2,000	(\$10,000)
Personal 2	(3,000)	-0-	(3,000)
Personal 3	(6,000)	8,000	<u>2,000</u>
Net loss on personal use property			(\$11,000)
Less: nondeductible floor			<u>(100)</u>
Net loss on nonbusiness property			<u>(\$10,900)</u>

Business income	\$80,000	
Business casualty	<u>(15,000)</u>	
AGI		\$65,000
Residential interest	\$ 6,000	
Property taxes	2,000	
Charitable Contributions	4,000	
Casualty losses [\$10,900 - (0.10 x \$65,000)]	<u>4,400</u>	(16,400)
Personal exemption		<u>(2,800)</u>
Taxable income		<u>\$45,800</u>

pp. I8-20 through I8-22.

I8-53 The bad debt deduction is \$0. Since Elaine is a cash-method taxpayer, she does not have any basis in the receivable. pp. I8-24 and I8-25.

I8-54 2000: \$0. No bad debt deduction is allowed since no bona-fide debtor-creditor relationship exists.

2001: \$0. No bad debt deduction is allowed since a bona-fide debtor-creditor relationship does not exist. p. I8-23.

I8-55 2000: \$0.

2001: \$4,500. Since the debt is a nonbusiness bad debt, no deduction is available in 2000 because the debt is not totally worthless. pp. I8-25 through I8-26.

I8-56 a.

Revenue from landscaping	\$ 60,000	
Minus: Expenses of landscaping	<u>(141,000)</u>	(\$81,000)
Plus: Julie's salary		45,000
Dividend income		1,200
LTCG on stock		<u>3,000</u>
AGI		(\$31,800)
Minus: Greater of itemized or standard deduction		
Interest on residence	\$ 6,000	
State and local taxes	<u>7,500</u>	
Total	\$ 13,500	
	or	
Standard deduction	<u>7,350</u>	(13,500)
Minus: Personal exemptions (\$2,800 x 2)		<u>(5,600)</u>
Taxable income (loss)		<u>(\$50,900)</u>

b. NOL Computation:

Taxable income (loss)			(\$50,900)
Plus: Nonbusiness deductions:			
Itemized deductions		\$13,500	
Minus: Nonbusiness income:			
Dividends	\$1,200		
LTCG	<u>3,000</u>	<u>(4,200)</u>	
Plus: Excess of nonbusiness deductions over nonbusiness income			9,300
Plus: Personal exemptions (\$2,800 x 2)			<u>5,600</u>
Net operating loss			<u>(\$36,000)</u>

pp. I8-28 through I8-31.

I8-57 a.

Revenue from landscaping	\$ 60,000	
Minus: Landscaping expenses	<u>(141,000)</u>	(\$81,000)
Add: Julie's salary		45,000
Dividends income		1,200
LTCG on stock		<u>3,000</u>
AGI		(\$31,800)
Minus: Greater of itemized or standard deduction		
Interest on residence	\$ 6,000	
State and local taxes	7,500	
Casualty loss	<u>4,500</u>	
	\$ 18,000	
	or	
Standard deduction	<u>7,350</u>	(18,000)
Minus: Personal exemptions (\$2,800 x 2)		<u>(5,600)</u>
Taxable income		<u>(\$55,400)</u>

b. NOL Computation:

Taxable income (loss)			(\$55,400)
Plus: Nonbusiness deductions:			
Itemized deductions	\$18,000		
Minus: Casualty loss	<u>(4,500)</u>	13,500	
Minus: Nonbusiness Income:			
Dividends	\$ 1,200		
LTCG	<u>3,000</u>	<u>(4,200)</u>	
Plus: Excess of nonbusiness deductions over nonbusiness income			9,300
Plus: Personal exemptions (\$2,800 x 2)			<u>5,600</u>
Net operating loss			<u>(\$40,500)</u>

pp. I8-28 through I8-31.

I8-58 a.

Revenue from landscaping	\$ 60,000	
Minus: Landscaping expenses	<u>(141,000)</u>	(\$81,000)
Add: Julie's salary		45,000
Dividends income		1,200
LTCG on stock		<u>3,000</u>
AGI		(\$31,800)
Minus: Greater of itemized or standard deduction		
Interest on residence	\$ 6,000	
Casualty loss	<u>7,500</u>	
Total	\$ 13,500	
	or	
Standard deduction	<u>7,350</u>	(13,500)
Minus: Personal exemptions (\$2,800 x 2)		<u>(5,600)</u>
Taxable income (loss)		<u>(\$50,900)</u>

b. NOL Computation:

Taxable income (loss)			(\$50,900)
Plus: Nonbusiness deductions:			
Itemized deductions	\$13,500		
Reduced by: Casualty loss	<u>(7,500)</u>	\$6,000	
Minus: Nonbusiness Income:			
Dividends	\$ 1,200		
LTCG	<u>3,000</u>	<u>(4,200)</u>	
Plus: Excess of nonbusiness deductions over nonbusiness income			
Plus: Personal exemptions (\$2,800 x 2)			1,800
Net operating loss			<u>5,600</u>
			<u>(\$43,500)</u>

pp. I8-28 through I8-31.

I8-59 a.

Revenue from Business	\$ 65,000	
Minus: Expenses from Business	<u>(105,000)</u>	(\$40,000)
Plus: Salary		12,000
Dividends income		1,000
Interest income		500
LTCL on stock		<u>(3,000)</u>
AGI		(\$29,500)
Minus: Greater of itemized deductions (\$3,000) or standard deduction (\$4,400)		(4,400)
Personal Exemption		<u>(2,800)</u>
Taxable income		<u>(\$36,700)</u>

b.

Taxable Income		(\$36,700)
Nonbusiness deductions	\$ 4,400	
Nonbusiness income	<u>(1,500)</u>	
Plus: Excess from nonbusiness deductions over nonbusiness income		2,900
Plus: Capital loss deduction		3,000
Personal exemption		<u>2,800</u>
Net operating loss		<u>(\$28,000)</u>

pp. I8-28 through I8-31.

Tax Form/Return Preparation Problems

I8-60 (See Instructor's Guide)

I8-61 (See Instructor's Guide)

Case Study Problems

I8-62 (See Instructor's Guide)

I8-63 (See Instructor's Guide)

Tax Research Problem

I8-64 (see Instructor's Guide)