

**CHAPTER 5**  
**Lecture Guide Examples**

**Example A** Joanne owns a cabin in a ski resort. During the year, Joanne and her family used the cabin a total of 25 days. She rented out the cabin for 50 days and received a total of \$10,000. Also, she incurred the following expenses:

Expense	Amount
Property taxes	\$1,500
Mortgage interest	3,000
Utilities	2,000
Insurance	1,500
Security and snow removal	2,500

In addition, she would have been entitled to \$12,000 depreciation if the property had been used only as rental property. Determine the proper treatment for Joanne's income and expenses related to the cabin.

**SOLUTION**

Item	Total Amount	Allocation Ratio	Rental Amount
Rental income	\$10,000		\$10,000
Property taxes (1)	1,500	50/365	-205
Mortgage interest (2)	3,000	50/365	-411
Subtotal			\$ 9,384
Utilities	2,000	50/75	-1,333
Insurance	1,500	50/75	-1,000
Security and snow removal	2,500	50/75	-1,666
Subtotal			\$ 5,385
Depreciation (3)	12,000	50/75	-5,385
Net income from property			\$ 0

- (1) The remaining \$1,295 can be taken as an itemized deduction.
- (2) The remaining \$2,589 can be taken as an itemized deduction.
- (3) If she had had sufficient income, Joanne could have deducted \$8,000 in depreciation. Instead, she will carry forward \$2,615 of depreciation.

**Example B** Paula is an artist who conducts business out of her home and qualifies for a home office deduction. Her gross earnings were \$11,500 and she incurred the following expenses: art supplies, \$1,100; advertising, \$575; home office expenses (already prorated): \$1,000 interest, \$400 taxes, \$800 depreciation, and \$100 utilities. (1) What expenses would she be permitted to deduct? (2) Would the expenses be deductible for AGI or from AGI? (3) Suppose her gross earnings were only \$2,400. What would her deduction be?

**SOLUTION**

- (1) First, compute the limit on the potential home office deduction:

Gross income	\$11,500	
less otherwise allowable expenses:		
interest	-1,000	
taxes	- 400	[total expenses = \$3,075]
less business expenses:		
art supplies	-1,100	
advertising	- 575	
Maximum h.o. expenses	\$ 8,425	

**CHAPTER 5**  
**Lecture Guide Examples**

Her home office expenses totaled:

depreciation	\$ 800
utilities	<u>100</u>
total	\$ 900

So, her total business deductions = \$3,075 + 900 = \$3,975.

- (2) Because she is self-employed, her deductions are above-the-line, and will appear on Schedule C.
- (3) If her gross income were only \$2,400, her maximum home office deduction would be \$0 (\$2,400 - 3,075). She can deduct the \$3,075 of expenses, but she may not deduct the \$900 of depreciation and utilities. However, she can carry over the \$900 to future years.

**Example C** When are the following items considered paid?

- a. Surgery was performed on September 1, and the bill was paid with proceeds of a loan taken out on September 30. The loan was repaid on January 5.  
Payment was made on September 30.
- b. The same facts as a., except the taxpayer signed a note payable to the doctor. The note was paid on January 5.  
Payment was made on January 5.
- c. Hotel bill for business travel charged on a VISA card on December 4. The VISA balance was paid on February 18.  
Payment was made on December 4.
- d. Mortgage payment called into the bank's "pay-by-phone" system on December 26. The payment appeared on the statement on January 2.  
Payment was made on January 2.
- e. Check for the Red Cross written on December 12, mailed on December 31, and cashed by the Red Cross on January 5.  
Payment was made on December 31.

**Example D** When are the following items deductible for (1) a cash method taxpayer, (2) an accrual method taxpayer? (**Problems 67 and 68, adapted**)

- a. Patrick rents office space for \$1,000 a month. He was short of cash and paid his November, December, and January rent at the end of January.  
(1) \$3,000 in January.  
(2) \$2,000 in first year and \$1,000 in second year.
- b. Samantha borrowed \$100,000 on a 12%, 1-year note on October 1. To get the loan, she had to prepay the \$12,000 of interest.  
(1) \$3,000 ( $\$100,000 \times 12\% \times 3/12$ ). Cannot deduct prepaid interest.  
(2) \$3,000.
- c. For the current year, Parr Corporation estimates its warranty expense to be 2% of sales. Sales for the year were \$2,400,000 and actual warranty costs were \$40,000.  
(1) \$40,000.  
(2) \$40,000 (cannot deduct estimated expense of \$48,000).
- d. On August 1 of the current, Parr Corporation paid \$3,600 for a 1-year fire insurance policy for the period from August 1 through July 31 of next year.  
(1) \$3,600 (OK under the 1-year rule).  
(2) \$1,500 ( $\$300/\text{month} \times 5 \text{ months}$ ).

**CHAPTER 6**  
**Lecture Guide Examples**

**Example A** Are the following taxpayers permitted to deduct travel expenses?

- (1) Harold is employed as a long-haul driver. He stores his belongings at his parents' home and makes periodic visits there. The rest of the time he is on the road and sleeps in motels or in his truck.
- (2) Harriet is employed as a short-distance hauler. Her husband and children live in Minneapolis. Harriet primarily makes one-day trips in the area surrounding Minneapolis, but sometimes makes longer trips and is gone for several days.

**SOLUTION**

- (1) Harold has no tax home, so he cannot deduct traveling expenses.
- (2) Harriet's tax home is in Minneapolis, so she can deduct traveling expenses when she goes out of town overnight.

**Example B** Rita traveled from New Orleans to New York on a combined business and pleasure trip and incurred expenses of: plane fare, \$600; meals, \$50 per day; lodging, \$150 per day. Assume that she spent: (1) five days conducting business and three days sightseeing, or (2) three days conducting business and five days sightseeing. Determine her deductible expenses.

**SOLUTION**

- (1) This appears to be a trip primarily taken for business, so she can deduct the following expenses *from* AGI.

Plane fare	\$ 600
Meals ( $\$50 \times 5 \times 50\%$ )	125
Lodging ( $\$150 \times 5$ )	<u>750</u>
Total	\$1,475

- (2) This trip appears to be mainly personal, so only the meals and lodging for the 3 business days are deductible (*from* AGI).

Meals ( $\$50 \times 3 \times 50\%$ )	\$ 75
Lodging ( $\$150 \times 3$ )	<u>450</u>
Total	\$ 525

**Example C** For each case below, determine the number of miles for which the taxpayer is permitted a deduction for transportation expenses.

- (1) George is employed by Xerox Corp. and drives 22 miles each way to work. One day George drove to a customer's office over the lunch hour. It was a 14-mile round-trip.
- (2) Teresa works full-time for B Corp. and works part-time for C Corp. Each day she leaves home at 7:30 a.m. and drives 30 miles to the B Corp. plant, where she works until 5:00 p.m. She eats dinner nearby and drives 20 miles to C Corp., where she works from 7:00 to 11:00 p.m. The drive home from C Corp. is 40 miles.
- (3) Jane drove 10 miles to her office and then drove home after making a business stop at a customer's office. The total distance she drove that day was 26 miles.
- (4) Victor is a manager in an accounting firm in downtown Little Rock, and he commutes to work. Though he normally works downtown, Victor sometimes works at a client's office. On one such occasion he drove directly from his home to the client's office, a round-trip distance of 40 miles. He did not go into the office, which is a 30-mile round-trip.

**SOLUTION**

- (1) 14 miles.
- (2) 20 miles.
- (3) 6 miles (the amount in addition to commuting).
- (4) 40 miles.

## CHAPTER 6 Lecture Guide Examples

**Example D** Is the taxpayer entitled to an educational expense deduction in each of the following situations?

- (1) A practicing tax accountant enrolls in an advanced tax course.
- (2) An auditing partner enrolls in a tax course in order to meet Ohio's continuing professional education (CPE) requirements for CPAs.
- (3) A Capital student interning with a Big Five CPA firm finishes her B.A. degree in accounting.
- (4) A CPA pursues a doctoral degree in accounting at Ohio State.

### **SOLUTION**

- (1) yes
- (2) yes
- (3) no
- (4) no

**Example E** Determine the amount of income and/or expense that must be reported. For expenses, determine whether the deduction is for or from AGI.

Larry incurred the following business expenses: \$800 for travel away from home (including \$100 of meals), \$500 for local transportation, and \$300 for entertainment. Assume he made a proper accounting and that he received the following reimbursement from his employer: (1) \$1,600; (2) \$2,000; or (3) \$1,200.

**SOLUTION** His expenses totaled \$1,600.

- (1) Because it's an accountable plan, he doesn't have to report either the income or the expenses.
- (2) He will report the \$2,000 in income and deduct \$1,400 as a miscellaneous itemized deduction [ $\$700 + (50\% \times \$100) + \$500 + (50\% \times \$300)$ ]. It is not an accountable plan if he kept the excess reimbursement.
- (3) He must determine which expenses the reimbursement applies to. Since  $1200/1600 = 3/4$ , then 75% of each expense was reimbursed, and 25% was not. The unreimbursed amounts were:

travel, non-meals	$[700 \times 25\%]$	=	\$175
travel, meals	$[100 \times 25\%]$	=	$25 \times 50\% = \$12$
transportation	$[500 \times 25\%]$	=	125
entertainment	$[300 \times 25\%]$	=	$75 \times 50\% = 38$

So, Larry will deduct \$350 ( $\$175 + 12 + 125 + 38$ ) as a miscellaneous itemized deduction. The reimbursement is in his income and he reports \$1,200 of expenses for AGI.

**Example F** Harry is an accrual method taxpayer who uses the specific write-off method for bad debts. In 2001, Harry made an unsecured business loan to Mary of \$3,000 in cash, which she agreed to repay in 2002. The loan became delinquent in 2002. Determine the amount which Harry would be permitted to deduct and the year of deduction if: (1) As soon as the loan became delinquent Harry discovered that Mary had skipped town, or (2) In 2002 Harry learned that Mary had filed for personal bankruptcy, and that unsecured creditors were expected to receive \$.20 on the dollar. However, in 2003, the settlement was made and Harry received only \$450. (3) Would your answers have differed if Harry used the cash method? (4) Would your answers have differed if the debt were non-business?

### **SOLUTION**

- (1) Harry would be able to deduct \$3,000 in 2002 as an ordinary deduction.

**CHAPTER 6**  
**Lecture Guide Examples**

- (2) In 2002, he could charge off \$.80 on the dollar, or \$2,400.  
In 2003, he could charge off an additional \$150.
- (3) The answers would be the same if he used the cash method because he actually loaned cash.
- (4) Same answer for (1), except it's a STCL. In (2), if it were a nonbusiness debt, he could not deduct any loss until the final settlement, so \$2,550 would be a STCL in 2003.

**Example G** During the year, Gwen had self-employment income of \$50,000. Compute the amount of self-employment tax and the self-employment tax deduction. How would your answer change if Gwen's self-employment income were \$95,000?

**SOLUTION**

If her self-employment income were \$50,000, her SE tax would be:

$$\$50,000 \times 92.35\% \times 15.3\% = \$7,065$$

$$\text{Deduction for AGI} = \$3,532$$

If her self-employment income were \$9,000, her SE tax would be:

	Social Security	Medicare
1. Net earnings from self-employment	\$ 95,000	\$ 95,000
2. Net SE earnings $\times$ 92.35%	\$ 87,732	\$ 87,732
3. Maximum tax base	\$ 84,900	
4. Smaller of step 2. or step 3.	\$ 84,900	\$ 87,732
5. Amount in step 4. times tax rate	12.4%	2.9%
Tax on each component	\$ 10,528	\$ 2,544
6. Total SE tax	\$ 13,072	
7. Deduction of 1/2 SE tax <i>for</i> AGI	\$ 5,863	

**Example H** Trevor is employed by Borden and he participates in their retirement plan. He also maintains an IRA, to which he contributed \$3,000 during the year. Determine his allowable IRA deduction assuming his AGI was (1) \$26,000; (2); \$47,000 or (3) \$38,000.

**SOLUTION**

(1) \$3,000.

(2) \$ 0.

(3) \$2,200.  $(\$3,000 - [(\$38,000 - 34,000) \times .20])$ , or  $(\$3,000 - 800)$

**Example I** Marge and Homer are both covered by employer-sponsored retirement plans, and their AGI is \$140,000. They each contributed \$3,000 to a Roth IRA, and each IRA earned \$300. (1) What is the tax treatment of the contributions and the interest? (2) How would your answer change if their AGI is \$154,000?

**SOLUTION**

(1) The \$3,000 contributions are not deductible, but the \$300 earnings are not taxable, either now or when they are withdrawn later (assuming Marge and Homer meet the criteria).

**CHAPTER 6**  
**Lecture Guide Examples**

- (2) Because their AGI exceeds \$150,000, Marge and Homer must reduce their Roth IRA contributions. The reduction is 40% ( $\$4,000 \text{ excess} \div \$10,000 \text{ phaseout range}$ ), so the maximum contribution for each is \$1,800.

**Example J** David and Joy Kim took out a \$30,000, 9% loan to help finance their son and daughter's education. Their son is a sophomore enrolled in 12 credit hours and their daughter is a senior taking 18 credit hours. The loan proceeds were divided equally among the two children, and went towards tuition and books. The Kim's modified AGI is \$55,000. How much of an interest deduction can the Kims take?

**SOLUTION**

The loan interest is \$2,700, but the deduction limit is \$2,500. The deduction is taken above the line. The remaining \$200 is not deductible below the line – it's personal.

**Example K** Susan Smith obtained a new job in Columbus. In moving from Boston, Smith incurred the expenses listed below. Her employer reimbursed her for the first two categories of expenses.

Travel expenses during the move from Boston	
(meals = \$195)	695
Charge for packing and moving household goods	5,600
Realtor's commission on sale of old residence	8,000
Expenses incurred in purchasing new residence	575

- (1) Determine Smith's allowable moving expense deduction. Is there any tax benefit to be gained from any of the expenses that are not deductible?  
 (2) What is the tax treatment of the reimbursement?

**SOLUTION**

Actual moving costs	\$5,600
Travel during move (\$695-195)	<u>500</u>
Total deduction	\$6,100

The nondeductible indirect expenses can produce a tax benefit. The realtor's commission reduces the amount realized on the sale of the old home, which thus reduces the gain, and eventually increases the basis of the new home. The purchase expenses increase the AB of the new home. The reimbursement of \$6,295 is included in Smith's income.

**CHAPTER 7**  
**Lecture Guide Examples**

**Example A** Are the following activities considered passive?

- (1) Wanda invested in a limited partnership that engaged in a catfish-raising operation.
- (2) Wanda invested in a general partnership that engaged in a catfish-raising operation. Wanda devotes about 600 hours per year to the operation.
- (3) Same as b., except Wanda has another full-time job and devotes only 50 hours to the operation.
- (4) Wanda owns a duplex. She lives in one unit and rents the other unit.
- (5) Wanda owns a coffee house and an apartment complex. She spends 600 hours managing the coffee house and 1,200 managing the apartments.
- (6) Wanda is a farmer. She owns land with a basis of \$200,000 and a fair market value of \$250,000. She farmed the land in 2000 and 2001, but leased it to another farmer in 2002 for \$3,000.

**SOLUTION**

- (1) Yes. Limited partners are virtually always assumed not to materially participate.
- (2) No. Wanda is a general partner and she participates actively for more than 500 hours per year.
- (3) Yes. Her participation is not material. (It *could* be material if her 50 hours constituted substantially all the participation of all individuals, but that scenario is unlikely.)
- (4) Yes. Almost all rental activities are considered passive.
- (5) No. The coffee house is clearly active, but the rental activity can also be considered active because of the “real property business” exception.
- (6) No. Although she rents the land, this situation falls under an exception whereby the property is used in a trade or business and the gross rental income is very small (less than 2% of the lesser of the unadjusted basis or the FMV).

**Example B** Sammy reported the following income and loss for the year:

Salary	\$200,000
Loss from activity X	(40,000)
Loss from activity Y	(10,000)
Income from activity Z	30,000

X, Y, and Z are all passive activities. How should Sammy treat the income and loss from his passive activities?

**SOLUTION** Sammy has a net passive loss for the year of \$20,000. He cannot use any of that loss to offset his salary income. The loss must be carried forward and should be allocated to the two loss activities as follows:

Activity X	\$20,000	×	\$40,000/\$50,000	=	\$16,000
Activity Y	\$20,000	×	\$10,000/\$50,000	=	\$ 4,000

**Example C** Shannon reported the following income and loss for the year on passive activities:

Salary	\$90,000
Income from activity A	7,000
Loss from activity B	(2,000)
Income from activity C	8,000
Gain from sale of activity C	15,000

In addition, \$30,000 of passive losses from activity C are suspended from prior years. A, B, and C are all passive activities. (1) How should Shannon treat the income and loss from her passive activities? (2) How would your answer change if the loss from activity B was \$12,000?

**CHAPTER 7**  
**Lecture Guide Examples**

**SOLUTION**

(1) Income from activity C	\$ 8,000	
Gain from sale of activity C	15,000	
Suspended losses from C	<u>(30,000)</u>	
Total loss from C		\$(7,000)
Income from activity A	\$ 7,000	
Loss from activity B	<u>(2,000)</u>	
Net from A & B		<u>5,000</u>
Shannon's deduction against salary income		<u><u>\$(2,000)</u></u>

(2) She would deduct \$7,000 from activity C and suspend a \$5,000 net loss on activity B.

**Example D** Nancy and Ron rent a house that they purchased several years ago and in which they previously lived. They personally perform substantially all the work related to the rental. The net loss on the rental amounted to \$16,500 for the current year. Also this year, they received \$105,000 in salaries, \$10,000 in interest and dividends, and \$12,000 in long-term capital gains. How much of the rental loss, if any, is deductible this year? (Assume that Nancy and Ron are not involved in other passive activities.)

**SOLUTION** Their "modified AGI" = \$105,000 + 10,000 + 12,000 = \$127,000, so for the special rental property exception they are limited to: \$25,000 - [(\$127,000 - 100,000) ÷ 2 = (\$27,000 ÷ 2) = \$13,500], or \$11,500. The remaining \$5,000 loss is suspended.

**Example E** Father sells land with a \$25,000 basis to his daughter for \$15,000. Daughter later sells this property for (1) \$14,000, (2) \$30,000, or (3) \$21,000. Determine the father's and daughter's gain or loss.

**SOLUTION**

The father has a nondeductible loss of \$10,000.

When daughter sells the property, she has:

	<u>(1)</u>	<u>(2)</u>	<u>(3)</u>
Gain or loss	\$(1,000)	\$15,000	\$ 6,000
Dad's loss to offset	<u>-0-</u>	<u>(10,000)</u>	<u>(6,000)</u>
Net gain or loss	\$(1,000)	\$ 5,000	-0-
Dad's loss never recog.	\$(10,000)	-0-	\$(4,000)

**Example F** Jordan purchased 100 shares of stock on 6-30-02 for \$1,500. For each of the situations below, determine the gain or loss realized, the gain or loss recognized, and the basis of the new stock.

- (1) Jordan sold the shares for \$1,000 on 12-15-02 and bought 100 shares for \$1,100 on 12-30-02.
- (2) Jordan then sold the new shares for \$1,800 on 1-15-03.
- (3) Jordan sold the new shares for \$1,000 (instead of \$1,800) on 1-15-03.
- (4) Jordan sold the old shares for \$1,600 on 12-15-02 and bought 100 new shares for \$1,500 on 12-30-02.
- (5) Same facts as (1) except Jordan bought the new shares on 11-30-02.

**CHAPTER 7**  
**Lecture Guide Examples**

**SOLUTION**

	Realized gain or (loss)	Recognized gain or (loss)	Holding Period	Basis of new stock
(1)	(500)	0	NA	1,600
(2)	200	200	ST	NA
(3)	(600)	(600)	ST	NA
(4)	100	100	ST	1,500 (cost)
(5)	(500)	0	NA	1,600

Note: (4) is not a wash sale.

**Example G** An unfortunate taxpayer suffered several casualty losses during the year. Business equipment was destroyed in a flood, his wife lost a diamond necklace and earrings when she was mugged, his son had an accident in the family car, and his business car was struck by a bus. The only insurance reimbursement received was \$2,000 for the business car. The taxpayer could have received \$600 reimbursement for the family car, but did not file a claim for fear his premiums would go up. Determine the effect of the casualties and theft on the taxpayer's AGI and TI. AGI was \$20,000 before taking the casualties into account.

Property	Adj. Basis	FMV	
		Before	After
Business Equip.	\$ 6,000	\$ 5,000	0
Necklace	1,000	900	0
Earrings	500	900	0
Personal Car	10,000	8,000	\$ 7,000
Business Car	12,000	9,000	4,000

**SOLUTION**

Business Equip. (total bus. loss)	AB	= 6,000 for AGI
Necklace	↓ in FMV of 900 }	= 1,400 - 100, or
Earrings	AB of 500 }	1,300 from AGI
Personal Car	[↓FMV - ins. reimb.]	= 400 - 100 = 300 from AGI
Business Car	[↓FMV - ins. reimb.]	= 3,000 for AGI

AGI before casualties =	\$20,000
- business equip.	-6,000
- business car	-3,000
Revised AGI	\$11,000
× 10%	×.10
10% floor	\$ 1,100

Itemized deductions:	
Necklace & earrings	\$1,300
Personal car	300
Total	1,600
- 10% floor	-1,100
Net ID	\$ 500

## CHAPTER 16

### Lecture Guide Examples

**Example A** Provide an explanation of the following citations.

- a. *Raymond Garner*, 42 TCM 1181, T.C. Memo 1981-542
- b. *David J. Weissman vs. Comm.*, 85-1 USTC ¶9106, 55 AFTR2d 85-539, 751 F.2d 512 (CA-2, 1984)
- c. *M. Lucile Harrison, et al.*, 59 T.C. 578 (1973), acq.

#### **SOLUTION**

- a. CCH reports this case in volume 42 of *CCH Tax Court Memorandum Decisions* beginning on page 1181. RIA reports this case in the *RIA T.C. Memorandum Decisions* as the 542d decision of 1981 (may also be cited as 81,542).
- b. The court decision was rendered by the Second Circuit Court of Appeals in 1984. CCH reports this case in volume 85-1 of the *U.S. Tax Cases* at paragraph 9106. P-H reports this case in volume 55 of the second series of the *American Federal Tax Reports* beginning on page 539. West reports this case in volume 751 of the *Federal Second Series* beginning on page 512.
- c. The U.S. Government reports this case in volume 59 of the *Tax Court of the United States Reports* starting on page 578. If a decision number is given (i.e., Dec. 37,680), and usually it is not, the case can be found in the CCH or RIA advance sheets. The IRS must have lost on at least a portion of the case because it acquiesced in the decision.

**FIGURE 16.7**  
**U.S. TRIAL COURTS**

	<b>U.S. Tax Court</b>	<b>U.S. District Court</b>	<b>U.S. Claims Court</b>
<i>Jurisdiction</i>	Nationwide	Specific district in which court is sitting	Nationwide
<i>Number of courts</i>	1	95	1
<i>Court location</i>	Judges travel to different cities	At least one court in each state	Washington, D.C.
<i>Number of judges per court</i>	19	1	16
<i>Subject matter</i>	Tax cases only	Many different types of cases, both criminal and civil	Claims against the Federal government, including tax refunds
<i>Payment of contested amount</i>	Taxpayer does not pay deficiency, but files suit against IRS to stop collection of tax	Taxpayer pays alleged deficiency and then files suit against the U.S. government for refund	Taxpayer pays alleged deficiency and then files suit against the U.S. government for refund
<i>Availability of jury trial</i>	No	Yes	No
<i>Appeal taken to</i>	U.S. Court of Appeals--based on the state of residence	U.S. Court of Appeals--based on the state of residence	U.S. Court of Appeals for the Federal Circuit

Source: Adapted from Pratt & Kulsrud, Outlines T-6

**FIGURE 16.8--PRECEDENT:  
WHICH DECISIONS MUST THE COURTS FOLLOW?**

DECISION	COURT					IRS
	District Court	Tax Court	Claims Court	Court of Appeals	Supreme Court	
District Court						
Own district	Y	N	N	N	N	N
Other districts	N	N	N	N	N	N
Tax Court	N	Y*	N	N	N	N
Claims Court	N	N	Y	N	N	N
Court of Appeals						
Own circuit	Y	Y	Y**	Y	N	N
Other circuits	N	N	N	N	N	N
Supreme Court	Y	Y	Y	Y	Y	Y
Code						Y
Treasury pronouncements						Y

\* There can be conflicts within the TC because of the *Golsen* rule.

\*\* The Federal Circuit must be followed.