
CHAPTER 6
BUSINESS EXPENSES

DISCUSSION QUESTIONS

1. Most expenditures that have a business purpose and meet the ordinary, necessary, and reasonable requirements are deductible. However, specific rules must be adhered to in determining the deductibility of many expenses that meet this test. Why are these specific rules necessary?

There are many business expenses that have a personal element to them. As such, they are subject to abuse by taxpayers. For example, meals and entertainment can be valid business expenses. However, due to the potential for taxpayers to attempt to deduct personal meal and entertainment expenses, specific rules on the deductibility of such expenses have been created. In addition to the qualifying requirements, most expenses that are usually considered to be personal in nature (e.g., car expenses) must be adequately substantiated.

2. What requirements must be met for meal and entertainment expenses to be deductible?

To qualify as deductible business expenses, meal and entertainment expenses must:

1. **Have a business purpose,**
 2. **Qualify as an ordinary and necessary expense of the business and not be lavish or extravagant (i.e., reasonable in amount),**
 3. **Be directly related to or associated with the active conduct of the taxpayer's business activity, and**
 4. **Be adequately documented.**
3. How does an entertainment expense directly related to business differ from an entertainment expense associated with business?

The two entertainment expense classifications are similar in that both:

1. **Require that the expense be incurred for a business purpose that is related to the active conduct of the taxpayer's business.**
2. **Both must qualify as an ordinary and necessary expense of the business and not be lavish or extravagant (i.e., reasonable in amount).**
3. **Both must satisfy substantiation requirements.**

The two entertainment expense classifications are different in that:

1. **A bona fide business activity must take place to qualify as a directly related entertainment expense. To qualify as an associated with expense, the entertainment must directly precede or follow substantial business discussions.**
2. **Directly related expenses are amounts spent to provide entertainment for the taxpayer and the person(s) involved in the conduct of the business activity. Associated with expenses may include expenses related to persons whose presence is appropriate for business reasons but not necessary for the actual**

conduct of business. The tax law refers to this requirement as expenses of persons closely connected with the individual who conducted business with the taxpayer. For example, the costs related to the presence of a business associate's spouse at a dinner following a substantial business meeting would qualify as an associated with expense.

The associated with test may be easier to satisfy than the directly related test. In addition, the persons whose expenses qualify for deduction is broader under the associated with test.

4. What problems does the taxpayer who uses an automobile for both business and personal purposes encounter? What option(s) does the taxpayer have regarding the automobile expense deduction?

When an asset is used for more than one purpose, the cost of the asset and any expenditures associated with the asset must be allocated between the two purposes in some reasonable manner. Because the business use of the automobile is deductible and the personal use is not, the automobile is treated as two separate assets for tax purposes. In addition, the expenses of operating the automobile must be allocated between business use and personal use.

The taxpayer may elect to use either the actual cost method or the standard mileage rate method to determine the allowable deductions on the automobile. Both methods require the taxpayer to substantiate the business miles driven. The actual cost method also requires the substantiation of the expenses related to the automobile. The standard mileage rate is 36 cents per mile in 2003.

5. What records are necessary to properly document travel, entertainment, and gift expenses?

A deduction is allowed for substantiated (proven) travel, entertainment, and gift expenses. To properly substantiate an expense, the taxpayer must make a written record as near to the time an expense is incurred as possible to show:

1. The amount of each separate expense,
2. The date of the entertainment or gift, or the time period the taxpayer traveled,
3. Where the entertainment took place, or the travel destination,
4. The description of a gift,
5. The business purpose of the expense, and
6. The business relationship between the taxpayer and persons entertained or given a gift.

6. Under what circumstances are business gifts deductible?

A taxpayer can deduct up to \$25 in gifts to business customers. The taxpayer is required to maintain documentation describing the taxpayer's relationship with the recipient, the date of the gift, the description of the gift, and the business purpose of the gift. The gift is not subject to the 50% limitation on entertainment and meals expenses.

7. Explain the criteria used to determine whether an educational expense is deductible or nondeductible and how education expenses are deducted on a taxpayer's return.

Individuals are allowed to deduct education expenses if the education expense meets either of the following requirements: (1) the education is required by law or

by the employer for the taxpayer to retain the taxpayer's job or (2) the expense maintains or improves the skills required in the taxpayer's trade or business.

Because education is viewed as a personal capital expenditure, education expenses are not deductible if the expense is incurred to (1) meet the minimum educational requirements required for the taxpayer's job or (2) if the education qualifies the taxpayer for a new trade or business.

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 2002 and 2003, 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 \$3,000 of qualified higher education expenses. In 2004 and 2005, the maximum deduction is increased to \$4,000. Therefore, from 2002 through 2005, 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. A taxpayer who claims the deduction cannot claim a HOPE or Lifetime Learning Credit (discussed in Chapter 8) for the same individual. However, a taxpayer may claim the deduction and receive a distribution from an Education IRA as long as the distribution is not used for the same educational expenses for which the deduction is claimed.

8. Can education expense incurred by one taxpayer be deductible whereas the same expense incurred by another taxpayer is not deductible? Explain.

An education expense is deductible when the expense is either (1) required by law or by the employer for the taxpayer to maintain her/his job, or (2) the expense maintains or improves the skills required in the taxpayer's trade or business. However, an education expense that (1) meets the minimum educational requirements required for the taxpayer's job, or (2) qualifies the taxpayer for a new trade or business might not be deductible. Therefore, an education expense that is deductible for one taxpayer could be treated as a nondeductible expense for another taxpayer.

For example, if two individuals are enrolled in the same advanced database management course, the tax treatment can vary based on the background of each individual. Assume that Judy has a B.S. in computer science and works full-time for Hazelnut Corporation as a computer programmer. She enrolls in the course to refresh her skills in database management. On the other hand, Sam is a full-time student who works part-time as a computer programmer for Pine Corporation and is taking the course to meet his undergraduate requirements for a degree. For Judy, the course is considered a deductible education expense because the course maintains or improves her skills. For Sam, the course generally would not be deductible. However, for tax years 2002 and 2003 Sam could get a deduction for AGI if his AGI is less than \$65,000.

9. Is all compensation paid to an employee deductible? Discuss the circumstances in which employee compensation cannot be deducted.

Payments for compensation paid to an employee are deductible to the extent that they are ordinary, necessary, and reasonable in amount. Compensation paid that is unreasonable in amount may not be deducted as a business expense.

Unreasonable compensation situations generally arise when the payment is being made to a related party. In such cases, taxpayers often try to transfer income from one party to another to lower the total tax paid. However, if the payment made is unreasonable for the duties and responsibilities of the payee, it will not be considered compensation and will not be deductible.

For publicly traded corporations, deductible compensation paid to the CEO and the four highest compensated officers other than the CEO cannot exceed \$1,000,000 for each person.

10. Explain the difference in the tax treatment of business and nonbusiness bad debts.

A business bad debt is deductible in the period in which the fact of the bad debt becomes known. That is, estimates of the amount of the debt may be made at the time the debt is known to be uncollectible. Adjustments for the actual amount of the bad debt are made in subsequent periods. Business bad debt deductions are deductible in full as a trade or business expense.

A nonbusiness bad debt is not deductible until the period in which the actual amount of the debt that will not be collected is known. Thus, estimates of nonbusiness bad debts are not allowed. In addition, nonbusiness bad debts are treated as short-term capital losses. This could result in the debt not being fully deductible in the period in which the amount of the bad debt is determined due to the capital loss deduction limitations (i.e., \$3,000 per year).

11. What accounting method must be used to account for bad debts that result from the sale of merchandise or the provision of services?

Only accrual basis taxpayers are allowed deductions for bad debts. Cash basis taxpayers have not recognized any income related to receivables and therefore, have no basis in the debt to deduct.

With a few limited exceptions, taxpayers must use the specific charge-off method to deduct bad debts. This method allows bad debt deductions only in the period in which an account is determined to be worthless. The tax law generally disallows the use of the allowance method of accounting for bad debts.

12. Explain how the tax benefit rule may apply to bad debt deductions.

Business bad debts are deductible in the period in which it is determined that the debt will not be collected. The amount of the deduction is based on an estimate of how much of the debt will not be collected. When the actual amount of the bad debt becomes known in a future period, adjustments to the estimate are made. Therefore, if the estimated bad debt turns out to be more than the actual bad debt, the taxpayer will receive amounts that were deducted in a prior period. The tax benefit rule requires any amounts received that were deducted in a prior period to be included in current period income to the extent that a tax benefit was received from the prior period deduction.

13. What requirements must be met to deduct life insurance premiums paid on an employee's policy?

Premiums paid on group-term life insurance policies are deductible. For other employee life insurance premiums to be deductible, the payment of the premium must constitute income to the employee. For the policy to be considered gross income for the employee, the employer cannot be the beneficiary of the policy.

14. Are sales taxes deductible? Explain.

Sales taxes paid on the purchase of business assets that are expensed in the current period (e.g., supplies) are deductible. However, sales taxes paid on the purchase of long-lived assets are capitalized as part of the cost of the asset. Therefore, the sales tax is deducted as the cost of the asset is recovered through time via amortization or depreciation or when the asset is sold. Sales taxes paid on personal use items are not deductible.

15. Are all legal fees paid by a taxpayer deductible? Explain.

To be deductible, legal fees must have a business purpose. The origin of the legal fee determines the purpose of the expenditure. If the legal fee originates in a profit motivated activity, then it is deductible. However, if the legal fee is generated for personal reasons, it is not deductible. For example, legal fees related to a divorce originate from a personal action. Therefore, even though the fee may be related in some way to a taxpayer's trade or business or investment assets, the fee is a nondeductible personal expenditure. If part of the fee in a divorce is specified as being for tax advice, that portion of the fee is deductible.

Legal fees that have a business purpose must be capitalized if they relate to the acquisition of, or the protection of title to a long-lived asset.

16. Why are deductions for adjusted gross income "better" than deductions from adjusted gross income?

Deductions FOR AGI are better because they provide more tax savings than deductions FROM AGI. That is, once the amount of a for AGI deduction is determined, it is not subject to any limits based on the taxpayer's income as are many of the FOR AGI deductions. Second, there is no minimum amount of FOR AGI deductions - whatever the taxpayer incurs is allowed as a deduction. In contrast, taxpayers with small amounts of from AGI deductions will use the applicable standard deduction in lieu of itemizing their actual deductions. Third, deductions FOR AGI reduce the taxpayer's AGI, making the FROM AGI deductions that are subject to an AGI limitation larger.

17. What is an accountable employee expense reimbursement plan? What is the significance of such a plan?

An accountable reimbursement plan is one in which employees are required to make an adequate accounting of their allowable expenses with the employer and return any excess reimbursements to the employer.

The significance of an accountable plan is that all reimbursements from the plan are deductible for AGI. Only unreimbursed expenses are deducted as miscellaneous itemized deductions, subject to the 2% of AGI limitation. In addition, the 50% meals and entertainment limitation does not apply to reimbursed expenses. If a reimbursement plan is not accountable, all deductions must be taken as miscellaneous itemized deductions, subject to the 2% and 50% limitations.

18. Why are self-employed taxpayers allowed to deduct their medical insurance premiums and self-employment tax for adjusted gross income?

The reason for allowing for AGI deductions for these two items is to attempt to equalize the treatment of self-employed taxpayers with employees. That is, employees receive the benefits of employer provided health insurance tax-free because the cost of the premiums is excluded from income. By allowing self-employed taxpayers to deduct the cost of their health insurance for AGI, an element of equality is provided between the two types of taxpayers. Similarly, employers match the Social Security payments of employees, which is not included in the employee's income. Because the self-employment tax is twice the Social Security tax, the deduction of 1/2 of the self-employment tax somewhat equalizes the tax treatment for employees and self-employed taxpayers.

19. Are all taxpayers allowed a deduction for contributions to a conventional individual retirement account? Explain.

All taxpayers are allowed to *contribute* \$3,000 to an individual retirement account. A taxpayer who is at least 50 years old is allowed to make an additional contribution of \$500. However, a deduction for the contribution is allowed only to those taxpayers who are not covered by an employer provided retirement plan. If an unmarried taxpayer is covered by an employer-provided retirement plan, the allowable deduction is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$40,000. For married taxpayers if both the husband and wife are covered by an employer-sponsored plan, the deduction is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$60,000. If only one spouse is covered by an employer provided retirement plan the allowable deduction for the spouse not covered by a plan is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$150,000.

20. How does the tax treatment of a conventional IRA differ from a Roth IRA?

All taxpayers are allowed to *contribute* to an individual retirement account. However, a deduction for the contribution is allowed only to those taxpayers who are not covered by an employer provided retirement plan. If an unmarried taxpayer is covered by an employer-provided retirement plan the allowable deduction is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$40,000. For married taxpayers if both the husband and wife are covered by an employer-sponsored plan, the deduction is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$60,000. If only one spouse is covered by an employer provided retirement plan the allowable deduction for the spouse not covered by a plan is phased-out ratably over a \$10,000 range beginning at an adjusted gross income of \$150,000.

The contribution to a Roth IRA is not deductible. The major benefit of a Roth IRA is that qualified distributions from it, including the income earned on the IRA assets, are not included in the taxpayer's gross income. Unmarried taxpayers with an adjusted gross income of less than \$95,000 may contribute \$3,000 to a Roth IRA. As with an IRA, a taxpayer who is at least 50 years old is allowed to make an additional contribution of \$500. However, the amount contributed to a Roth IRA must be reduced by any contributions made to other IRA accounts. When an unmarried taxpayer's adjusted gross income exceeds \$95,000, the amount that can be contributed is reduced ratably over a \$15,000 range until no contribution is allowed when adjusted gross income exceeds \$110,000. For married taxpayers with an adjusted gross income of less than \$150,000, each spouse can contribute \$3,000 to a Roth IRA. The amount that can be contributed is reduced ratably over a \$10,000 range when adjusted gross income exceeds \$150,000 and is fully phased-out when adjusted gross income exceeds \$160,000.

21. Who is eligible to make and receive contributions to an Education IRA?

All taxpayers can make a nondeductible contribution of up to \$2,000 to an education IRA for the benefit of an individual who is not 18 years of age. However, the total amount contributed to an individual's Education IRA is limited to \$2,000. For unmarried taxpayers, the amount of the contribution is phased out ratably over a \$15,000 range beginning when adjusted gross income exceeds \$95,000 and is fully phased-out when adjusted gross income exceeds \$110,000. For married taxpayers this amount is phased out ratably over a \$30,000 range beginning when adjusted gross income exceeds \$190,000, and is fully phased-out when adjusted gross income exceeds \$220,000.

22. Is the interest on education loans always deductible? Explain

A qualified education loan is one that is used to pay for tuition, fees, room and board, and other necessary education expenses. The maximum amount of interest that can be deducted is \$2,500. Any amount in excess of the maximum is considered personal interest and is not deductible. The interest deduction is phased out ratably for single taxpayers over a \$15,000 range beginning when adjusted gross exceeds \$50,000 and is fully phased-out at \$65,000. For married taxpayers, the \$30,000 phase-out begins when adjusted gross income exceeds \$100,000 and is fully phased out when adjusted gross income exceeds \$130,000.

23. Explain the general requirements that must be met to obtain a deduction for moving expenses and the type of moving expenses that are deductible.

The two general requirements are the distance and time requirements. The taxpayer's commuting distance from the old residence to the new job must be more than 50 miles than the distance would have been from the old job. The time test requires the taxpayer be employed for 39 weeks in the 12-month period following the move (78 weeks in 2 years for self-employed taxpayers).

Only direct moving expenses are deductible for adjusted gross income. Direct moving expenses are limited to:

- **the cost of moving household goods and personal effects to the new residence.**
- **the transportation and lodging costs of moving the taxpayer and the taxpayer's family from the old residence to the new residence.**

The taxpayer cannot deduct the cost of meals incurred in moving from the old residence to the new residence.

PROBLEMS

24. A.J. is the vice president for Keane Products, a marketing consulting firm. On a business trip to New York City, he meets with three executives from Keane's top account. After the meeting, A.J. takes them to dinner and then to the theater. The theater tickets cost \$350. The cost of the meal is \$190, including sales tax of \$17 and a tip of \$34. Throughout the evening, A.J. pays \$42 in cab fares. How much can A. J. deduct as an entertainment expense?

A.J. can deduct \$175 (50% x \$350) for the theater tickets and \$95 (50% x \$190) for the meal. The entertainment qualifies as an expense associated with the conduct of the taxpayer's trade or business because it follows a substantial

business discussion. The \$42 cab fare is fully deductible as transportation and is not subject to the 50% rule because it is not considered to be an entertainment expense. Thus, A.J.'s total deduction for the evening is \$312 (\$175 + \$95 + \$42). Instructor's Note: Even if A.J. and the clients did not have a business meeting before the theater, the entertainment is deductible if they had a business discussion at dinner.

25. Karl is the vice president of finance for Wyatt Industries. Last month, he took a client to an afternoon baseball game. The box-seat tickets cost \$30 each. Because the client had a plane flight after the game, Karl was unable to take her to dinner. During the game, Karl spent \$15 on sodas and snacks. What amount can Karl deduct as an entertainment expense? Assume that Karl and the client went to dinner and that the meal cost \$88. How much can Karl deduct as an entertainment expense?

For the entertainment to qualify under the associated with test, two requirements must be met. First, there must exist a clear business purpose, other than goodwill, for the entertainment. Karl probably could establish that this test is met. However, the second test requires that the entertainment occur either preceding or following a substantial business discussion. Given the facts of this example, this did not occur. Therefore, the \$37.50 [(\$60 tickets + \$15 food) x 50%] of entertainment expense are considered a nondeductible personal expense. Instructor's Note: The facts of the problem imply that Karl met the client at the game and that no business discussions preceded the game.

If Karl went to dinner with the client and business was discussed, Karl can deduct \$44 (\$88 x 50%) as a business meal expense. In addition, because a business discussion took place following the baseball game, the \$37.50 in entertainment expenses are deductible. Karl's total meal and entertainment expense is \$81.50 (\$44 + \$37.50).

28. For each of the following situations, explain whether a deduction should be allowed for entertainment expenses:
- a. Gayle, a dentist, invites 50 of her best patients to her daughter's wedding reception. The cost of the reception related to the presence of her patients is \$5,000.

Gayle cannot deduct the \$5,000 of entertainment expenses. The wedding reception is not an ordinary and necessary expense of Gayle's business. The reception is a personally motivated event which lacks a business purpose.

- b. Stan is one of 5 shift supervisors responsible for 100 employees at Label House, Inc. He regularly meets with the other shift supervisors at the plant. In addition, Stan makes it a practice to go to lunch at least once a week with each of the other 4 shift supervisors in order to network. During the current year, Stan pays \$1,500 for his and the other supervisors' lunches. Stan's job description does not require him to entertain the other supervisors.

Stan may not deduct the \$1,500. The expenses related to Stan's meals are personal living expenses. Because Stan's supervisory position is not affected by the entertainment (i.e., not required as part of his job), the lunches are not an ordinary and necessary expense of his job.

- c. Jan is a real estate broker who holds an open house for a different client each Sunday afternoon. During the open house, she provides cookies and soft drinks for whoever visits the house. Jan pays \$2,000 for open house entertainment.

The \$2,000 Jan paid for refreshments at the open house is deductible. The expenses are in the nature of advertising or promoting goodwill and are an ordinary and necessary expense of a real estate broker. These expenses are not subject to the 50% limitation, under the exception for food and entertainment provided to the general public.

- d. Felicia is vice-president of sales for Drivitt, Inc. She invited the company's major clients and some of her coworkers from Drivitt to her annual Super Bowl party. Most guests attend with their spouses. The party is held in a separate room at a local sports bar and costs her \$1,500.

The expense of the party does not qualify as an entertainment expense because it fails both the directly related and associated with tests. The directly related test requires that the entertainment expense meet four test, one of which is that a bonafide business activity take place during the entertainment. This is probably not the case, because the setting for the entertainment is a bar.

For the entertainment to qualify under the associated with test, two requirements must be met. First, there must exist a clear business purpose, other than goodwill, for the entertainment. Felicia probably could establish that this test is met. However, the second test requires that the entertainment occur either preceding or following a substantial business discussion. Given the facts of this example, this did not occur. Therefore, the \$1,500 entertainment expense is considered a nondeductible personal expense.

31. Julianita is a sales representative for a food distributor and spends only 1 day of the week in the office. Her office is 12 miles from home. She also has a part-time job as a bartender. Typically, she works 2 nights during the week and 1 night on the weekend. The restaurant where she works is 5 miles from her office and 10 miles from her home.
- a. What portion(s) of Julianita's travel is considered business?

Julianita can deduct the cost of traveling from home to her business clients and back. She can also deduct the cost of traveling from her office to her clients and back to her office. The cost of traveling to her office and then home, as she does 1 day a week, is considered commuting and is nondeductible. However, the cost of traveling from either her office or clients to her second job as a bartender is deductible. The cost of traveling home from her bartending job is not deductible because the travel is considered commuting. Finally, any out-of-town traveling Julianita incurs is fully deductible.

- b. During the year, Julianita keeps the following record of her travel:

	Miles
Home to office	588
Office to home	353
Office to restaurant	150
Restaurant to home	1,500
Home to restaurant	500
Home to clients to home	8,850
Clients to restaurant	2,100

If she uses the standard mileage rate, what amount can she deduct as a business expense?

Julianita's deductible business expense is \$3,996 (11,100 x 36 cents). The standard mileage rate for 2003 is 36 cents per mile. In computing her deduction, Julianita may deduct the mileage from home to her clients and back home (8,850), the miles from her clients to the restaurant (2,100) and the mileage from her office to the restaurant (150). The miles from home to her office and back are considered commuting, as are the miles from her home to the restaurant and from the restaurant to her home.

32. Cassandra owns her own business and drives her van 15,000 miles a year for business and 5,000 miles a year for commuting and personal use. She purchases a new van in 2003 and wants to claim the largest tax deduction possible for business use. Cassandra's total auto expenses for 2003 are as follows:

Gas, oil, and maintenance	\$ 3,840
Insurance	775
Interest on car loan	1,200
Depreciation	3,060
License	180
Parking fees and tolls (all business)	240

Determine Cassandra's 2003 deduction for business use of the van.

Because this is the first year Cassandra uses the van, she must select an accounting method to determine the costs associated with the van. She has the option of using either the standard mileage rate method or the actual cost method to determine her deduction on the van. Based on the calculation of the deduction under each method, the actual cost method results in a \$491 (\$6,131 - \$5,640) larger deduction. 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 Cassandra is self-employed, she can deduct the business portion (75%) of the interest expense under both methods.

Standard Mileage Deduction:

15,000 miles x 36 cents	\$ 5,400
Add: Parking and tolls	240
Total deduction	<u>\$ 5,640</u>

Interest expense (\$1,200 x 75%)	<u>900</u>
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Actual Cost Deduction:

Total actual expenses (other than parking, tolls and interest)	\$ 7,855
Business usage percentage (15,000 mi. ÷ 20,000 mi.)	x 75%
Allocated actual cost	\$ 5,891
Add: Parking and tolls	240
Total deduction	<u>\$ 6,131</u>

Interest expense (\$1,200 x 75%)	<u>900</u>
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Instructor's Note: For reporting purposes Interest expense is separately stated on Schedule C.

35. 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
Incidentals -- \$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:

Airfare	\$ 475
Hotel (\$175 x 4)	700
Meals (\$40 x 4 x 50%)	80
Incidentals (\$25 x 4)	100
Total deduction	<u>\$ 1,355</u>

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:

Airfare	\$ -0-
Hotel (\$175 x 2)	350
Meals (\$40 x 2 x 50%)	40
Incidentals (\$25 x 2)	50
Total deduction	<u>\$ 440</u>

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

- c. Assume the same facts as in part a, except that Juanita's husband Jorge accompanied her on the trip and the hotel's single occupancy rate is \$150. Jorge went sightseeing every day and attended business receptions with Juanita at night. Assume that Jorge's expenses are identical to Juanita's. What amount may Juanita and Jorge deduct as travel expense?

None of Jorge's expenses are allowed as a business deduction unless there is a substantial business purpose for his presence *and* he is an employee of Juanita's business. Because Jorge fails both of these requirements, none of his expenses are deductible. Because the hotel rate is the greater for a double occupancy than for a single, Juanita can only deduct \$150 per night for lodging. The \$25 difference is considered a personal expense and allocated to Jorge. Juanita can deduct the following amount:

Airfare	\$ 475
Hotel (\$150 x 4)	600
Meals (\$40 x 4 x 50%)	80

Incidentals (\$25 x 4)
Total deduction

100
\$ 1,255

41. 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. Depending on Forest's AGI, the expense is either a deduction FOR AGI or is a miscellaneous itemized deduction which is reduced by 2% of adjusted gross income (see Chapter 8). If Forest is single and his AGI is less than \$65,000 (\$130,000 if married), the expense is a deduction FOR AGI, otherwise the expense is a miscellaneous itemized deduction. 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 could qualify Forest for a new trade or business.

- c. Elise is a recent graduate of law school and has been hired by a local firm. The firm expects her to pass the bar exam on her initial attempt. To prepare for the bar exam, she is taking a law review course that costs \$1,500.

Even though Elise is a graduate of law school and is working in a local law firm, she is not considered a lawyer until she passes the bar exam. The law review course she takes to pass the bar exam is not deductible because it is an education expense that qualifies her for a new trade or business (e.g., a lawyer). However, if the course is offered at a qualified institution and Elise is single with an AGI of less than \$65,000 (\$130,000 if married), up to \$3,000 of the cost of the course qualifies as a deduction FOR AGI.

- d. Simon is the managing partner of a CPA firm and is required to attend 30 hours of continuing education every year. State law requires that 5 hours be in ethics training. The 5-hour ethics course costs \$400; the remaining 25 hours of continuing education cost \$1,800.

The cost of the ethics seminar is deductible because it is required by law. The cost of the 25 hours of continuing education is deductible for two reasons. First, the 25 hours are required by law so that Simon can maintain his license to practice. Second, the courses either maintain or improve his skills as an accountant.

44. 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.

45. 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.

Total debt	\$ 8,000
Amount of bad debt previously deducted	(4,800)
Amount received in payment of bad debt	<u>(2,700)</u>
Current year bad debt	<u>\$ 500</u>

- 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.

Total debt	\$ 8,000
Amount of bad debt previously deducted	(4,800)
Amount received in payment of bad debt	(3,300)
Current year gross income	<u>\$ (100)</u>

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).

50. For each of the following situations, state whether the expense related to the transaction can be deducted as an insurance expense:
- Baker Company pays the insurance premium to provide each of its employees with a \$50,000 whole life insurance policy. Baker and the insurance company consider the employee the owner of the policy. As owner of the policy, the covered employee designates the beneficiary of the life insurance proceeds in the event of the employee's death. Each employee's policy costs \$2,000 per year.

The \$2,000 premium paid for each employee is not a deductible insurance expense. Only premiums on group-term life insurance qualify for deduction as life insurance expense. Because Baker does not benefit directly or indirectly from the policy, the insurance premiums are deducted as additional compensation paid to the employee (the employee must include the \$2,000 in gross income). When the employee dies, the beneficiary of the policy excludes the insurance proceeds from gross income.

- Baker Company has a nondiscriminatory self-insured medical reimbursement plan for the benefit of its employees. Once a month, Baker transfers \$1,000 in cash from its general bank account to a special medical reimbursement checking account. The transfer is based on the premium an insurance company would demand to provide the same benefits to the employees.

The \$1,000 per month deposited into the medical reimbursement checking account is not deductible as an insurance expense. The company still controls the money while it is in the checking account and can withdraw it for general business use at any time. In addition, the amount deposited represents an estimated expense that is not permitted as a tax deduction. The amount actually reimbursed to employees from the medical reimbursement account can be deducted as a medical insurance expense and excluded from the employee's gross income.

- The employees' of Baker Company receive large sums of cash in the mail. To protect against loss, Baker pays a \$500 annual insurance premium for an employees fidelity bond.

The \$500 premium paid for the employees fidelity bond is deductible as an insurance expense. The purpose of the fidelity bond is to protect Baker from losses due to an employee's dishonesty.

- Baker Company is owned by Ross. Baker pays a \$1,500 annual premium for a sickness and disability income continuation insurance policy on Ross. The purpose of the policy is to give Ross \$3,500 per month if he is unable to work for Baker because he is sick or disabled.

The \$1,500 premium paid on the income continuation policy is not deductible as

an insurance expense. The premium is considered a personal expense. If Ross collects the \$3,500 per month benefit because he becomes ill or disabled, the payments are excluded from his gross income. The income is excluded because when the company made the payments, the premium amount was included in Ross's income.

51. State whether the following taxes are allowed as a current deduction for taxes paid by a business:

a. Sales tax on the purchase of a desk

The sales tax paid on the purchase of an asset is not currently deductible. The sales tax must be added to the basis of the asset and can be recovered through a depreciation deduction. However, a sales tax imposed on a business for items benefiting only the current tax year can be deducted (i.e., supplies, small tools, other consumable items).

b. State and local income, real estate, and personal property taxes

State and local income, real estate, and ad valorem personal property taxes are allowed as a deduction when paid or accrued based on the taxpayer's accounting method.

c. Federal income, estate, and gift taxes

Federal income, estate, and gift taxes cannot be deducted.

d. An employer's payment to the IRS of federal income and Social Security taxes withheld from an employee's wages

Payment to the IRS of taxes withheld from an employee's wages is not deductible by the employer. The payment to the IRS represents a transfer of a payment from the employee to the IRS. The employer is just a middleman who facilitates the payment. The employer does deduct the gross wages paid to the employee. In addition, the employer can deduct the employer's share of the Social Security tax when it is paid to the IRS.

57. During the current year, Carson pays \$1,500 in child support and \$2,000 in alimony to his ex-wife. What is Carson's allowable deduction, and how should it be deducted on his tax return?

Carson is allowed a deduction for adjusted gross income for the \$2,000 of alimony he paid to his ex-wife (who includes the alimony in her gross income). The child-support payment is not deductible by Carson nor is it taxable to his ex-wife.

59. Alvin is an employee of York Company. During the year, he incurs the following employment-related expenses:

Travel	\$ 4,000
Meals	2,400
Lodging	2,500
Entertainment	1,100

a. How should Alvin treat these expenses if York Company has an accountable employee business expense reimbursement plan and Alvin is reimbursed

1. \$ 9,000?

Alvin is in a net deduction situation. The \$9,000 is included in gross income and Alvin is allowed a deduction for adjusted gross income (AGI) for the \$9,000 of reimbursed expenses. The remaining \$1,000 of expenses are deductible as itemized deductions, subject to the 50% meals and entertainment limitation and the overall 2% of AGI limit for all miscellaneous itemized deductions. The from AGI deduction before the 2% limit is \$825, calculated as follows:

Reimbursement ratio = $\$9,000 \div \$10,000 = 90\%$
 Unreimbursed percentage = 10%

Travel (\$4,000 x 10%)	\$ 400
Meals (\$2,400 x 10% = \$240 x 50%)	120
Lodging (\$2,500 x 10%)	250
Entertainment (\$1,100 x 10% = \$110 x 50%)	55
Total itemized deduction	<u>\$ 825</u>

2. \$ 10,000?

Because the plan is accountable and the reimbursement equals actual expenses, no gross income is reported and no deductions are taken.

3. \$ 11,000?

Because this is an accountable plan, the \$1,000 excess reimbursement is included in Alvin's gross income and no deductions are allowed.

- b. How would your answer to part a change if York's reimbursement plan were nonaccountable?

With a nonaccountable plan, any reimbursement is included in gross income. None of the expenses are deductible for adjusted gross income. The expenses are deducted as miscellaneous itemized deductions, subject to the 50% meals and entertainment limitation and the 2% of AGI limit. In each case, the from AGI deduction before the 2% limit is \$8,250, calculated as follows:

Travel	\$ 4,000
Meals (\$2,400 x 50%)	1,200
Lodging	2,500
Entertainment (\$1,100 x 50%)	550
Total itemized deduction	<u>\$ 8,250</u>

- c. How would your answer to part a change if Alvin were self-employed (i.e., receiving no reimbursements)?

If Alvin is self-employed, the expenses are considered to be trade or business expenses and therefore, deductible FOR AGI. However, the meals and entertainment limitations still apply and Alvin's deduction will be \$8,250 as calculated in part (b) above. However, as FOR AGI deductions they are not subject to any further limitation; that is, the 2% AGI limit is only for unreimbursed employee business expenses.

62. Thomas is single and a self-employed architect. During 2003, Thomas's income from his

business is \$100,000. He also pays \$2,200 for a medical insurance policy.

- a. How should the medical insurance policy payment be reflected on his 2003 tax return?

Thomas is allowed a deduction for adjusted gross income for the cost of the policy.

- b. What is his 2003 self-employment tax deduction?

Thomas is allowed to deduct 1/2 of the self-employment tax paid as a deduction for adjusted gross income. Because this deduction reduces his self-employment income, the amount of self-employment income subject to the tax is 92.35% of self-employment income. His self-employment income subject to the tax is \$92,350 (\$100,000 x 92.35%). Because he is over the self-employment tax ceiling of \$87,000 in 2003, he will pay a tax of 12.4% (6.2% x 2) on \$87,000, plus 2.9% (1.45% x 2) on \$92,350. His self-employment tax is \$13,466 and his deduction for adjusted gross income is \$6,733.

Net Self-employment income (\$100,000 x 92.35%)		<u>\$ 92,350</u>
OASDI on \$87,000 x 12.4%	\$ 10,788	
MHI on \$92,350 x 2.9%	<u>2,678</u>	
Total self-employment tax		<u>\$ 13,466</u>
Deduction for one-half of self-employment tax (\$13,466 x 50%)		<u>\$ 6,733</u>

- c. Assume the same facts as in part a, except that Thomas is married, his wife's salary is \$30,000, and they are covered by a medical policy from her employer?

If his wife's employer provides her with medical coverage, no deduction is allowed for adjusted gross income for his policy. The \$2,200 policy cost is an itemized medical expense deduction (see Chapter 8).

63. Carlos and Angela are married and file a joint return. During the current year, Carlos's salary is \$40,000. 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 \$65,500.

Both taxpayers have earned income. Because neither Carlos nor Angela is covered by a pension plan, they each can contribute and deduct up to \$3,000. Thus, they may contribute and deduct a total of \$6,000 for adjusted gross income.

- b. Angela does not work outside the home, and their adjusted gross income is \$43,000.

Even though Angela does not have earned income, they are allowed to contribute and deduct a maximum of \$6,000 for adjusted gross income because their total earned income exceeds \$6,000. However, they must establish separate IRA accounts and the total amount contributed to each account cannot exceed \$3,000.

- 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 \$3,000 to her IRA. Because Carlos is at least 50 years of age, he is allowed to contribute \$3,500 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 \$60,000. The deduction is fully phased out when adjusted gross income exceeds \$70,000. The maximum contribution amount is not affected by this limitation, only the deductible amount of the contribution. Angela's \$3,000 deduction must be reduced by 55% $[(\$65,500 - \$60,000) \div \$10,000]$ and leaves her with an allowable deduction for adjusted gross income of \$1,350 $[\$3,000 - (\$3,000 \times 55\%)]$. Carlos's \$3,500 deduction is also reduced by 55% $[(\$65,500 - \$60,000) \div \$10,000]$ and leaves him with an allowable deduction for adjusted gross income of \$1,575 $[\$3,500 - (\$3,500 \times 55\%)]$. Their total deduction for AGI is \$2,925 $(\$1,350 + \$1,575)$.

- d. Assume the same facts as in part a, except that Carlos is covered by an employer-sponsored pension plan.

Because Carlos is covered by an employer-sponsored pension plan, the amount of his IRA deduction is reduced because their adjusted gross income exceeds the \$60,000 phase-out level. Therefore, he may contribute \$3,000 but the amount he can deduct must be reduced by 55% $[(\$65,500 - \$60,000) \div \$10,000]$. This leaves an allowable deduction for adjusted gross income of \$1,350 $[\$3,000 - (\$3,000 \times 55\%)]$.

Because Angela is not covered by an employer-sponsored pension plan, and their total adjusted gross income does not exceed \$150,000, she may contribute \$3,000 and deduct the entire contribution for adjusted gross income. Therefore, their maximum contribution is \$6,000 and their maximum deduction is \$4,350.

Instructor's Note: Carlos's deductible contribution will be fully phased-out when their AGI exceeds \$70,000. When their AGI exceeds \$150,000, Angela's deductible contribution would begin to be phased-out and would be fully phased-out when AGI exceeds \$160,000.

66. Chanda is 36, single, and an active participant in a qualified employee pension plan. Determine the maximum Roth IRA contribution that she can make in each of the following cases:
- a. Her adjusted gross income for the year is \$66,000.

A single taxpayer with an adjusted gross income of less than \$95,000 is allowed to make a \$3,000 nondeductible contribution to a Roth IRA. Therefore, the maximum Chandra is allowed to contribute to her Roth IRA is \$3,000. This assumes that she did not make any contributions to other IRA accounts during the year.

- b. Her adjusted gross income for the year is \$102,000.

When a taxpayer's adjusted gross income exceeds \$95,000, the amount that can be contributed to a Roth IRA is phased out ratably until no contribution is allowed when adjusted gross income equals \$110,000. The amount of Chandra's Roth IRA deduction must be reduced because her adjusted gross income exceeds the \$95,000 phase-out level. Therefore, she must reduce the amount she contributes by 46.67% $[(\$102,000 - \$95,000) \div \$15,000]$ and can contribute only \$1,400 $[\$3,000 - (\$3,000 \times 46.67\%)]$ to her Roth IRA.

- c. Her adjusted gross income for the year is \$126,000.

Because Chandra's adjusted gross income exceeds \$110,000, she is not allowed to make a contribution to a Roth IRA.

- d. Her adjusted gross income for the year is \$44,000, and she made an \$1,800 contribution to a deductible IRA account.

The maximum amount that a taxpayer can contribute to all of his or her IRA accounts is \$3,000. Because Chandra made an \$1,800 contribution to another IRA account, the maximum amount that she can contribute to her Roth IRA is \$1,200 (\$3,000 - \$1,800).

72. Simon graduated from Lessard University last year. He financed his education by working part-time and borrowing \$16,000. During the current year, he pays \$1,400 of interest on his student loan.

- a. What amount can Simon deduct as student loan interest if his adjusted gross income is \$33,000?

Simon can deduct the \$1,400 of student loan interest for adjusted gross income. A qualified education loan is one that is used to pay for tuition, fees, room and board, and other necessary expenses. The maximum amount of interest that can be deducted is \$2,500. Any amount in excess of the maximum is considered personal interest (discussed in Chapter 8) and is not deductible. The interest deduction is phased out ratably for single taxpayers with adjusted gross income between \$50,000 and \$65,000.

- b. What amount can Simon deduct as student loan interest if his adjusted gross income is \$62,000?

The maximum amount of student loan interest that can be deducted is phased-out ratably when adjusted gross income exceeds \$50,000. Since his adjusted gross income is greater than \$50,000 the amount that he can deduct must be reduced by 80% [(\$62,000 - \$50,000) ÷ \$15,000]. This leaves him with an allowable deduction for adjusted gross income of \$500 [\$2,500 - (\$2,500 x 80%)]. The remaining \$900 (\$1,400 - \$500) of interest is personal and is not deductible.

73. Myron graduates from college this year and lands a job with the Collingwood Corporation in Dallas. After accepting the job, he flies to Dallas to find an apartment. Myron uses \$2,000 his grandmother gave him as a graduation gift to pay a moving company to transport his household goods from Atlanta. He doesn't drive directly to Dallas but goes via Panama City to vacation with friends. In going to Dallas via Panama City, he incurs the following expenses:

Transportation of household goods	\$2,000
Lodging	675
Meals	330
Mileage (1,560 miles @ 12 cents per mile)	187
House-hunting trip:	
Airfare	325
Lodging	165
Meals	110

The expenses listed include \$375 for lodging and \$230 for meals in Panama City. The

direct mileage between Atlanta and Dallas is 1,340 miles. When Myron arrives in Dallas, he is informed that the moving van has mechanical problems and will not arrive for two days. Instead of sleeping on the apartment floor, he stays in a local hotel, paying \$55 per night; he also spends \$60 for meals. What is Myron's allowable moving deduction?

Myron can deduct \$2,461 of moving expenses for adjusted gross income.

Transportation of household goods	\$ 2,000
Lodging during move (\$675 - \$375)	300
Transportation (1,340 x \$.12)	161
Total	<u>\$ 2,461</u>

Myron can only deduct his direct moving expenses. Direct moving expenses include the cost of moving household goods and personal effects to the new residence, and the transportation and lodging costs of Myron moving from his old residence to his new residence. His mileage is deductible at \$.12 per mile. However, Myron can only deduct the direct mileage from Atlanta to Dallas. The additional mileage via Panama City is personal. The housing hunting expenses, the hotel costs upon arriving in Dallas, and all his meal expenses are considered personal in nature and are not deductible. The \$2,000 gift from his grandmother is not taxable and does not affect the amount of his deductible moving expenses.

76. Salvador is an insurance representative for the Hendricken Insurance Company. Recently, he heard that the controller of his largest account, Gore Plastics, was asking other insurance representatives to submit quotes on the cost of providing workers' compensation insurance for the company. Hendricken's contract with Gore is due to expire in two months. Knowing that the controller of Gore is an avid golfer, Salvador sends him the new Big Whomper Driver. The golf club costs \$350. Salvador submits the bill for the golf club to the company, and the expense is approved for reimbursement by the vice president of finance.

The issue is whether the Hendricken Company can deduct the cost of the golf club as an ordinary and necessary business expense. The deduction for business gifts is limited to \$25. Therefore, the Hendricken Company will only be allowed a deduction of \$25 for the golf club. Because Salvador's intent in making the gift has a business purpose -- retaining Gore as a client -- the controller of Gore must include the value of the golf club in gross income. It does not qualify as an excludable gift.

80. Jake loaned his cousin, Arnold, \$10,000 in March 2001 to open a cybercafe in Santa Barbara. Arnold signed a loan agreement to pay Jake 7% interest annually, with the principal due in 2006. Jake received his 2001 interest payment but did not receive any interest payment in 2002. In March 2003, Jake's father informs him that his cousin has filed for bankruptcy.

There are three potential issues. The first is whether the loan is a valid bad debt. Assuming it is a valid bad debt, the second issue is whether the debt is a business or nonbusiness bad debt. The third issue is when (i.e., what year) the bad debt is deductible. It appears that the loan is a valid debt since it contains a written promise to pay, a stated interest rate, and a date for repayment. Because the loan is not related to Jake's business, the loan is considered a nonbusiness bad debt and is deductible as a short-term capital loss in the year in which the actual amount of the loss is known. Therefore, Jake will be entitled to a bad debt deduction (i.e., short-term capital loss) when the bankruptcy proceedings are concluded.