Using the courts' method, the taxpayer has no net rental income and personal itemized deductions of $12,534.

Clearly, the court position is more favorable to the taxpayer in many instances.

EXHIBIT 8.2 **HOME OWNERSHIP CLASSIFICATION FOR INCOME TAX PURPOSES**

- Personal residence
- Second home
- Vacation home (rental less than 15 days)
- Mixed-use vacation home (>14 days of rental; personal use more than the greater of 14 days or 10% of rental days)
- Rental homes (>14 days of rental; personal use less than the greater of 14 days or 10% rental days)

EXPENDITURES

Unless otherwise provided in the Code, personal expenses are not deductible. Most itemized deductions, and some adjustments to income (such as the tuition and fees deduction and student loan interest), are personal expenses that Congress has permitted taxpayers to deduct to further policy goals. For example, Congress considers home ownership to be a worthy goal, so it allows taxpayers to deduct mortgage interest and real estate taxes paid on their personal residence and one vacation home. Ownership of a personal residence is not active conduct of a trade or business or an activity entered into for profit, so without the special exception in the Code, expenses associated with home ownership would not be deductible.

SPECIFIC DEDUCTIONS

This section of the chapter will address limitations on the following specific deductions:

- Bad debts
- Worthless securities
- Section 1244 stock
- Losses of individuals
- Research and experimental expenditures
- Net operating losses
- Depreciation

Case Study 8.3

Bad Debt Expenses

Todd A. and Carolyn D. Dagres, Petitioners v. Commissioner of Internal Revenue, Respondent, 136 T.C. No. 12 (March 28, 2011).

Todd is a manager of Venture Capital Funds. In 2000, he made a loan of $5 million to Mr. Schrader, a business associate, who provided leads on companies in which the Venture Capital funds might invest. The loan was re-negotiated in 2002, and Mr. Schrader stopped making payments in 2003. In settlement of the debt, Mr. Schrader transferred some securities to Todd in 2003. Todd claimed a $3,635,218 business bad debt deduction on his 2003 income tax return. The IRS issued a notice of deficiency for 2003, disallowing the deduction as a business bad debt, and assessing $981,980 in income tax plus an accuracy related penalty of $196,369. The IRS claimed that "the debt was a non-business bad debt because it was a personal loan and not created in connection with your trade or business… accordingly, taxable income is increased by $3,635,218." While the IRS did not completely disallow the loss, the notice of deficiency attempted to classify it as a personal bad debt, which would be treated as a short term capital loss, resulting in no tax benefit to Todd in 2003.

The court held that since Todd was in the trade or business of managing Venture Capital Funds, his bad debt loss was proximately related to that trade or business, and therefore the loss on the loan qualifies as a business bad debt deduction under IRC §166(a). The court considered the loan proximately related to Todd's trade or business because his "dominant motivation for lending $5 million to Mr. Shrader was to gain preferential access to companies and deals to which Mr. Schrader might refer him, so that ... [Todd] could use that information in the Venture Capital activities." Since the dominant motivation for the loan was business related, the debt could be classified as a business bad debt (and, therefore, could be deducted in full against other income) as opposed to a personal bad debt (which is required to be treated as a short term capital loss, subject to the $3,000 loss limitation rule for a given tax year).

Bad Debts

The tax benefits and classification of bad debts depends on whether the bad debt is a business or personal bad debt.

Business bad debts are only deducted if the taxpayer uses the accrual method of accounting. If the business is a cash-basis taxpayer, income would not have been reported if it was not received. One of the general rules of income taxation is that deductions can only be taken for amounts brought into income, so if the taxpayer is a cash-basis taxpayer, no income would have been reported and no deduction will be permitted.

EXAMPLE 8.10

Bruce is a CPA. He prepared Cindy's tax return and sent her a $2,000 bill for the work. Cindy refused to pay because it took Bruce 8 months to complete the return. Cindy has since disappeared. If Bruce is an accrual-basis taxpayer, he includes the $2,000 in income upon the completion of the tax return then writes it off when he discovers that he cannot collect. If Bruce is a cash-basis taxpayer, he does nothing because he has not yet recognized the $2,000 as income.

EXAMPLE 8.11

MedCare Clinic is an accrual basis taxpayer and has a $10,000 receivable from a drug company. The drug company files for bankruptcy and the clinic now expects to recover only $1,000 of the outstanding balance ($0.10 on the dollar) next year. The clinic can deduct $9,000 this year. If they only collect $500 next year instead of the expected $1,000 then they can deduct the additional $500 next year.

Businesses that use the accrual method of accounting report income when it is earned (when all events necessary to earn the income have been performed), not when it is received. Accrual method taxpayers may deduct bad debts to offset income reported but not received.

Most businesses are required to use the specific charge-off method, which allows the business to deduct the bad debt as an ordinary loss in the year in which the debt becomes partially or wholly worthless. An ordinary loss deduction is allowed, since accrual accounting subjected the income earned but not received to ordinary income tax in the year in which the income was reported. The only way to offset this ordinary income inclusion is to allow an ordinary loss deduction.

Key Concepts

Underline/highlight the answers to the following as you read:

1. Describe the circumstances under which bad debts are deductible.
2. Explain the rules for taking a loss on a worthless security.
3. Describe the special tax treatment available for Section 1244 stock.
4. Explain the net operating loss rules.

Some businesses (such as financial institutions) are permitted to use the **reserve method** of bad debt deductions, allowing them to take a bad debt deduction based on a percentage of accounts receivable representing the historical percentage of accounts that go bad.

If the bad debt is classified as a nonbusiness bad debt, the **specific charge-off method** must be used. A nonbusiness bad debt deduction is allowed only when the debt becomes wholly worthless, and is always treated as a short-term capital loss. No deduction is permitted for partial worthlessness when the debt is a nonbusiness bad debt.

Worthless Securities

On occasion (hopefully not too often) an investor will purchase a security that later becomes worthless. These taxpayers are entitled to take a loss on a security that becomes worthless during the taxable year. IRC §165 creates an artificial sale date on the last day of the taxable year in which the security becomes worthless. For most taxpayers, since they are cash basis taxpayers, the artificial sale date will be December 31. Fiscal year taxpayers may have a different artificial sale date.

The impact of the artificial sale date is to classify the loss as a long-term loss unless the taxpayer either purchased the investment in the same year that it became worthless, or purchased it on the last day of the tax year preceding the security becoming worthless (a holding period of exactly one year is not considered long-term).

Example 8.12

Kelly, an avid reader, purchased common stock in Jane Austin Industries, Inc. on February 1 of this year. On August 30 of this year, the company announces that it is filing Chapter 7 bankruptcy and that the common shareholders should not expect to receive anything on liquidation of the corporation. Since the stock became worthless during the year, there will be a constructive sale of the stock on December 31, and Kelly will be able to claim the amount she invested (her basis) as a loss deduction this year. The loss will be a short-term capital loss, since she held the stock for less than a year as of the artificial sale date.

Example 8.13

John purchased common stock in Satellite Television, Inc. on December 31 of last year. On August 30 of this year, the stock became worthless. A constructive sale will occur on December 31 of this year, and John will be able to claim the amount he invested (his basis) as a loss deduction this year. The loss will be a short-term capital loss, since he held the stock for exactly one year (not more than one year) on the date of the artificial sale.

EXAMPLE 8.14

Randy purchased 100 shares of Yankees Inc. on October 1 of last year. Unfortunately, Yankees Inc. has had some trouble, and became worthless on March 1 of this year. A constructive sale will occur on December 31 of this year, and Randy will be able to claim the amount he invested (his basis) as a loss deduction this year. The loss will be a long-term capital loss, since he is deemed to have held the stock for more than one year as of the artificial valuation date. If Randy was able to take the loss based on the day that Yankees Inc. shares became worthless, he would have been able to classify the loss as a short-term capital loss, which would potentially offset higher taxed income (recall that short-term capital gains are taxed at ordinary income tax rates, while the maximum long-term capital gains rate is 20%).

In the Yankees, Inc. example above, note that the tax benefits of the transaction may be affected by the creation of an artificial sales date. As a practical matter, some brokers will allow clients to sell worthless securities for a penny to book the transaction as a sale. While the client will not receive any cash from the transaction, the sale occurs on the actual trade date instead of on the artificial trade date presumed under IRC §165. Selling the worthless security in a book transaction can, in certain circumstances, allow the taxpayer to categorize the loss as a short-term capital loss.

EXAMPLE 8.15

Use the same facts as the prior example, with the exception that, on September 15, Randy sold the shares of Yankees, Inc. for a penny through his broker. When Randy completes his tax return, he will show a short-term capital loss for Yankees, Inc. since he did not hold the shares for more than one year as of the sale date, September 15 of this year. If Randy had other short-term capital gains this year, the loss of Yankees, Inc. would offset those short-term capital gains taxed at ordinary tax rates, generating a larger tax benefit for Randy compared to using the loss to offset long-term capital gains taxed at the 20% rate.

Case Study 8.4

Wash Sale and Worthless Securities

Stephen and Ann Schwalbach, Petitioners v. Commissioner of Internal Revenue, Respondent. 111 T.C. No. 9 (September 8, 1998).

Stephen Schwalbach (Dr. Schwalbach) practiced dentistry in River Falls. He was employed full time by Associated Dentists of River Falls, f.k.a. River Falls Dental Association (Associated Dentists), a personal service corporation that he owned equally with another dentist named Timothy Knotek.

On June 21, 1993, Dr. Schwalbach paid $16,050 for a 5/6 interest in 6,000 shares of stock in a corporation named Impression Delivery Corp. (Impression); the total purchase price was $19,266. Approximately 3 weeks later, the 6,000 shares were sold for $7,374, and 6 days after the sale, Dr. Schwalbach purchased an interest in another 4,100 shares of Impression. The Schwalbachs did not recognize a loss in 1993 on the sale of the stock because his CPA considered the purchase-sale-purchase as a "wash sale" under §1091. In 1994, the Schwalbachs, upon the advice of the CPA, reported a short-term capital loss of $16,050 on their 1994 Schedule D, Capital Gains and Losses, with respect to Impression's stock. The CPA rendered his advice after ascertaining that Impression had ceased operations and was facing litigation over allegedly fraudulent practices.

The IRS disallowed the $16,050 loss reported by the Schwalbachs. According to the notice of deficiency, "It has not been established that the company known as Impression Delivery Corp. was insolvent or out of business in the year 1994. Further, it has not been established that you had an adjusted basis in this company in order to claim this loss." The Schwalbachs ultimately conceded that they may not deduct this loss for 1994.

The burden of proving that a security is worthless falls on the taxpayer. Generally, a taxpayer must establish that the securities had value at the beginning of the tax year, that the securities became worthless during the year and that there was an identifiable event that caused the worthlessness.

SECTION 1244 STOCK

Much of the economic growth experienced in the United States is due to the operation of small businesses. Small businesses are riskier from an investment perspective, since they are often subject to strict competition and have an unproven business track record.

To encourage investment in small business enterprises, Congress enacted Section 1244 of the Code, which allows the first $50,000 of losses ($100,000 for taxpayers who are married filing jointly), per year, on Section 1244 stock to be classified as an ordinary loss instead of a capital loss. Any additional loss incurred on the stock would still qualify as a capital loss.