

DIVIDENDS

Dividends to shareholders are taxable only to the extent the payments are made from either Net Income (current earnings and profits) or Retained Earnings (accumulated earnings and profits).

- Return on Investment: EARNINGS AND PROFITS
 - Return of Investment: CAPITAL
 - Capital Gain: LIABILITIES
- } cannot be chosen by a taxpayer

When a corporation issues a simple stock dividend, the shareholder does not realize income. However, if the shareholder has the option of receiving cash instead, he/she must realize the value of the stock received, rather than the cash rejected.

TAX BENEFIT RULE

If a taxpayer obtains a deduction for an item in one year and in a later year recovers all or the portion of the prior deduction, the recovery is included in gross income in the year received.

Example: In 1999 Mimi deducted as a loss a \$1,000 receivable from the customer when it appeared the amount would never be collected. The following year, the customer paid \$700 on the AR. Mimi must report that \$700 as gross income in 2000.

INCOME FROM DISCHARGE OF INDEBTEDNESS

A transfer of appreciated property (FMV > AB) in satisfaction of debt is an event that triggers the realization of income. It is similar to a sale of appreciated property followed by payment of debt.

Example: Jack owes Washington Mutual \$100,000 on a secured note. He satisfies the note by transferring to the bank a common stock with AB = \$60,000 and FMV = \$100,000. Jack must recognize a \$40,000 gain on the transfer.

If the creditor doesn't exercise his/her right to foreclosure (forgives the debt), the debtor will realize income from discharge of indebtedness, unless it is a gift, bankruptcy discharge, student loan or seller's cancellation of buyer's indebtedness.

Example: Eagle Electrics is unable to meet the mortgage payments on its factory building. Knowing about the depressed market for industrial property in the area, mortgage holder agrees to forgive all amounts past due and to reduce the principal amount of the mortgage. Forgiven portion of the debt will be taxable to Eagle Electronics as ordinary income and reduction of mortgage payment is going to reduce the adjusted basis in the asset.

Example: Michael owes Apple Bank \$100,000 on unsecured note. Unable to meet his payments, he transfers to the bank a common stock with AB = \$60,000 and FMV = \$95,000. In this case, \$35,000 will be taxed as a gain on transfer and \$5,000 will be treated as ordinary income.

CLASSIFICATION OF DEDUCTIBLE EXPENSES

The Tax Law has an all-inclusive definition of income – income from whatever source derived is included in gross income. Income cannot be excluded unless there is a specific statement to that effect in the Internal Revenue Code. Similarly, deductions are disallowed unless a specific provision in the tax law permits them. Deductions *for* AGI can be claimed whether or not the taxpayer itemizes. Deductions *from* AGI result in a benefit only if they exceed the amount of standard deduction. Deductions *for* AGI are also important in determining the amount of itemized deductions because many of itemized deductions are subject to limit to a certain floor.

DEDUCTION FOR AGI

- Deductions for trade and business expenses allowed by §162
- Deductions that result from losses on the sale or exchange of property
- Deductions attributable to property held for the production of rents and royalties
- Deduction for payment of alimony
- Expense reimbursements (from employee) in connection to performance of services
- Deductions for contributions to traditional IRA, etc.

DEDUCTIONS FOR TRADE AND BUSINESS EXPENSES

In order to be deductible, a business expense must be *ordinary* (within the scope of business), *necessary* (prudent person would incur the same expense), and *reasonable* (in amount).

What is a trade or business expense? It includes allowance for salaries or other compensation, travel and rental expenses. To qualify as a trade or business activity Common Law requires:

- (1) Expectations to make profit;
- (2) Regularity and consistency of trade or business;
- (3) Active participation.

Certain business expenses are not permitted under §162, such as charitable contributions, illegal bribes, fines and penalties.

What about expenses relating to an illegal business? All allowable expenses are treated in the same way as any legal trade or business. Exception is the case of drug trafficking - only the cost of material may be deducted for AGI.

TIMING OF EXPENSE RECOGNITION

A taxpayer's accounting method is a major factor in determining taxable income. The expenses of *cash basis* taxpayer are deductible only when they are actually or constructively paid with cash or other property. Promissory note does not satisfy this requirement. The period in which *accrual basis* taxpayer can deduct an expense is determined through *all events test* (to create taxpayer's liability), *estimation of expenditure* (amount can be determined) and *the economic performance test*.

Example: On December 22, 2002, Subliminal Records sponsored a Christmas party in Silvercup Studios. Huang Cleaning was paid \$1,500 to clean up the auditorium after the event. Since the studio is closed over the Christmas, Huang's cleaners did not perform the job until January 3, 2003. The expense is deductible in 2002, when it was paid for. However, should Subliminal have had an accrual basis of accounting, they will deduct the expense in 2003 - when the events occurred.

What about prepaid contracts? If the benefits of the expenditure are to be consumed by the end of the second year, current deduction of the entire amount is allowed. If benefits extend to the third year, only the portion attributable to the year of payment may be deducted (like amortization expense calculation).

BUSINESS INVESTIGATION

Investigation expenses are expenses paid or incurred to determine the feasibility of entering a new business or expanding an existing one. If the taxpayer is in a business *same as* or *similar to* that being investigated, all investigation expenses are deductible in the year paid or incurred. When the taxpayer is not in a business that is the same as or similar to the one being investigated, the tax result depends on whether the new business is acquired or commenced. If actual acquisition or commencement occurs, the expenses must be capitalized or amortized over the period of 60 months or more. If new business does not launch, the deduction is not allowed.

HOBBY LOSSES

Business or investment expenses are deductible only if the taxpayer can show that the activity was entered into for the purpose of making a profit. Hobby loss rule applies if the activity is not engaged in for profit and the expenses are deductible to the extent of hobby income. In addition, the Code provides a *rebuttable presumption* that an activity is profit seeking, if it shows profit 3-out-of-5 years (exception for horse-breeding activity presumption is 2-out-of-7 years).

Hobby expenses must be deducted in the following manner:

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|--|---|--|
| <ol style="list-style-type: none"> (1) Otherwise deductible expenses (2) Expenses that do not affect AB (3) Depreciation and amortization | } | Itemized Deduction, subject to 2% of AGI |
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RENTAL OF VACATION HOMES

Since the Code allowed "above the line" deduction of all expenses attributable to property held for the production of rents and royalties, taxpayers were tempted to deduct essentially personal expenses as rental losses.

Primary Personal Use: If the residence is rented for fewer than 15 days in a year, the rent income is excluded from gross income (without limitations) and otherwise deductible expenses (mortgage interest and property taxes) are deductible.

Primarily Rental Use: If the residence is rented for 15 days or more in a year and is not used for personal purposes for more than 14 days (or 10% of total days rented), all business expenses may be deducted "above the line", including depreciation and maintenance.

	Percentage of Use	
	80% Rental	20% Personal
Income	\$ 4,800	\$ -
Expenses		
Mortgage Interest (\$6,000)	(4,800)	(1,200)
Property Taxes (\$500)	(400)	(100)
Maintenance (\$1,500)	(1,200)	(300)
Depreciation (\$2,400)	(1,920)	(480)
Total Expenses	<u>\$ (8,320)</u>	<u>\$ (2,080)</u>
Rental Income (Loss)	<u>\$ (3,520)</u>	<u>\$ -</u>

- Taxpayer deducts the \$3,520 rental loss “above the line”.
- Property taxes of \$100 can be used for itemized deduction, but mortgage interest of \$1,200 is not. The cottage is not a qualified residence.
- The portion of maintenance and depreciation attributable to personal use is not deductible.

Personal/Rental Use: If the residence is rented for 15 days or more and is used for personal purposes for greater of 14 days or 10% of days rented, expenses will be allocated between personal days and rental days. Business expenses must be deducted in the same layers as hobby expenses, but they must be allocated between personal and rental days before the limits are applied.

	IRS Method 60/90	Court Method 60/365	
Gross Income	\$ 10,000	\$ 10,000	
Mortgage Interest (\$12,410)	<u>(8,273)</u>	<u>(2,040)</u>	
Remainder	1,727	7,960	
Maintenance (\$2,400)	<u>(1,600)</u>	<u>(1,600)</u>	
Balance	127	6,360	} assuming 60/90, not 60/365
Depreciation (\$9000)	<u>(127)</u>	<u>(6,000)</u>	
Rental Income	<u>\$ -</u>	<u>\$ 360</u>	

→ (\$6,000) is limited to income

CONVERSION TO RENTAL PROPERTY

If a personal property is rented or held available for rental for at least 12 consecutive months, it may be allowed to be treated as “Primarily Rental Property”. The period begins or ends in the taxable year in which the residence is rented or held for rental at a fair price. The residence must not be rented to a related party.

TRANSACTION BETWEEN RELATED PARTIES

Since IRS views family as a single unit, it places restriction on the recognition of gains and losses from related party transactions. Without these restriction, relationships created by birth, marriage and business would provide endless possibilities for engaging in financial transaction that produce tax savings with no real economic change. Uncles & aunts, cousins and nieces & nephews are not considered to be related parties for the purposes of this restriction.

The Code provides for the disallowance of any losses from sales of property directly or indirectly between related parties. When the property is subsequently sold to a nonrelated party, any gain recognized is reduced by the loss previously disallowed (up to the gain).

Example: Frida sells common stock with a basis of \$1,000 to her brother Ralph for \$800. Ralph sells the stock several years later for \$1,150. Frida's \$200 is disallowed upon the sale to Ralph, and only \$150 of gain is taxable to him upon the subsequent sale.

GOODWILL VERSUS THE COVENANT NOT TO COMPETE

On the sale of the property where the sales price exceeds the FMV of the asset, a planning opportunity may exist for the seller and the buyer.

BUYER: Because both a covenant and goodwill are capitalized and amortized over a period of 15 years, the tax result of a covenant and goodwill are similar.

SELLER: Sale of goodwill is treated as a capital gain, whereas a covenant not to compete as ordinary income.

Therefore, in negotiation the sales price, should factor in the tax benefit to the seller of having the excess amount labeled goodwill rather than a covenant not to compete. Of course, if the noncompetitive aspects of a covenant are important to the buyer, part of the excess amount can be assigned to a covenant.

MUNICIPAL BONDS AND INTEREST EXPENSE

As we have studied in the previous chapters, interest received from municipal bonds is exempt from taxes. But we have just learned that interest expense may be deducted as a business expense. Deduction disallowance provisions, however, make it impossible to make money at the expense of the government by excluding interest income and deducting interest expense (no arbitrage).

BAD DEBTS

Noncollectible debt is a type of incurred by all businesses. We must distinguish business bad debts (from the business of lending money) from personal bad debts. The Code allows “above the line” deduction in both cases; however, the timing of deduction is different.

Business Bad Debt is deductible as an *ordinary loss* in the year incurred. The deduction can be taken in the year of *partial* or *total worthlessness* (no need for final settlement).

Personal Bad Debt is deductible only in the year of *total worthlessness*. Partial bad debt is not deductible unless there is a *final settlement*. Nonbusiness bad debt is treated as a *short-term capital loss* subject to all limitation.

Bankruptcy is generally an indication of partial worthlessness of the debt, but it is not necessarily a final settlement in itself.

WORTHLESS SECURITIES

Worthless securities are not same as penny stocks; they are completely worthless. A loss is allowed during the year of worthlessness, and it is treated as capital loss deemed to have occurred on the last day of the taxable year.

Example: Wilson bought \$3,000 stocks of Wolt Corporation on May 1, 2001. The company went bankrupt and the stock became worthless on April 1, 2002. Since we deduct the capital loss on the last day of the taxable year, we will treat \$3,000 as long-term capital loss (May 1, 2001 – December 31, 2002 = 19 months).