Common Loss Limitations and Disallowances

personal expenditures

Generally not deductible some exceptions apply, usually not associated with public policy concerns • interest and taxes on personal residence and one additional home **public policy limitations**

activities that violate public policy do not generate tax deductions

- penalties fines bribes and kickbacks non deductible even
- when customary foreign corrupt practices act
- political contributions, excessive compensation, hobby losses, rental of vacation
    - homes
    - **Illegal Activities and Income taxation**

illegal business expenses deductible as if business were legal fines

- and bribes still non deductible trafficking in controlled
- substances (drugs) only cost of goods sold is a deductible

business expense

- applies to trafficking marijuana where such activity is legal according to state law
    -

Political and Lobbying expenditures

General Rules • no business or personal deduction is allowed for political contributions

Deductions are allowed for lobbying:

- to monitor legislation and de minimis in house
- expenses (limited to 2,000) if greater than 2,00

  n0ne can be deducted

Excessive Executive Compensation

For publicly held corporations:

- CEO, principal financial officer (and anyone who holds one of these positions at any time during the taxable year) and the three highest compensated executives salaries are deductible up to 1 million each

Does not include payments to qualified

- retirement plans payments excludible from
- gross income

Hobby Activity

activity not entered into for profit personal

- pleasured associated with activity examples
- raising dogs
  - 8 gardening

sometimes difficult to determine if an activity is profit motivated or a hobby

Profit Pursuit Factors

- manner activity is managed time and effort
- expended expertise of taxpayer and advisors
- taxpayers success in similar activities history of
- profit/loss in similar activities amount of occasional
- profits generated expectation that assets will
- increase in value financial status of taxpayer
- whether personal pleasure dictates involvement
-

Presumptive Rule of Section 183

If activity shows profit 3 out of 5 years (2 out of 7 years for horses) presumption is that taxpayer has a profit motive rebuttable presumption shift burden of proof to IRS to show that

- the taxpayer did not have a profit motive other taxpayer has burden to prove profit
- motive **hobby vs for profit activities**

Profit activity deduct expenses above the line

- at risk and passive loss rule may apply
- hobby activity income is included
  - above the line expenses (prior to
  -

2018) allowed only to extent of income

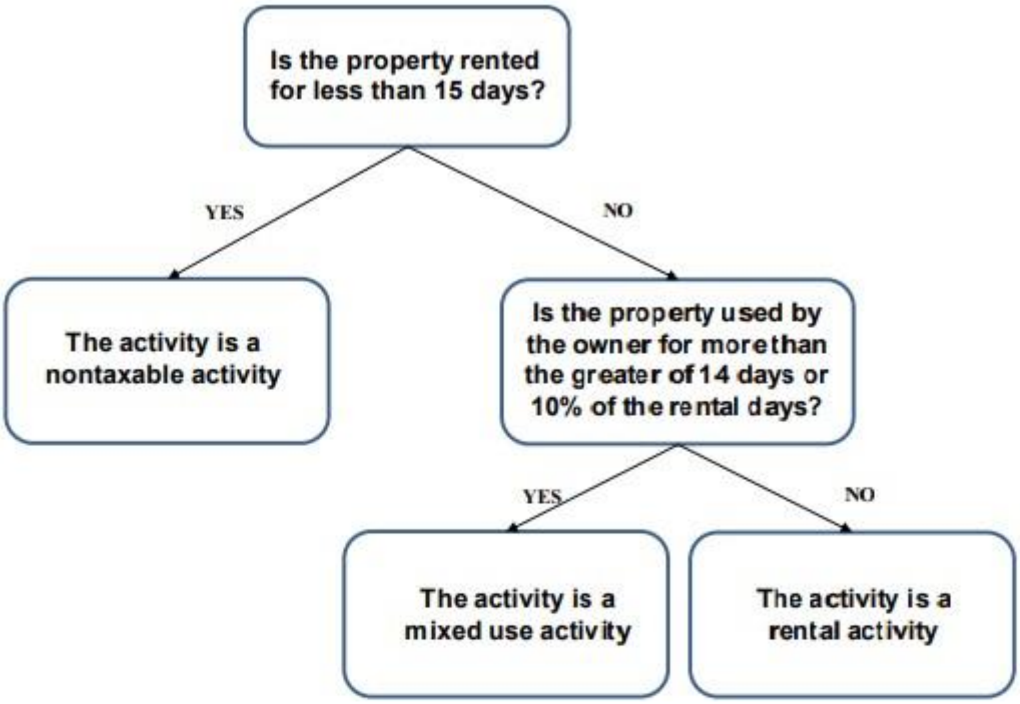
deducted below the line

- subject to the 2% floor
  - unless deductible without regard to profit motive (such as mortgage interest and taxes)

Classification of Rental Real estate activities

Types of rental real estate non

- taxable rental use primarily
- rental use mixed use
- Personal use real estate tax rules
- differ personal residences second
- homes



Non taxable rental activity

Rental for less than 15 days income is

realized but no recognized no expenses

may be claimed • mortgage interest and

property taxes (up to 10,000) treated as

personal expenses may be claimed on a

schedule A (itemized deductions)

Primarily Rental Use vacation home

characteristics rented for more than 14 days

- personal use is not more than greater
- of
    - 14 days
    - 10% of rental days

Tax consequences income is recognized all allocable expenses are

- deductible, even if it results in a loss ability to claim loss may be
- limited by passive activity rules
-

Mixed used vacation homes

characteristics rented for more than 14 days

- personal use is greater than greater
- of:
    - 14 days
    - 10% of rental days **tax consequences** income is

recognized allocable expenses are deductible to extent of

- income tier rules form hobby loss expenses apply
- 2% floor does not apply (as was the case with hobby losses pre 2018) - the
    - expenses are deducted above the line o unused expenses can be carried forward
    - EXAMPLE

Keegan spends relatively little time at his beach home, and rents the home out for 200 days during the year. Identify if the rental activity will be classified as a rental or mixed use activity

Personal Use	Classify As:	
	Rental Use	Mixed Use
7 days	X	
18 days	X	
25 days		X

Rental vacation homes

expenses allocation (personal v rental) mortgage

- interest and taxes
  - IRS requires allocation based on total days used courts have
  - allowed allocation based on days in the year (365) other expenses
- allocated based on total days used

Limitations of specific deductions

1. bad debts
2. worthless securities
3. section 1244 stock
4. losses of individuals
5. net operating losses (NOLs)
6. depreciation

Limitation on bad debts

Business bad debts only deductible if accrual method of accounting is used generally

- required to use specific charge-off method in year the debt becomes partially or
- wholly worthless o some business can use the reserve method

Personal bad debt

- specific charge of method must be used allowed only when debt is wholly
- worthless always treated as short term capital loss, regardless of holding
- period related party debts are suspect and are usually treated as gifts
-

Classification of bad debts

determination of whether bad debt is business or personal is made at the time debt is

created individuals have non-business bad debts unless:

- in the business of loaning money or bad debt is associated with
- the individuals trade or business

Worthless securities

loss deduction allowed for securities that becomes worthless during the year artificial sale

- date: last day of the year in which the securities became worthless for individuals
  - (cash-basis taxpayers) this is December 31st
  - causes holding period to be short term unless the security was purchased prior to the last day of the preceding year

Section 1244 stock

stock may be classified as section 1244 stock if it is held by original purchaser the initial

- capitalization of the company was 1 million or less tax treatment if sold at a loss, the
- first 50,000 (100,000 for MFJ) each year is treated as an ordinary loss excess losses

for year follow normal capital loss rules section 1244 does not apply to gains

- EXAMPLE
  - In 2017, Kasey (a single mom) purchased a 20% interest in a newly organized
  - company, Mishka Enterprises, Inc. for $100,000. Unfortunately, the company did not succeed, and Kasey’s interest became worthless in 2021. What are the tax
- consequences for Kasey?
- the first 50,00 of loss is treated as ordinary loss not subject to
  - limitation the remaining 50,00 of loss is treated as long term
- capital loss kaseys holding period was greater than 1 year
  - assuming that kasey had no other capital transactions for the year, she can deduct
- 53,000 on her 2021 income tax return

Losses by individuals

generally personal losses are not deductible • example: loss on sale of

personal residence is not deductible individuals can deduct losses

incurred in a trade or business incurred in a transaction entered into

- for profit
- caused by fire, storm, shipwreck, or other casualty or by theft (if the loss resulted from
- a presidentially declared disaster during tax year 2018-2025)

Net Operating Losses (NOL)

business losses are above the line deductions and offset future income

- losses from trade or business operations, casualty and theft, or foreign government confiscations can create a NOL

Carryback/forward rule

- NOL can be carried forward indefinitely
- NOL carryovers are allowed to be a claimed in taxable year up to the lesser of the
    - carryover amount
    - 80% of taxable income determined without regard to the deduction for NOLs

CARRYBACK OF NOLs IS NO LONGER PERMITTED TCJA 2017

Excess Business Loss limitation

after 2017 excess business losses are not permitted to be deducted by a

noncorporate taxpayer excess business losses are carried forward and add to a

taxpayers NOL the excess loss is the amount over 289,000 (578,000 for joint return)

in 2023

Depreciation

allowed for assets used in a trade for business an activity for the

- production of income represent return of capital • basis is
- returned to the owner over the useful life of the asset personal

assets and land are not depreciated • basis is returned to the owner

when the property is sold

Retirement Plan Penalties

Excess IRA contributions Penalty (too much) if 6% excise

- tax for contributing too much if corrected by due
- date of return, does not apply

Early Distribution Penalty (too early)

- 10% excise tax for taking early distribution
- 25% for SIMPLE plan distributions withing 2 years of entry
- Exceptions apply

Late distribution Penalty (too late) 50%

- excise tax for not taking enough
- must take distributions beginning at age 70.5, 72, 73 or 75 depending on year of birth

Applies to Distribution from:	Exception to 10% Early Withdrawal Penalty
Both Qualified Plans & IRAs	Death
Both Qualified Plans & IRAs	Attainment of age 59½
Both Qualified Plans & IRAs	Disability
Both Qualified Plans & IRAs	Substantially equal periodic payments (Section 72(t))
Both Qualified Plans & IRAs	Medical expenses that exceeds 7.5% of AGI
Both Qualified Plans & IRAs	Tax levy
Both Qualified Plans & IRAs	Qualified birth distribution up to $5,000 for birth or adoption
Only Qualified Plans	QDRO or state order under divorce*
Only Qualified Plans	Attainment of age 55 and separation from service
Only Qualified Plans	Public safety employee separated from service after age 50
Only IRAs	Higher education expenses
Only IRAs	First time home purchase (up to $10,000)
Only IRAs	Health insurance for unemployed

Other loss disallowance

Temporarily Disallowed	Permanently Disallowed
Section 1031 Exchanges	Related Party Transactions
Wash Sales	Gifts Below Fair Market Value
	Loss on Sale of Personal Residence

Wash sale rules

applies when a taxpayer sells a security for a loss purchases a substantially smaller

- security withing 30 days before or after sale
- (61 days total)

tax consequences

- loss is not recognized added to the basis of the
    - replacement property
    -