Chapter 6

Individual Deductions

SOLUTIONS MANUAL

**Discussion Questions**

1. [LO 1] It has been suggested that tax policy favors deductions for AGI compared to itemized deductions. Describe two ways in which deductions for AGI are treated more favorably than itemized deductions.

*Itemized deductions must exceed the standard deduction before taxpayers receive any tax benefit from the deductions (this is equivalent to an overall floor limit). In contrast, business deductions that are deductible for AGI (above the line) reduce taxable income without being subject to an overall floor limit. Also, itemized deductions are subject to many mechanical limitations including ceilings and floors, whereas business deductions are generally not subject to these limits.*

2. [LO 1] How is a business activity distinguished from an investment activity? Why is this distinction important for the purpose of calculating federal income taxes?

*Both business and investment activities are motivated primarily by profit intent, but they can be distinguished by the level of profit-seeking activity. A business activity is commonly described as a sustained, continuous, high level of profit-seeking activity, whereas investment activities don’t require a high level of involvement. The distinction between business and investment activities is critical for determining whether a deduction associated with the activity is above or below the line, or even deductible. With one exception, business expenses are deducted for AGI. The lone exception is unreimbursed employee business expenses, which are not deductible. In contrast, investment expenses are deductible as itemized deductions, if deductible at all, with one exception. Expenses associated with rental and royalty activities are deductible for AGI regardless of whether the activity qualifies as an investment or a business.*

3. [LO 1] Explain why Congress allows self-employed taxpayers to deduct the cost of health insurance as a for AGI deduction when employees can only itemize this cost as a medical expense. Would a self-employed taxpayer ever prefer to claim health insurance premiums as an itemized deduction rather than a deduction for AGI? Explain.

*This deduction provides a measure of equity between employees and the self-employed. The cost of health insurance is essentially a personal expense. However, employees typically aren’t required to pay insurance premiums because their employers pay the premiums for them as a form of compensation. The employer is allowed to deduct the premium as a compensation expense, and the employee is allowed to exclude from taxable income the value of the premiums paid on his behalf. Thus, from the employee’s perspective, this arrangement has the same effect as if (1) the employer pays the employee cash compensation in the amount of the premium and (2) the employee pays the premium and deducts the expense for AGI (completely offsetting the compensation income). In contrast to employees, self-employed taxpayers pay their own health insurance costs, because they don’t have an employer to pay these costs for them. Absent a rule to the contrary, self-employed taxpayers would deduct their medical expenses as itemized deductions subject to strict limitations, because the cost of the health insurance is a personal expense rather than a business expense. To treat employees and self-employed taxpayers similarly, Congress allows self-employed taxpayers to deduct personal health insurance premiums as for AGI rather than itemized deductions. Thus, self-employed taxpayers are able to (1) receive business income and (2) use the business income to pay their health insurance premiums and deduct the premiums as a for AGI deduction (completely offsetting the business income they used to pay the premium). Given the preferential treatment of for AGI deductions relative to itemized deductions, a self-employed taxpayer should never prefer to claim health insurance premiums as an itemized deduction rather than a deduction for AGI.*

4. [LO 1] Explain why Congress allows self-employed taxpayers to deduct the employer portion of their self-employment tax.

*To put self-employed individuals on somewhat equal footing with other employers that are allowed to deduct the employer’s share of the social security tax. Hence, self-employed taxpayers are allowed to deduct the employer’s share of the self-employment tax.*

5.

10. [LO 2] Under what circumstances can a taxpayer deduct medical expenses paid for a member of his family? Does it matter if the family member reports significant amounts of gross income and cannot be claimed as a dependent?

*A taxpayer can deduct medical expenses incurred for members of his family if they are dependents (i.e., either qualified children or qualified relatives). For purposes of deducting medical expenses, a dependent need not meet the gross income test (§213(a)).*

11.

14. [LO 2] Describe the conditions in which a donation of property to a charity will result in a charitable contribution deduction of fair market value and when it will result in a deduction of the tax basis of the property.

*Taxpayers deduct the fair market value of property (noncash) donations when they donate:*

*(1) a capital asset that has appreciated in value (the value is greater than the basis of the property) and the taxpayer has owned the asset for more than a year before donating it (but see exceptions below), or*

*(2) appreciated business assets (value greater than basis) the taxpayer owned for more than a year before donating but only to the extent that the gain on the asset would not be treated as ordinary income if it had been sold.*

*However, the deduction for an appreciated capital asset that is tangible, personal property is limited to the adjusted basis of the property if the charity uses the property for a purpose unrelated to its charitable purpose.*

*Taxpayers donating ordinary income property (or capital loss property) deduct the lesser of (1) the fair market value of the property and (2) the adjusted basis of the property. Thus when the value of ordinary income property (or capital loss property) is less than the basis, taxpayers deduct the value.*

*Thus, taxpayers deduct the basis of the property when they contribute:*

*ordinary income property that has appreciated in value.*

*capital gain property donated to private nonoperating foundations (other than stock).*

*capital gain property consisting of tangible personal property and the charity uses the property (and the taxpayer should have reasonably expected that) for a purpose unrelated to the reason it is a charity.*

*appreciated business assets held more than a year to the extent that the gain would be recaptured as ordinary income under the depreciation recapture rules.*

15. [LO 2] Jake is a retired jockey who takes monthly trips to Las Vegas to gamble on horse races. Jake also trains race horses part time at his Louisville ranch. So far this year, Jake has won almost $47,500 during his trips to Las Vegas while spending $27,250 on travel expenses and incurring $62,400 of gambling losses. Explain how Jake’s gambling winnings and related costs will be treated for tax purposes.

*Jake’s $47,500 of gambling winnings is included in his gross income. The gambling losses and expenses (total of $89,650) are only deductible as an itemized deduction, limited to the amount of gambling winnings. Thus, only $47,500 will be deductible.*

16. [LO 2] {Research} Frank paid $3,700 in fees for an accountant to tabulate business information (Frank operates as a self-employed contractor and files a Schedule C). The accountant also spent time tabulating Frank’s income from his investments and determining Frank’s personal itemized deductions. Explain to Frank whether or not he can deduct the $3,700 as a business expense or as an itemized deduction, and provide a citation to an authority that supports your conclusion.

*Under Reg §1.67-1T(c), expenditures that relate to both a business activity (deductible for AGI) and the production of income or tax preparation (nondeductible) must be allocated between the activities on a reasonable basis. It would seem that billable hours would provide just such a basis.*

42. [LO 2] This year Randy paid $28,000 of interest on his residence (Randy borrowed $450,000 to buy his residence, and it is currently worth $500,000). Randy also paid $2,500 of interest on his car loan and $4,200 of margin interest to his stockbroker (investment interest expense). How much of this interest expense can Randy deduct as an itemized deduction under the following circumstances?

a. Randy received $2,200 of interest this year and no other investment income or expenses. His AGI is $75,000.

b. Randy had no investment income this year, and his AGI is $75,000.

*a. Randy can deduct $30,200. The interest on the car loan is nondeductible personal interest but Randy may deduct all $28,000 of his interest on the home loan as an itemized deduction because the loan is less than the limit of $750,000 on acquisition indebtedness. The deduction for the $4,200 of margin interest (investment interest expense) is limited to net investment income. Because the $2,200 of interest income qualifies as investment income and Randy has no deductible investment expenses, the investment interest expense would be limited to his $2,200 in net investment income. Randy would carry forward $2,000 to next year.*

*b. Randy may deduct all $28,000 of his interest on the home loan as an itemized deduction. Randy has no net investment income. Hence, the investment interest would not be deductible this year and would carry forward to next year.*

43. [LO 2] Janyce, a single taxpayer, has AGI of $125,000 and paid the following taxes this year. Calculate how much Janyce can deduct for taxes as an itemized deduction this year.

State income tax withholding $7,200  
 State income tax estimated payments 600  
 State income tax refund (applied to this year’s tax) 800  
 State automobile tax (based on car’s value) 1,900

*All of the above taxes are deductible ($7,200 + $600 + $800 + $1,900 = $10,500) but they are limited to a maximum deduction of $10,000.*



