KWALL, THE FEDERAL INCOME TAXATION OF INDIVIDUALS
CORRECTION TO QUIZ QUESTION

CHAPTER 9

CURRENT (**INCORRECT**) Q&A

Question 4

In 2016, Larry loaned $10,000 to his friend, Maria. Subsequent to making the loan, the friends grew apart and Maria never repaid Larry. Larry made many unsuccessful efforts to collect money from Maria. By the end of 2019, it was clear that the debt was worthless. As a result, Larry claimed a $10,000 bad debt deduction on his 2020 tax return. Is Larry entitled to a bad debt deduction?

A. Yes, and it was fine for Larry to claim the deduction on his 2020 tax return.

B. Yes, but Larry should have claimed the deduction on his 2019 tax return.

C. No.

Answer

A. Incorrect. The debt is a non-business debt. A non-business bad debt is a miscellaneous itemized deduction. Miscellaneous itemized deductions are not allowed for any tax year beginning before 2026. IRC § 67(g). Thus, Larry is not entitled to the deduction.

B. Correct. The debt is a non-business debt. A non-business bad debt is a miscellaneous itemized deduction. Miscellaneous itemized deductions are not allowed for any tax year beginning before 2026. IRC § 67(g). Thus, Larry is not entitled to the deduction. If a deduction were allowed, it should have been claimed on his 2019 tax return because the facts indicate that the debt was worthless by the end of 2019.

C. Correct. The debt is a non-business debt. A non-business bad debt is a miscellaneous itemized deduction. Miscellaneous itemized deductions are not allowed for any tax year beginning before 2026. IRC § 67(g). Thus, Larry is not entitled to the deduction.

CORRECTED Q&A

Question 4

In 2016, Larry loaned $10,000 to his friend, Maria. Subsequent to making the loan, the friends grew apart and Maria never repaid Larry. Larry made many unsuccessful efforts to collect money from Maria. By the end of 2019, it was clear that the debt was worthless. As a result, Larry claimed a $10,000 bad debt deduction on his 2020 tax return. Is Larry entitled to a bad debt deduction?

A. Yes, and it was fine for Larry to claim the deduction on his 2020 tax return.

B. Yes, but Larry should have claimed the deduction on his 2019 tax return.

C. No.

<u>Answer</u>

A. Incorrect. The debt is a non-business debt. IRC § 166(d) allows a deduction for non-business bad debts that become wholly worthless within the taxable year. The deduction is deemed to result from "the sale or exchange * * * of a capital asset held for not more than one year." IRC § 166(d)(1)(B). Because the deduction is attributed to a sale or exchange of property, the deduction is subtracted from gross income in arriving at adjusted gross income. See IRC § 62(a)(3). However, Larry claimed the deduction in the wrong tax year because the facts indicate that the debt was worthless by the end of 2019.

B. Correct. The debt is a non-business debt. IRC § 166(d) allows a deduction for non-business bad debts that become wholly worthless within the taxable year. The deduction is deemed to result from "the sale or exchange * * * of a capital asset held for not more than one year." IRC § 166(d)(1)(B). Because the deduction is attributed to a sale or exchange of property, the deduction is subtracted from gross income in arriving at adjusted gross income. See IRC § 62(a)(3). The deduction should be claimed on his 2019 tax return because the facts indicate that the debt was worthless by the end of 2019. The impact of attributing the deduction to the sale or exchange of a "capital asset held for not more than one year" will become clear when the topic of Characterization is explored in Chapter 16.

C. Incorrect. The debt is a non-business debt. IRC § 166(d) allows a deduction for non-business bad debts that become wholly worthless within the taxable year. The deduction is deemed to result from "the sale or exchange * * * of a capital asset held for not more than one year." IRC § 166(d)(1)(B). Because the deduction is attributed to a sale or exchange of property, the deduction is subtracted from gross income in arriving at adjusted gross income. See IRC § 62(a)(3).

Page 277 – Substitute the following for the Worth Noting:

WORTH NOTING - Non-business bad debts. IRC § 166(d) allows a deduction for non-business bad debts that become wholly worthless within the taxable year. The deduction is deemed to result from "the sale or exchange * * * of a capital asset held for not more than one year." IRC § 166(d)(1)(B). Because the deduction is attributed to a sale or exchange of property, the deduction is subtracted from gross income in arriving at adjusted gross income. See IRC § 62(a)(3). The impact of attributing the deduction to the sale or exchange of a "capital asset held for not more than one year" will become clear when the topic of Characterization is explored in Chapter 16.

Page 322, Example 10-C (reflecting reduction in sec. 213 floor from 10% to 7.5%)

EXAMPLE 10-C *Deductible medical expenses.* Eric has adjusted gross income of $100,000 in Year 1. He incurs medical expenses of $12,000 in Year 1.

If none of Eric's medical expenses are reimbursed, he may deduct only $4,500 of medical expenses in Year 1. (His unreimbursed medical expenses of $12,000 exceed 7.5% of his adjusted gross income [7.5%x$100,000=$7,500] by $4,500.)

By contrast, if as little as $4,500 of Eric's $12,000 of medical expenses is reimbursed by insurance, he cannot deduct *any* of his remaining $7,500 of unreimbursed medical expenses in Year 1. (If $4,500 of his medical expenses are reimbursed, his unreimbursed expenses of $7,500 do not exceed 7.5% of his adjusted gross income [7.5%x$100,000=$7,500].)

THE FEDERAL INCOME TAXATION OF INDIVIDUALS

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In late 2019, Congress amended the law that applies to a child's unearned income. The old law is explored on pages 524-29 of the casebook. The new law can be applied to tax years beginning in 2018. In light of the amendment, please make the following changes to pages 524-29.

Replace the heading on page 524 with the following:

D. Higher Tax Rates on Child's Unearned Income - § 1(g)

Replace the final paragraph on page 524 with the following:

IRC § 1(g), often referred to as the "kiddie tax," virtually eliminates the incentive to transfer ownership of income-producing property to a child by significantly curtailing the ability to apply a child's tax rate to income from property. The kiddie tax generally applies to children under the age of 18 and, in certain circumstances, to students under the age of 24. See IRC § 1(g)(2). The kiddie tax does not modify the principle that income from property owned by a child is taxed to the child. However, the kiddie tax causes the bulk of the income generated by a child's property to be taxed at the rate of tax the parent would have paid *if* that income had been taxed to the parent.

Delete pages 525-28 and Problem 15-2 on page 529, and insert the following:

> **EXAMPLE 15-D** *Simplified illustration of kiddie tax.* Parents file a joint return in 2018 and report taxable income of $400,000. Note that any additional taxable income of Parents in 2018 would be taxed at a rate of 35% (see Tax Table for Married Individuals Filing Joint Returns, p. 507).[1] Child owns income-producing property that generates $9,000 of taxable income in 2018. Child has no other income in 2018. What is Child's 2018 income tax liability?
>
> In the absence of the kiddie tax, Child's tax liability would be **$900**[2] (see Tax Table for Unmarried Individuals, p. 505).
>
> Under the kiddie tax, income generated by property owned by Child is still taxed to Child. However, Child's tax is computed by determining how much additional tax Parents would have paid *if* the income from Child's property had been taxed to them. Parents' had taxable income of $400,000. If the $9,000 generated by Child's property had been added to Parent's taxable income, it would have been taxed at a rate of 35% (see Tax Table for Married Individuals Filing Joint Returns, 507). Hence, if the $9,000 of Child's income

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[1] This casebook utilizes the rate tables in effect in 2018 because the 2018 rate tables are currently reflected in the Code. See p. 506, fn 3 for further explanation. To compute the actual income tax liability of an individual in a given year, one must use the rate tables in effect for that year.

[2] $9,000 taxable income x 10% tax rate = $900.

had been taxed to Parents, it would have increased Parents' tax by **$3,150**.[3] The Kiddie Tax, therefore, increases *Child's* 2018 tax liability from $900 to $3,150. The 2018 tax liability of Parents is not affected by the kiddie tax.[4]

Example 15-D reveals why the kiddie tax eliminates the incentive for high-income parents to transfer ownership of income-producing property to a child to reduce the tax imposed on the income generated by the property. If Parents in Example 15-D retained ownership of the income-producing property, they would have been taxed on the $9,000 of income it generated and it would have resulted in a $3,150 tax liability to them. By transferring ownership of the property to the child, the child is taxed on the $9,000 of income it generated but the tax remains the same ($3,150). If the child owns the property, however, the child will owe the tax. Thus, transferring the property to the child shifted the tax liability to the child but did not reduce the amount of that liability.

Note that the kiddie tax applies to *all* income-producing property owned by the child, not just to property the child received from a parent. Regardless of who transferred the property to the child, the kiddie tax causes the income from *all* property owned by the child to be taxed at the parents' tax rate. Hence, if a high-income grandparent transfers property to a grandchild, the income will be taxed at the parents' tax rate; *not* the grandparent's rate.

EXAMPLE 15-E *Simplified illustration of transfer of income-producing property to grandchild.* Grandparents file a joint return in 2018 and report taxable income of $600,000 (see Tax Table for Married Individuals Filing Joint Returns, p. 507). Note that any additional taxable income of Grandparents in 2018 would be taxed at a rate of 37% (see Tax Table for Married Individuals Filing Joint Returns, p. 507) . Grandparents made a gift of income-producing property to Grandchild that generates $9,000 of taxable income in 2018. Grandchild has no other income in 2018. Assume, unrealistically, that Grandchild's Parents ("Parents") have no taxable income in 2018. What is Grandchild's 2018 income tax liability?

In the absence of the kiddie tax, Grandchild's tax liability would be $900[5] (see Tax Table for Unmarried Individuals, p. 505).

Under the kiddie tax, income generated by property owned by Grandchild is still taxed to Grandchild. However, Grandchild's tax is computed by determining how much additional tax *Parents* would have paid *if* the income from Grandchild's property had been taxed to Parents. If the $9,000 generated by Grandchild's property had been added to Parents' taxable income, it still would have been taxed at a rate of 10% because it was assumed that Parents had no other taxable income in 2018 (see Tax Table for Married Individuals Filing Joint Returns, p. 507). Hence, if the $9,000 of Grandchild's income had been taxed to Parents, it would have increased Parents' tax by $900.[6] In this situation, the kiddie tax does not increase Grandchild's 2018 tax liability because the tax Parents would have paid

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[3] $9,000 x 35% = $3,150.

[4] Under certain circumstances, however, a parent may elect to include the child's unearned income on the parent's tax return. See IRC § 1(g)(7).

[5] $9,000 taxable income x 10% tax rate = $900.

[6] $9,000 x 10% = $900.

on the $9,000, had it been taxed to them ($900), is not greater than Grandchild's tax liability in the absence of the kiddie tax ($900).

Note that if the $9,000 of income from Grandchild's property had been taxed to Grandparents, it would have been taxed at 37% resulting in a tax of $3,330.[7] But the kiddie tax taxes a child's income from property at the *parents'* tax rate, regardless of who transferred the property to the child.

Why is Congress unlikely to be concerned that the transfer of income-producing property by high-income grandparents to a grandchild with low-income parents can significantly reduce the tax burden on such income (e.g., in Example 16-E, the tax on the $9,000 was reduced from $3,330 to $900)? In other words, how likely is it that high-income grandparents will be transferring income-producing property to a grandchild with low-income parents?

Notes

1. *Non-application of kiddie tax to earned income.* The kiddie tax is imposed on the "net unearned income" of a child to whom it applies. See IRC §§ 1(g)(1)(B)(ii), (3). Net unearned income excludes any "earned income" of a child. See IRC § 1(g)(4)(A)(i). Thus, small amounts of income earned by a child from babysitting or shoveling snow is not subject to the kiddie tax. Similarly, a large amount of income earned by a child who stars in movies is also not subject to the kiddie tax.

2. *Kiddie tax cannot reduce tax liability.* The kiddie tax will never reduce a child's tax liability. The child's liability is the *greater of* the tax that would be imposed without regard to the kiddie tax, or the tax resulting from the application of the kiddie tax. See IRC § 1(g)(1). Thus, the child movie star who earns $1,000,000 from acting and $25,000 of unearned income will pay tax on the earned income, as well as the unearned income, at a rate of 37%. This is the case even if the unearned income would have been taxed at a lower rate had it been taxed to the movie star's parents.

3. *Non-application of kiddie tax to threshold amount of unearned income.* The kiddie tax does not apply to every dollar of a child's unearned income. Rather, it applies only to unearned income in excess of a threshold amount. See IRC § 1(g)(4)(A)(ii). In recent years, the threshold amount has been approximately $2,000.[8] The vast majority of children do not have more than $2,000 of unearned income. Thus, the kiddie tax only applies to those children who own relatively large amounts of income-producing property.

Problem 15-2 *Simplified application of kiddie tax.* Parents file a joint return in 2018 and report taxable income of $500,000 (see Tax Table for Married Couples Filing Joint Returns, p. 507). Child owns income-producing property that generates $6,000 of taxable income in 2018. Child also earns $3,000 from babysitting in 2018. What is Child's 2018 income tax liability? To simplify the calculations, ignore any standard deduction to which Child is entitled.

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[7] $9,000 x 37% = $3,330.

[8] The actual threshold amount in 2018 was $2,100.