**Federal Income Tax Outline**

**Professor Streng Fall 2012**

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**ABBREVIATIONS:**

**FMV:** fair market value

**NOL:** net operating loss

**HCE:** Highly compensated employee

**RAFMV:** readily ascertainable fair market value

**EITC:** Earned Income Tax Credit

**PA:** Passive Activity

**AMT:** Alternative Minimum Tax

**CG:** capital gains

**CL:** capital losses

# I. INTRO

* 1. **Historical Background of IRC**
     1. First the US started using excise taxes on liquor, carriages, slaves, and real property
     2. Jefferson repealed taxes; tariffs became the federal revenue source
     3. Income tax re-administered as flat tax in 1894
        1. Constitutional challenge based on mandate that direct taxes on states must be apportioned to states based on population
           1. No one knows exactly what a “direct tax” is
           2. It is agreed that a head tax—flat amount on everyone—is a direct tax
           3. Problem is that if you apportion income tax on the basis of population, people in different states would pay different rates; people in poorer states would pay a higher tax rate
  2. **Gross income §61**
     1. GI includes all income from whatever sources derived. Income from compensation, dividends, gains from dealings in property, and discharge of debt are common types. However, particular code sections exclude certain types of income from GI
  3. **Four ways Congress preferences types of income w/tax**
     1. Exclude something from gross income (§119)
     2. Allow a deduction (§170)
     3. Allow a tax credit (§24)
     4. Impose tax at a lower rate on certain classes of income: this is the current approach w/capital gains
  4. **Deductions**
     1. **Subtractions from income in computing taxable income. There are two type of deductions**
        1. Deductions from GI in computing AGI: Certain expenditures are deducted (subtracted) from GI in computing AGI
        2. Deductions from AGI in computing taxable income: The TP subtracts his or her personal exemptions and then take the larger of either the standard deduction or the itemized deduction. The standard deduction is a statutorily set amount, and the itemized deduction is the sum of all allowable itemized deductions.
  5. **Taxable Income**
     1. §63(a): for individuals who don’t itemize their deductions, it is adjusted income minus deductions
     2. §63(b): for individuals who do itemize, it is gross income minus deductions allowed.
     3. §62(a): adjusted gross income is gross income minus deductions
     4. The rule that applies to the total amount of income of the top rate in your bracket along with all of the lower rates.
  6. **Taxpayers: Categories**
     1. Married individuals filing jointly
     2. Heads of Household
     3. Single Individuals
     4. Married individuals filing separately
  7. **Leisure Time and Income Taxation**
     1. The extra money you make above normal hours will be taxed at the highest rate in your bracket—this is the most relevant number when thinking about responses to incentives of work v. leisure time.
  8. **Marriage and Income Taxation:** COME BACK TO THIS DURING INCOME ATTRIBUTION
     1. **Policy:** Should the government be encouraging people to marry or not? If so, should they do it through the tax system, in a ways that encourages some people to marry and not others, or encourages the secondary earner not to work?
        1. Bush Tax Cuts did provide some relief to the marriage penalty but only at the expense of increasing the marriage bonus/the penalty on the high wage earner staying single.
        2. It is impossible for the federal tax code to be neutral on marriage encouragement with the progressive rates structure and commitment to treating all married couples the same regardless of each spouse’s contribution
  9. **Paying Taxes**
     1. **Procedure**
        1. TP files a return with IRS service center
        2. Potential audit
        3. Potential appeal to IRS appeals office
        4. If TP fails, can litigate in
           1. US Tax Court: appealable to US Court of Appeals

If you sue here, don’t have to pay first and then sue for a refund—you can refuse to pay until it rules

No right to a jury trial here

Article I judge

Will follow the law of the Circuit where TP lives

* + - * 1. US Federal District Court: Appealable to US Court of Appeals

Article III court

Normal civil procedure

* + - * 1. US Court of Federal Claims: Appealable to Federal Circuit

Article I court

* + - 1. If TP fails at that level, can appeal to SCOTUS but only on certiorari
  1. **Time Value of Money**
     1. It is generally understood to be better to pay taxes in the future than in the present.
     2. You can set aside a small amount of money in one year and thirty years later have a lot more; so it is better to pay taxes on a certain amount many years in the future than on the same amount today.
     3. The farther in the future you defer it, the less it is worth today (so you want to defer for as long as possible).
     4. **Formula:** Present Value = Future Value divided by [one plus the interest rate] to the power of the compounding period.
        1. **Example:** in present dollars, a $25K bill in thirty years costs only $4350 or so. $25K/(1 + 0.06) to the power of 30 = $4350.
        2. **Example 2:** $20K in five years with a 10% interest rate is 20K/[1+10%]to the power of 5. Present value = $12,418.

# INCOME

* 1. **Definitions**
     1. **Income**
        1. ***Haig-Simons definition of income*:** what you spend plus what you save in a given time period – accretion of wealth
           1. Would also include imputed income (parent raising child instead of paying for childcare).
           2. We don’t use this definition for tax purposes
           3. Y = C + ΔW 🡪 accounts for consumption and any change in wealth
           4. “accession of wealth”

Consumption (occurring during the measurement periods)

Increase (if any) of the value of property rights during the measurement period

* + - * 1. Defines a comprehensive tax base, but difficulties arise in measuring all consumption and in valuing assets each year.
      1. **Economic:** Consumption plus savings (see consumption tax section)
         1. Under this approach, income is the value of any economic benefit received by the TP regardless of the form of the benefit

Tangible items: the receipt of cash or other property generates income under this approach, even if it comes from an unusual source, such as a windfall

Barter: The exchange of services for services constitutes income to both service providers. Rev. Rul. 79-24

Intangible benefits: the receipt of an intangible benefit would be included in GI under this approach. For example, if one TP satisfies another TP’s legal obligation, the latter has income in the amount of the satisfaction. *Old Colony*. But noneconomic benefits (such as a sunny day in Oregon) are not income under this principle.

* + - 1. **Items that are NOT Income**
         1. Imputed income: the value of services one performs for oneself or one’s family and the value of any property used that one owns is imputed income, which is not considered income for FIT
         2. Capital recovery: a TP income from the sale or exchange of property is his or her profit on the transaction, not the total amount received. A TP is entitled to receive his or her capital investment in the property tax-free, although the timing of this recovery is a matter for legislative determination.
         3. Loans: Neither the creation nor the repayment of loans is a taxable event. However, forgiveness or discharge of a loan may generate income to the debtor.
      2. There is no crisp definition of income for tax purposes
      3. SCOTUS initial definition (later abandoned): gain derived from labor, capital, or both. *Eisner v. Macomber*, p. 46 🡪 proved too narrow
      4. **Commissioner v. Glenshaw Glass** (70) *also a Windfall case*
         1. FACTS: two cases involving receipt of punitive damages; both TPs excluded the punitive damages they received since they weren’t derived from income or capital, and that was the going definition of income at the time.
         2. HOLDING: punitive damages are undeniably accessions to wealth over which the TPs have complete dominion, so they are income, and the definition of “gain derived from labor or capital’ is abandoned
         3. Since this case, there is a presumption that *any increase in wealth is income*
    1. **Amount of gain or loss *= amount realized minus adjusted basis* §1001(a)**
    2. **Amount realized =** $$received plus FMV of property **§1001(b)**
       1. **§1001**: realization event occurs when a TP exchanges property, receiving some materially different item.
       2. **§1001(a):** Realized gain or loss is equal to the difference btw the amount realized on a sale or other disposition of property and the adjusted basis of the property transferred
    3. **Adjusted basis=** basis as adjusted by §1016 **§1011(a)**
       1. **§1016(a)(2)**: adjustment is what you took or could have taken for depreciation.
       2. **§1016** prevents TP from using basis twice to get extra deductions. Depreciation deductions are just an advanced recovery of basis.
    4. **Basis of property**= cost of property **§1012**
       1. **Carryover/substitute basis:** adjusted basis in the hands of the transferee is the same as adjusted basis in the hands of the transferor. **§1015(a)**
       2. **Special rule:** For determining LOSS, the basis is the FMV at the time of the gift if it was less than the transferor’s adjusted basis; FMV is only used when the result will be a loss
       3. If neither of the above calculation methods “work” then there is no gain or loss for tax purposes
  1. **Excludable/Non-Income Compensation (Employer In-Kind Compensation)**
     1. **§61(a)(1)** Compensation income is he consideration transferred for the performance of services, whether in the form of salary, fees, commissions, or fringe benefits, and whether in the form of cash, property, or other services
        1. **Character:** ordinary income, potentially taxable at the highest tax rate
     2. **Old Colony** (50)
        1. FACTS: ER paid federal income tax on behalf of EE
        2. HELD: This is compensation to the EE and included in GI – pyramid problem
     3. **Benaglia v. Commissioner** (52)
        1. FACTS: TP was a manager of hotels in Hawaii; required as part of job that he and his wife live and take meals at one of them. IRS said TP had an undervalue of §7,845 for each year he’d worked there, for the FMV a guest would pay to stay and eat there for a year.
        2. HOLDING: Living and eating there was not income at all b/c (1) parties didn’t intend for room and board to be compensation (2) room and board were provided *for convenience of ER*
           1. it was a condition of employment and necessary to ER.
           2. Room and board, unlike stock, personal and non-transferable
           3. Room and board hard to value here b/c certainly not worth to EE/TP what it would be worth to a guest.
        3. DISSENT: room and board was not value-less and K letter has room & board as one of the terms
     4. **IRC §119:** if meals and lodging are provided *for the convenience of the ER* and the EE is told they have to live and take their meals *on the ER’s premises* as a condition of employment, then meals and lodging will not be included as EE’s income.
        1. Codifies the Benaglia holding, butNo intent requirement as there was in Benaglia
        2. *Kowalski*, (57) – meals in kind must be furnished to employees (gave troopers cash to purchase meals = taxable & not excludable)
        3. Business premises: if owned by the original business, regardless of where the offices are, they are the business premises (*Lindemann*)
        4. Employee status required: DNA to self-employed HOWEVER an employee may be treated as such even if they own all the shares (*J. Grant Farms*, p. 58)
        5. GI does not include qualified campus lodging (§ 119(d))
     5. **IRC §125: Cafeteria Plans**, p. 62 – EE may choose among a variety of noncash benefits but may not opt to take cash
        1. Use it or lose at end of year
        2. Non-discrimination rule applies
     6. **§132(a)(1) No additional cost services:** can’t cost the ER anything, including lost revenue, to provide to EE - any service provider by ER to EE for use by EE if such service is offered to customers and hasn’t been purchased and would exist regardless of whether employee used it – *no substantial additional cost*
        1. under §132(j) must not be concentrated among highly compensated EEs without also being given to a group of EEs that does not discriminate on the basis of highly-paid
        2. §132(b) says it must be something that the ER offers for sale to customers in the ordinary course of business of the ER in which the EE provides services
        3. Generally applies to spouse and dependent children of EE under §132(h)(2)(A) and retired or disabled EEs or the surviving spouse of an EE under §132(h)(1)
        4. 2 or more ERs are allowed to make a reciprocal agreement for the provision of tax-free no-additional-cost services to their EEs, if the agreement is in writing and neither will incur substantial additional cost in providing the services. §132(i). (ie. Airline attendants)
     7. **§132(c) Qualified EE Discount**: EEs can get a reasonable discount on property or services offered for sale to customers by ER who employs the EE getting the discount
        1. **Goods:** Ceiling is the profit percentage: (aggregate sales price minus the aggregate cost) /aggregate sales price. §132(c)(1)(A)
        2. **Services:** discount cannot exceed 20% of the price at which the service is offered for customers. §132(c)(1)(B).
        3. If the discount is greater than the ceiling, the amount the EE saves over the amount they would save with the qualified discount is included in their taxable income.
        4. Generally applies to spouse and dependent children of EE under §132(h)(2)(A) and retired or disabled EEs or the surviving spouse of an EE under §132(h)(1).
        5. **No exclusion** for discounts on property held for investment or real property. §132(c)(4).
        6. Generally, reciprocal agreements do not apply to this section
     8. **§132(d) Working Condition Fringe:** if it is something that the EE could deduct as a business deduction if she bought it herself (i.e. ordinary and necessary business expense - §162 or §167), the ER can provide it to her without it being includable in her income.
        1. Somewhat more valuable this way as an exclusion than if EE deducts it herself
           1. Certain EE business expenses deductible only if TP itemizes §63; with working condition fringe that never comes in to the picture
           2. EE business expenses generally deductible only to the extent they exceed 2% of TP**’s** AGI. §67.
     9. **§132(e) De Minimis Fringe:** coffee and doughnuts, personal use of copy machine. Costs government $7B a year but alternative is crazy. Amt is so small, it’s a waste of time to track it
        1. Occasional dinners paid for by ER and brought to the office, or even an occasional cash allowance for dinner, to extend working hours probably count under this section.
        2. Membership in a private country club or gym does not count. Reg. §1.132-6(e)(2)
           1. However if an ER builds an athletic facility on its premises, EEs do not have to include the value of use of those facilities in their income where the use of the facility is primarily for the use of EEs and their spouses and dependent family members. §132(j)(4).
        3. Having a cafeteria where the meals are cheaper than normal (just above cost for ER) counts for an exclusion. §132(e)(2).
     10. **Frequent Flier Miles**
         1. Can be traded for (1) other airline tickets, (2) flight upgrades, or (3) other )non-airline) merchandise
         2. Not de minimus – can clearly determine what the value is – transportation fringe
         3. Should be income to recipient, but it’s not – Congress throwing in the towel instead of trying to apply rules to the manner of use of the miles
         4. EXCEPT if transferred for property, then it’s income
         5. Personal use of miles accumulated during business trips: reimbursed or deducted?
     11. **§132(f) Qualified Transportation Fringe** Exclusion if ER provides or reimburses for a transit pass, transportation in a commuter highway vehicle (§132(f)(5)(B)), or parking w/in a monetary limit see § for limit.
         1. No nondiscrimination requirement—can be offered only to HCEs and still be excludable from their taxable income
         2. If you are given a choice b/w cash and parking, you get an exclusion if you choose parking, but not if you choose cash. Somehow meant to be an environmental initiative but utilization of ER parking went way up after this was allowed.
     12. **Haverly v. US**, p. 65 squib – *benefits from other than employer*
         1. FACTS: professor receives sample textbooks from a publisher. He donates them and claims a charitable contribution.
         2. HELD: In order to claim charitable deduction, he must claim gross income. Ledger must balance out.
     13. **§105 Health Insurance (see exclusions):** employers can deduct the cost of medical insurance provided for employees.
         1. **§106:** benefits received by EE are excluded from their GI
         2. Self-employed can also deduct the costs of medical care, including health insurance
     14. **Valuation Issues**
         1. **Turner v. Commissioner** (67)
            1. FACTS: TP won steamship tix to Argentina. Tix FMV is not the same as value to family and tix were non-transferrable and non-refundable. FMV was $2200 but settled for $1400
            2. HELD: Court looked to value at time of transfer and redemption rather than at time TP won the tickets.
  2. **Imputed Income** (71)
     1. the accession to wealth that can be attributed, or imputed, to a person when he avoids paying for services by providing the services to himself, or when he avoids paying rent for durable goods by owning the durable goods.
     2. Owner-Occupied Housing: rental value of owner-occupied house is imputed economic income to owner who lives in her home—you don’t have to pay rent b/c you live in your own house. Right to live in or allow someone else to do so is part of the value, as is appreciation. So there is no good policy reason why we don’t allow deduction on cost of rent, but of course we also shouldn’t start taxing imputed value of owner-occupied housing.
     3. Services: w/in Household - Shouldn’t start taxing them, but the failure to tax them does cause distortions
        1. Barter Transactions – Rev. Ruling 79-24 (76) – exchanged items are includable in GI as valued at FMV (§6045 – brokers)
  3. **Windfalls** – within the scope of §61
     1. **Reference:** *Glenshaw Glass* (78): Damages recovered for lost profits plus punitive damages for violations of anti-trust laws – undeniable accessions to wealth, clearly realized and over which the TP has complete dominion” are includible in GI
     2. **Cesarini v. US** (81): $5000 found in piano is a windfall and includable in GI.
        1. Reg. **§1.61-14(a)** requires TP’s finding treasure to include it in GI when reduced to undisputed possession. This Reg Section is consistent with **§61’s** statutory scheme to include all income in GI**.**
        2. Crt rejected TP argument that **§74** (prizes) or **§102** (gifts) would exclude this amt from GI
  4. **Gifts**
     1. **§102(a):** gross income does not include property acquired by gift, bequest, devise, or inheritance; i.e. gifts are excluded from income for tax purposes. (but no deduction to donor for wealth transfer)
        1. This applies only to the value of the gift at the time of its receipt (the principle of the gift or bequest), not income which the gift subsequently generates. §102(b)(2).
        2. E.g. with a gift/bequest of a trust, if both the corpus and income were exempt from tax under §102(a), the exclusion would be greater when divided interests were created than when the entire property was given to one person
     2. **Basis - §1015:** a recipient of property by ift or inheritance must determine the basis he or she has in the property.
        1. **Property Received by gift:** The recipient of property by gift takes the donor’s basis in the gift, plus a portion of any gift tax paid on the transfer. However, if at the time of the gift the FMV was less than the basis, for purposes of determining loss on subsequent sale or disposition, the done takes the FMV of the gift on the date of the gift
        2. **Property Received by inheritance - §1014**: The recipient of property through inheritance takes as his or her basis in the property the FMV of the property on the date of the decedent’s death
     3. **What constitutes a gift for tax purposes?**
        1. **Definition**: A gift is a transfer made with detached and disinterested generosity.
        2. **Income from Property**: the exclusion does not apply to the income derived from property received by gift
        3. **Commissioner v. Duberstein** (83)
           1. FACTS: TP got a Cadillac from a business contact as a thank-you for a good lead; TP did not want it and tried to refuse, but the business contact gave it to him anyway (even though he already had a car). Then he didn’t include the value of the Cadillac as income, but it was written off as a business expense. The Commissioner asserted deficiency for the car’s value against him.
           2. HOLDING: Car was income; it was compensation for Duberstein’s past services and incentive for future services
        4. **Stanton v. United States** (84, part of Duberstein)
           1. FACTS: When TP retired from working for a church to go into business for himself, the church he worked for gave him $20K to be paid in monthly installments “in appreciation for the services rendered” by him. The members of the board described it as a gift/gratuity based on his great personality and excellent work, but there was also evidence of ill-feeling b/w Stanton and some of the board members. He had on enforceable claim to a pension or retirement benefits.
           2. HOLDING: The SCOTUS remands to the district court again. On remand, the trial court again holds that the payment was a gift, based on the standard of *“detached and disinterested” and based on generosity*.
        5. Deciding this is to be based on experience with the mainsprings of human conduct to the totality of the facts of each case 🡪 have to try every case, clogging the system
        6. Eventually SCOTUS says that whether a payment is a gift is an issue for the trial court, determining *donor’s intent*, and will be upheld unless clearly erroneous.
        7. §102(c)(1) – disallows gifts btw ER and EE
        8. **US v. Harris** (91)
           1. FACTS: Two sisters accepted gifts from an older man for housing, food, spending money. Convicted for tax evasion for failing to report it as GI
           2. HELD: Donor’s intent is a critical consideration in determining whether something was a gift. Not enough certainty this was payment for services to justify a criminal conviction.
        9. **Tips** are not gifts, and are includable in GI as payment for services rendered – enforced thru information reporting §6053
           1. **Gambling** – *Olk* (100) – not a gift and included bc hoping for a benefit – not detached and disinterested generosity or impulsive generosity
           2. **Tips to Homeless** – includable but impossible to enforce and likely unreported
     4. **Scholarships, Prizes, and Awards**
        1. **§74**: Prizes and awards are included in GI unless the recipient did nothing to be selected, the recipient is not required to render substantial future services as a condition of receiving the prize, and immediately transfers the prize to charity.
        2. Scholarships covering tuition and required fees, books, supplies, and equipment at non-profit schools are excluded from gross income. §117.
           1. However, scholarships to go toward room and board are includable in gross income.
           2. Exclusion does not apply to scholarships conditioned on the performance of teaching, research, or other services. §117(c).
     5. **Helpful Payments: Welfare and Unemployment**: welfare is excluded (C/L), but unemployment is included §85 – welfare paid out in interest of public welfare, not within the definition of income under §61
     6. **Social Security** – imposed when deducted from your paycheck, not included in GI
     7. **Basis in gifts**
        1. **Rules** 
           1. **Carryover/substitute basis:** adjusted basis in the hands of the transferee is the same as adjusted basis in the hands of the transferor. **§1015(a) – “**transferred basis”
           2. **Special rule:** For determining LOSS, the basis is the FMV at the time of the gift if it was less than the transferor’s adjusted basis; FMV is only used when the result will be a loss
           3. If neither of the above calculation methods “work” then there is no gain or loss for tax purposes
           4. If property is **transferred at death** by bequest, inheritance, etc, the basis in the hands of the transferee is “stepped up” to the FMV at the time of death. §1014(a).

accrued gain evaporates – disappears from tax base - loophole

STRENG: alternative approaches – make death a realization event, use gift tax mechanisms, or allow estates to opt out of estate tax, but go into carryover basis regime

* + - 1. **Taft v. Bowers** (104)
         1. FACTS: A bought 100 shares of stock for $1K which he held until 1923 when the FMV had become $2K. Then he gave them to B who sold them during 1923 for $5K. B says that she only owes tax on the appreciation during her ownership of the stock ($3K) but the IRS says she owes tax on $4K, the total appreciation since A bought it.
         2. HOLDING: Congress does have the power to require a succeeding owner to assume the place of the donor in terms of taxation—so the basis of the inter vivos gift is the same in the hands of the donee as it was in the donor. B owes taxes on the entire $4K increase in value. The stock represented only a single investment of capital, that made by the donor. Basis transfers with the gift.
         3. STRENG: Const. argument – is it within the taxing power of Congress to to require a TP to pay taxes on income derived by someone else? YES – it is still income within the 16th A
      2. **Transfer of appreciated property to pay debt** - §1012 – transferor has a recognition of gain event and transferee has a basis of the value of the property
      3. **Transfer of Appreciated Property to Political Organizations** - §84 – gain recognition to a person who transfers appreciated property to a political organization
         1. STRENG: Why do we do this? no inclusion by transferee bc tax-exempt and don’t want it to disappear from the tax base
      4. **Income of a decedent** – Income earned, in an accrual accounting sense, before death and is subject to income tax under §691. The income must be allocated to someone: the estate, an heir, or someone else
  1. **Recovery of Capital** (110)
     1. **Allocation of Basis**: if only a portion of indivisible property is sold, pro rata allocation of basis. Reg. §1.61-6(a) A method of equally and proportionately allocating money, profits or liabilities by percentage
     2. Timing of when TP recovers basis determines when TP pays tax.
     3. **Example:** Π buys 10 acres of land, all the same, for $1000. Sells a few years later for $1500. Gain is $500, that is the taxable income. $1000 was just capital converted to different forms (cash🡪land, then land🡪cash).
     4. **Inaja Land v. Commissioner** (107) FUNDAMENTAL FOR BASIS RECOVERY
        1. FACTS: TP bought land for $61K bordering on water to be used as a fishing club. The city polluted the water and TP sues and gets $50K, $1000 of which went to atty’s fees. IRS said $49K was taxable income b/c use of land was for profit, it didn’t exceed the cost of the land, and the money was for lost profits. TP said it was not for lost profits b/c the reward didn’t exceed cost of land and only constituted recovery of capital (or that it was impossible to separate recovery of capital and loss of profits).
        2. IRS ARGS: The money was compensation for loss of present and future income and consideration for release of many meritorious causes of action which represented ordinary income. Also, the Π failed to allocate the sum b/w taxable and nontaxable income, so it did not sustain its burden of showing IRS error.
        3. Π ARGS: The consideration was paid for the easement granted to the city and the consequent damage to Π’s property rights; that it was an easement means it is not practical to attempt to apportion a basis to the damaged property.
        4. HOLDING: The reward was not paid for loss of profits, it was for the conveyance of a right of way and easements and for damages to Π’s land and its property rights. The IRS is wrong. Capital recoveries in excess of cost are taxable income, but here it is impractical to apportion basis to the parts of the property damaged. Therefore, because the payment was recovery of capital/basis, and it was less than Π’s cost basis for the whole property, there is no capital income, and a basis of $12K left on the property ($61K minus $49K). ADJUSTED BASIS RULE bc impractical to attempt to allocate
        5. STRENG: note *Burnet* reference – open transaction treatment – basis recovery occurs first
  2. **Annuities and Life Insurance:** (117)
     1. Policy holder is often the insured, but doesn’t have to be. Insured pays a certain amount in premiums and insurance company will pay death benefit to survivors if insured dies during the policy period.
     2. **Life insurance**
        1. **§79:** Group Term Life Insurance purchased for EE
        2. **Term Insurance:** bet b/w insured and life insurance company—just death benefit protection during a specified period of time. Payment only for actuarial risk. Small investment return during coverage period. No value at expiration of the term.
        3. **Whole Life Insurance:** Often level payments and early year payments exceed actuarial risk cost. Involves a savings element that produces investment return which reduces insurance cost (but is not GI).
        4. **§101(a):** Proceeds of life insurance K’s payable by reason of death of the insured are excluded from gross income. All death benefits are excludable.
           1. **Transfer for consideration** limitation: §102(a)(2) no exclusion where the transfer is for value (transfers with carryover basis or transfers to partners, partnership or corporation (DNA other shareholders)
           2. **§101(g)** treatment of viatical settlements: exclusion extends to amounts paid to or for the care of chronically or terminally ill insureds
        5. **Insurable Insurance Requirement:** you can’t buy life insurance on someone with whom you don’t have some kind of relationship; this is an attempt to restrict dead peasant insurance by ERs.
        6. **§101(g)(1) Safe Harbor – treated as Paid by reason of death**
           1. Any amount received for a terminally ill individual
           2. Any amount received for a chronically ill individual
        7. **K paid out before death:**
           1. Not deductible by payor for premium payments made
           2. Exclusion from income, under §101, when proceeds received. Post death interest is NOT excluded. Gain derived is subject to GI inclusion
           3. Loans are NOT treated as distributions §72(e)(5)(A)
     3. **Annuities**: pays out during the life of the individual; pays for you not dying soon enough as opposed to having died too early. Payments being made periodically for life or term
        1. **§61(a)(9)**: a TP receiving a regular annuity paymen is receiving a partial return of the invested capital, and the balance of the payment is income. To determine the amount of payment that is excluded from GI, multiply the payments by the exclusion ratio.
        2. **Exclusion ratio:** Investment in the K/ Total expected return under the K. The amount of the payment in excess of the excluded amount is included in GI of the TP, subject to certain limitations
        3. **Method of purchase:** (1) lump sum; (2) or periodic payments
        4. **Fixed Payment Annuity:** an agreed sum (for a term) or at intervals (for a life, ie actuarial factor)
        5. **Variable Annuities:** based on the results from equity security investments through annuity
        6. **Joint and Survivorship payment**: until the death of the survivor of multiple annuitants – usually longer payout period since two lives involved – husband and wife purchase these and hope they don’t die together
        7. **Tax Treatment:** very favorable. There are three main tax benefits.
           1. **§72(a)**: TP not taxed during time the money is accumulating, unlike a savings account, bonds, or stocks where interest and dividends are taxed as earned whether withdrawn or reinvested.

§72(u) says that if you are a corporation and hold a deferred annuity, you WILL be taxed on inside build-up, unlike an individual

* + - * 1. **§72(b):** when money is withdrawn, some is taxable and some is return on basis—investment in the contract is the basis and that is divided by expected return (actuary comes up with expected return).

**Steps:** (1) Determine the total income tax basis; (2) Determine the expected return (payment amt times the anticipated # of payments); (3) Ratio is applied to each payment when received. **FORMULA**: total tax basis/expected payments \* Each Payment = Amt excluded from GI

**Example:** TP invests §500K and actuaries say expected return is $1.5M. Ratio is 1/3, so $1 of every $3 that is withdrawn is a return of basis. If the annuity is $45K/yr, only $30K of that is taxable.

You don’t ACTUALLY get basis back at a steady rate—you get more earnings in the early years, but the tax code treats you as though you are getting a pro-rata amount each time, which is a tax advantage.

If someone dies too soon, estate can deduct the remainder of the K

* + - 1. **Policy Rationales:** Encourages savings so people can pay for their own retirement.
      2. **Other treatment options:** (1) as value accrues to the K; (2) as payments are made either before or after annuity K payments commence – can get recovery of basis first, but not currently favored option, apply a constant interest rate
      3. **Borrowing Against an Annuity**: tax treatment much less favorable than it used to be.
      4. **STRENG:** “refund feature” – most states have regulation that says if don’t get cash investment back, it will be refunded – necessary when purchaser dies soon after purchase, before the K gains value
    1. **Gambling Gains/Losses**
       1. §165 (d) Gambling losses can only offset gambling winnings – if come out ahead, GI – no deduction for losses from other portion of GI
       2. **STRENG**: “Tax basket” – separating the whole thing from GI
       3. Enforcement: withhold at source for large winnings, right there when they cash in their chips (20% if >$5000 - §3402(q)); information return to IRS from casino for winnings >$600; Self-assessment (penalty of perjury)
    2. **Recovery of Loss**
       1. **Clark v. Commissioner** (121)
          1. FACTS: TP’s tax preparer gave him bad advice, telling him to file jointly with his wife. If he had filed separately he would have saved $19,941 in income tax. Tax preparer paid him that amount a few years later.
          2. HOLDING: TP is allowed to exclude that payment from faulty tax preparer from his income in the year it was paid bc intended to return TP to position he should have been in.
  1. **Annual Accounting**
     1. **General:** we calculate income on the basis of each year, annually—what happens to TP in each year,
        1. Pretty arbitrary as a convention
        2. Generally the calendar year for individuals, may vary for businesses
     2. **Problems:** can inaccurately measure a TP’s ability to pay particularly for transactions that span more than a year. Some code sections have evolved to address problems
        1. **The net operating loss deduction §172:** a TP’s excess of deductions over expenses constitutes a NOL that the TP may carryover
        2. **Claim of Right Doctrine and §1341**: a TP must include amounts in GI over which there is a claim of right and unfettered use, even if the TP may be reqd to return all or a portion of the amount to another person. **§1341** calculates the tax due if TP is reqd to return items previously included in I, in a TP-friendly way
        3. **Tax Benefit Rule §111:** the recovery of an item that constituted a deduction in a prior year will be income to TP to the extent of the prior tax benefit.
     3. **The Clark v. Sanford Brooks** **Problem**
        1. **Burnet v. Sanford & Brooks** (126)
           1. FACTS: TP had net losses totaling $176,271 over a period of three years in a contract w/government. It received $192,577.59 in a suit with the govt, which was the loss plus interest.
           2. HOLDING: TP had to include not only the interest but also the $176,271 in income in the year they received the settlement from the govt bc he had included the 176k in losses on prior tax returns. Every year stands on its own

**Clark LOSS RECOVERY OUTCOME RATIONALE**

($19,941) $19,941 recovery Recovery of capital

1932 1934 excludable

**Sanford & Brooks** ($176,271) $176,271 recovery Annual, not

1913-1915 1920 includable transactional,

Accounting

* + - 1. **Why the difference?**
         1. Difference in initial expenditures:

Clark, did not and could not have deducted the loss when it happened, so maybe court is trying to line up economics with tax. It was not deducted when it was lost, so it was off the tax radar, and when he received it a couple years later it was off the radar

Sanford & Brook: did take the deduction on the losses for three years. So if it had gotten the money back tax free, it would not have netted out to zero. However, their income was zero in those years, so them taking the deduction didn’t change the taxes they were paying; this means that the situations really weren’t equalized after all.

* + - * 1. What COULD the court have done to solve the unfairness?

Give individuals w/negative income a payment from the government in amount you would have paid in taxes if you have made the amount that you lost.

BAD: could incentive creation of paper losses to get gov’t money

GOOD: might incentive people to take beneficial risks.

* + - 1. **Legislative Responses to The Difference**: Net operating loss (NOL) deduction enables averaging of business income (losses) over multiple years
         1. **§172(c)**: ***NOL*** is tax deductions minus gross income
         2. **§172(a):** you get a deduction for the sum of your NOL plus your NOL carryback
         3. **§172(b)(1)(A):** ***NOL carryback*** is allowed for two years prior and ***NOL carryover*** is allowed for twenty years in the future.
         4. **§172(b)(2):** you do your carrybacks first, then carry forward
         5. **§172(b)(3):** you can waive carry BACKS if you want to (not carry forwards)
         6. Basically, you can take unused loss and move it back and forward in time to eat up income.
         7. Under the §172 regime, the TP in Sanford & Brooks could have carried forward the $176K loss for 20 years, wiping out the entire $176K settlement they received a few years later.
      2. **Accounting for Long term Contracts**: “percentage of completion” §460 – accrue profit as progress is made towards finalizing the project
      3. **Capital Expenditures** – purchase cost must be capitalized to create basis and basis is recovered over the anticipated useful life of the asset – “matching” principle
    1. **Claim of Right**
       1. **North American Oil Consolidated v. Burnet** (131)
          1. FACTS: TP and US Government are fighting over land, which is generating income. In 1916, that income held by a receiver pending dispute resolution. In 1917 TP wins, and 1916 income is paid to TP. IRS says that money was taxable to 1917 when received; TP says it is taxable to 1916 when earned, or 1922 when the last appeal was decided in its favor. (Tax was higher in 1917 b/c of war than it was in 1916 or 1922)
          2. HOLDING: TP has to be taxed on the income in 1917. If a TP gets earnings ***under a claim of right***, he must report them to the government even though someone else might claim he is not entitled to the money and even though he might lose it in court later (can deduct it at that time if he does). The TP here did not do that in 1916; and he received the money in 1917; so that’s when it is taxable to him.
       2. **Proper Taxable Year** 
          1. **§446** – TP shall compute taxable income under method of accounting on which TP “regularly computes his income in keeping books”
          2. **§446(b)** exception where TP’s method “does not clearly reflect income”
       3. **United States v. Lewis** (134)
          1. FACTS: On 1944 return, TP reported $22K which he had received as an EE’s bonus; however as a result of subsequent litigation, it was decided that the bonus was improperly computed and he had to return $11K to his ER. Until that judgment, he had claimed and used the $22K entirely as his own under the good faith “mistake” belief that he was entitled to it.
          2. HOLDING: entire amount includable in 1944; though TP gets a deduction in 1946 when he had to return half of his bonus. Under the claim of right doctrine, there is no exception merely because a TP is mistaken about his claim of right.
       4. **Legislative Response: §1341:** if the amount was included in income in prior years b/c it appeared that TP had an unrestricted right to it (***claim of right***) then TP gets a deduction on current year for that amount if it turns out TP did not have a right to that amount.
          1. What will happen is either:

TP will compute the tax taking into account the deduction TP will get in current year

Take the amount of tax TP would not have paid in the prior year if TP had not included the amount then, and take that as a deduction in the current year

* + - * 1. Brings you back up to $0 if you are a loser under claim of right.
        2. Does not take away any windfall that might come to TP under claim of right.
        3. Voluntary payments are not eligible for this treatment
    1. **Tax Benefit Rule**
       1. **§111(a):** Exclusionary rule: gross income won’t include income from recovering an amount TP deducted in a previous year as long as the deduction did TP no benefit in year it was deducted.
          1. **Inclusionary Rule:** is not available to exclude a recovery if the prior year deduction did produce a tax benefit. Return or recovery of the money or other property that was subject of a prior year’s income tax deduction must be included in income in the year of its recovery to the extent that the deduction did reduce taxes in the prior years
          2. **Alice Phelan Sullivan Corp v. US** (140)

FACTS: Co made a charitable contribution and claimed deduction for FIT, property was then returned to donor.

HELD: Included in GI to the extent of the lesser of (a) the earlier deduction or (b) the FMV of the property

* + - 1. **§111(c):** An increase in a net operating loss (NOL) carryover that is still around is treated as reducing tax for the purpose of §111(a).
      2. **Inconsistent Events Rule** (140)
         1. *Hillsboro*: Repayment to bank shareholders of taxes on shareholders previously paid by the bank corp. NO recognition reqd of the banks when refunds were made to shareholders.
         2. *Bliss Dairy*: Distribution of previously expense assets (cattle feed) in a corporate liquidation. Recovery was reqd to the corp on the distribution.
         3. *Dissent*:allow to file amended tax returns if S/L hasn’t run
         4. *Rule*:Deduction available in earlier year; but, notax benefit realized in the earlier year; then later, when reversal of the earlier transaction, no GI since no tax benefit realized earlier.
      3. **§111** is chiseling away at the idea of an annual accounting period – this is transactional accounting for this item
         1. TP’s perspective: can be helpful, but if rule of inclusion comes into play as in Case I there is no relief from change in tax rates.
      4. **Income Averaging:** NOT done now; idea is that TP could average for a certain number of years to protect against swings in income. Made more sense when top marginal rates were very high.
  1. **Recoveries**
     1. **Recovery of lost profits** – ordinary income when received; *Sanford & Brooks*, p. 132
     2. **Punitive Damages** – includable in GI; *Glenshaw Glass*, p. 78
     3. **Recovery for Destroyed Property** – GI inclusion as property sale; gain as proceeds in excess of tax basis; possible gain postponement through reinvestment up to amt of proceeds; §1033
  2. **Personal Injury Reimbursement**
     1. **§104(a)(2):** any damages received on account of personal injury/sickness are excludable, from workers compensation or settlement of a suit, whether a lump sum or periodic, *except punitive damages or lost profits*.
        1. “Lump sum or periodic” (144) language means that Π/TP can choose an annuity; if Π/TP chooses an annuity, not only are the damages untaxed, the interest is as well
           1. Good deal for Π—creates an incentive to structure settlements to provide deferred periodic payments
           2. Bad for Δ who will be taxed on interest earned on money put aside for the periodic payments to Π, and will have to invest a larger sum in order to stretch the payments out.
        2. Generally Δ funds such payments through an insurance product
           1. Neither Π nor Δ thus pays taxes
           2. Π gets more money in the long run b/c not taxed on interest (i.e. if Π took a lump sum and invested it, the interest would be taxable income, but payments coming out of life insurance at whatever rate Π wants are not taxable to Π).
        3. NO exclusion for lost profits/lost compensation reimbursements.
        4. Exclusion does not include libel or discrimination awards.
        5. Can exclude psychological/psychiatric medical expenses if they can be proven.
        6. TP excluding the income can be someone other than the person who suffered the injury or sickness (e.g. spouse, dependent).
        7. The only case in which punitive damages are excludable are when a state ONLY allows recovery of punitive damages.
        8. **Rationale:** Exclusion serves as a proxy for a system of depreciating human capital.Other args for and against taxation of certain awards.
           1. **Medical Expenses:** Places the injured person in the same financial position they would be in without the injury; fairness dictates she should not pay more than others in taxes
           2. **Lost Wages:** replaces funds that would have been taxed otherwise; fairness dictates that she should be taxed on income she would have been taxed on but for the accident.
           3. **Punitive Damages:** These are complete windfall to the recipient so should be taxed (the only argument against taxation is that not taxing these gains might encourage more people who are actually wronged to sue to recover)
  3. **Health Insurance**
     1. **§106(a)**: EE’s gross income doesn’t include ER-provided coverage of accident or health insurance. Section also covers retired former EEs, and spouses and dependents of EEs, but not unmarried couples who aren’t dependents. ER-provided domestic partner/same sex couple coverage creates extra federal taxable income to EE.
        1. ER provided doesn’t mean ER has to pay the whole bill, but ER-provided portion will be excluded from EEs income
        2. Policy originated from wage controls during WWII, when ERs had to compete for EEs using fringe benefits; by 1954 it was common not to consider health benefits income, so Congress went along with it.
     2. **§104(a)(3):** Recoveries under a medical insurance policy are excluded from GI – even when recoveries exceed cost of care
        1. TP’s disability insurance benefits also excluded from GI
     3. **§104(a)(1):** Workers comp payments excluded from GI
     4. **§105(b):** benefits out of an ER-provided health or accident plan also not includable in EE/beneficiary’s taxable income. Seems like a huge incentive to consume medical services, b/c of the tax subsidy at both ends.
     5. Some think repealing these rules would increase the number of insured people (with other reforms, presumably)
  4. **Indebtedness**
     1. Creation of a loan is not a taxable event to either the creditor or the debtor, for neither has a net economic benefit. If creditor foregoes collection of the debt, the debtor will have a benefit equal in amount of the debt foregone. Loan proceeds are not includable in GI (because of an offsetting liability producing no accession to wealth
        1. Loan repayments are not deductible (similarly, no accession to wealth occurs)
        2. Rules are applicable to non-recourse loans
     2. **Principle:** we don’t tax borrowed money as income, but there is no specific provision in the IRS excluding it from income. The rationale is that when you borrow it, you are the same time taking on a contractual obligation to repay it, so there is no net accession to wealth. This is another little dig at annual accounting, note.
     3. **§61(a)(12):** inclusion of income from discharge of indebtedness
        1. If discharge the indebtedness for less than what you owe, difference is includable in GI
        2. **Enforceable debt**: To have discharge of indebtedness income, there must be an enforceable debt in the first place.
     4. **US v. Kirby Lumber** (147)
        1. FACTS: TP issued bonds (debts) in 1923 for $12M, then bought back 1/12 of the bonds for $862K.
        2. HOLDING: the $138K difference IS taxable income. Those who buy the bonds are loaning TP money; when TP paid off the loan by buying back the bond, it was discharging indebtedness, in this case for less than the amount of the loan.
     5. **Deidrich v. Commissioner** (159)
        1. FACTS: TP wanted to give a gift of stock to kids on the condition that the kids would pay the gift tax.
        2. HOLDING: The difference b/w the basis and the gift tax is income to TP. At the time of the gift, TP sustained a debt to the government for the amount of the gift tax, and kids discharged the debt, so it was income for the discharge of indebtedness.
     6. **Exclusion: Insolvency and BR §108(a):** there is no income from discharge of indebtedness if the indebtedness happens when you are in bankruptcy under Title 11 or insolvent. However, for insolvency w/o BR, the income from discharge of indebtedness can only be excluded to the extent of the insolvency immediately before the debt discharge.
        1. **§108(e)(5):** reduction in debt for a purchase price is a reduction in purchase price and not COD income to the purchaser.
        2. **§108(f)(2):**  COD income relief on cancellation of a student loan – under limited circumstances
        3. **§108(h):**  relief from COD income when mortgage lender forecloses on TPs residence. But, reduce tax basis for residence.
     7. **Effect on Basis:** Basis in property includes the amount borrowed to buy property, and amount realized on sale of that property includes relief of indebtedness. Assumption of indebtedness is also included in basis of property bought/received.
     8. **Contested/Disputed Liability:** If a TP in good faith disputes the amount of debt, a subsequent settlement of the debt is treated as the amount of the debt for tax purposes. It is not necessary for the debtor to include in his taxable income the difference btw the parties #.
     9. **Gifts:** if a gift is forgiven out of detached and disinterested generosity, the debt forgiveness is a §102 gift and therefore not taxable. See Reg §1.1015-4
     10. **§1011:** charitable bargain sale
     11. **Zarin v. Commissioner** (150)
         1. FACTS: TP accumulated $3.4M gambling debt at a casino. NJ law says it was unenforceable, illegal gambling debt. Casino and TP settle for $500K. IRS said he had $2.9M income from the discharge of indebtedness.
         2. HOLDING: TP did NOT have income from discharge of indebtedness.
            1. It was not debt under §108(d)(1) b/c TP was not liable for it (because NJ law prevented the casino from holding him liable for it) and did not hold property subject to the debt. He paid the $500K for which he was legally responsible, and since he was legally obligated to no more, there was no income from discharge of indebtedness.
            2. Contested liability doctrine (see above): it follows that when a debt is unenforceable, the amount of the debt and not just the existence of obligation to pay it is in dispute; even unenforceable gambling debts are usually collected in part. The parties attached a value to the debt lower than its face value that was not set until the settlement. Therefore the debt was a contested liability and there is no discharge of indebtedness under this theory.
  5. **Nonrecourse Debt:**
     1. Almost always secured by property; debtor not personally liable for repayment, so foreclosure is the common method of recovery by creditor.
     2. Reg. §1.1001-2(a)(1), the amount realized includes the amount of liabilities from which the transferor is "discharged"
     3. Reg. §1.1001-2(b), the fair market value of the security is NOT relevant for determining the amount of liabilities being discharged
     4. **Crane v. Commissioner**(165) (with rounded off numbers)
        1. FACTS: TP inherits land and building in 1932 with a FMV of $255K; his basis is stepped up to that amount. Land and building were fully mortgaged with a debt of $255K. TP claims a total of $25K in depreciation deductions for a few years, and in 1938 sells the property for $2500 cash and the assumption of the mortgage by the buyer.
        2. TP ARGUMENTS: the property she inherited is not the land and the building, but the equity in the land and building--$0 since it was fully mortgaged. She claims her only gain was the $2500, and admits she shouldn’t have taken the $25K in deductions but that it is too late to do anything about that.
        3. HOLDING: TP took the deductions and on the sale the government is entitled to recapture that benefit. Here’s how it will happen:
           1. Her original basis in the property under §1014(a) is $255K, the FMV at the time of inheritance.
           2. An adjustment to basis under §1016(a)(2) will be depreciation, so her adjusted basis is $239K ($255K-$25K)
           3. The amount realized is the cash plus the discharge of indebtedness, so $257,500 ($2500 plus $255K)

This would be easy if it was recourse debt, a no brainer

The court decides this is the case even though it was non-recourse debt.

* + - * 1. Her gain, therefore, is $27,500 ($257,500 minus $230K). This happens to be equal to the depreciation deductions she took plus the cash she got from the buyer.
    1. **Debt and Property Purchase**: Acquisition of debt is included in the buyer’s tax basis for an acquired property
       1. Includes “seller financed” debt
       2. Property can be acquired with debt attached
    2. **Estate of Franklin** (172, notes case) *Cf. Tax Shelters*
       1. FACTS: investors/doctors want to shelter money from income, form an investment partnership which buys motel appraised at $600K for $75K cash and $1.2M in nonrecourse debt. Loan called for $9K/yr interest; they leased motel back to sellers, who made $9K lease payments on it. *As a practical matter what the sellers sold to the investor/doctors for $75K was the right to take the depreciation deductions.* Partnership claimed the $1.2M was their basis and take depreciation on that. Pretty clear that in 30 years they plan to walk away from debt, the sellers will foreclose and get the motel back.
       2. HOLDING: The sale was a sham—there was no intent for the property ever to change hands. This was typical of most tax shelters though this one pushed the envelope a bit more. In cases like this, ***where the TP has inflated nonrecourse debt, only the amount of recourse debt equal to the FMV of the property will be included in basis (along with any cash payments by TP)***.
    3. **Pleasant Summit Land** (172)
       1. Depreciation deduction was allowed – but only to the extent that the nonrecourse debt did not exceed the FMV of the property. That amt was effectively recognized as tax basis on the acquisition
       2. Difference: case here involved preexisting debt, provided by a 3rd party lender to which the property was subject when acquired
    4. **Commissioner v. Tufts** (173)
       1. FACTS: Similar to Crane, but the FMV was less than the debt, but not an abuse case like Franklin; instead, the value of the property dropped naturally. Cost basis in 1970 of $1,895,000; $45K cash investment and nonrecourse debt for $1.85M. TP claimed a depreciation deduction in 1971 and 1972 of $440K, making their adjusted basis $1,445,000. In 1972 they basically give property away b/c FMV has fallen below debt; buyer gives negligible cash and assumes debt when it is $1.4M.
       2. HOLDING: as in Crane, ***the amount realized includes amount of non-recourse debt the buyer assumes***. So amount realized is $1.85M, adjusted basis is $1.455M ($1.8M minus $440K). That means the gain is $395K. This could also be seen as the depreciation deductions TP took minus the cash they put in, $440K - $45K.
       3. O’Connor Concur: logical way to treat this transaction would be to bifurcate it into two transactions: a sale of property and a discharge of debt. Results in a net gain of same amount, but the character of the gain and loss are different. Sale transaction produces capital gain or loss, and the discharge of debt is ordinary income. This discharge of debt may be subject to exclusion under §108

O’Connor’s Result

|  |  |
| --- | --- |
| **Property Transaction** | **Discharge of Debt Transaction** |
| Amt Realized = $1,400,000 (FMV) | Face amt of debt = $1,851,500 |
| Less adjusted basis = $1,455,740 | Debt satisfied = $1,400,000 |
| Loss on sale = -$55,740 | Discharge of debt = $451,500 |

* + - 1. **Reg. §1.1001-2**
         1. **(a)(1)** – the amt realized include the amt of liabilities from which the transferor is “discharged”
         2. **(a)(4)(i) –** the sale of property that secures a nonrecourse liability “discharges” the transferor from the (nonrecourse) liability
         3. **(b)** – the FMV of the security is *not* relevant for determining the amt of liabilities being discharged.
  1. **Recourse Debt**
     1. Personal liability
     2. Rev. Rul. 90-16 (181) – trying to narrow the implications of *Tufts* – bank send 1099-OD to IRS to pursue debt – represented by bifurcation paragraph on 181
  2. **Illegal Income**
     1. **Gilbert v. Commissioner** (180)
        1. FACTS: TP took $1.9M w/o permission from his co. to finance a merger. Lawyers told him to give the co. a promissory note that he’d pay it back and pledge his own property as security. Company fails to perfect its security interest, so it ends up behind the IRS in priority on TP’s property. QP is whether TP should be taxed as a thief or borrower.
        2. LAWS
           1. THIEVES: if you steal money and keep it, you have income from the theft, same if you steal and promise to pay it back in that year. If you steal and ACTUALLY repay in same year, no income from the theft.
        3. HOLDING: This is not a typical embezzlement case; TP not taxed as thief b/c he was not self-interested in embezzlement and b/c he meant to pay it back. Consensual recognition of the debt with intent to repay so no embezzlement occurred (and no GI)
        4. STRENG: look to intent of borrower. If he has to repay this amt several years later, he can claim a deduction
     2. **James v. US** (183 – in *Gilbert*)
        1. HELD: Embezzled funds DO constitute GI. No intent to repay existed at time of embezzlement. TP has obligation to include on his return even if he is liable for returning the funds.
  3. **Tax Exempt Bonds**
     1. **§103:** exempts interest on state, municipal, and other such bonds for TP who holds them/gets the interest from them.
     2. It is the locality that benefits—the interest rates are lower on tax-exempt bonds, and the difference in interest is a subsidy to the locality from the federal government.
     3. Limits on tax-exempt bonds:
        1. Private activity bonds §141(e) & 142 – *cf. School bonds*
        2. Registration Requirement
        3. Arbitrage bonds - §148
     4. This starts to break down because not everyone is taxed at the same rate:
        1. Localities have to increase interest rates to attract TPs at a lower rate; can’t issue different bonds for different tax brackets
        2. Above doesn’t change cost to government, but does reduce subsidy🡪difference goes to TP in highest tax brackets.
  4. **Gain on the sale of one’s principal residence** (191)
     1. §121 provides for an exclusion of gain realized on the sale of a principal residence
        1. Requirements: principal residence; used for two of last five years; limit to $250,00 gain, unless married; then $500,000 exclusion (on joint return)
        2. Exclusion available only once every two years
     2. Eliminates necessity of proving one’s basis
  5. **Special Tax Rate for Dividends** (193)
     1. **§61(a)(7)** specifies inclusion of dividends in GI but at capital gains rate (15%)
     2. §1(h)(11)(A): At end of this year, code section expires and becomes ordinary income

# TIMING

* 1. **Realization of Gains**
     1. **Policies behind not taxing until “realization”**
        1. Liquidity issues
        2. Gain could evaporate (although this *could* be solved be a deduction for loss if it does evaporate)
        3. Valuation problems
        4. Also, in terms of economic-only income gives some TPs control of when they are going to pay tax that other TPs don’t have
     2. **Eisner v. Macomber** (37, 197)
        1. FACTS: TP had shares of Co., and Co. issued 50% stock dividend (for every two shares, TP got one free).
        2. NOTE: There can also be cash dividends, but this was a stock dividend.
        3. IRS ARGUMENTS that she should be taxed on the dividend
           1. TP**’s** wealth increased by virtue of the dividends
           2. Even if she’s not richer, the fact of the distribution is a realization of wealth that accumulated in corporate form
           3. They don’t need realization even at all—an increase of wealth at corporate level taxable to TP as shareholder
        4. HOLDING: the dividend is not taxable income. Stock dividend doesn’t make holders any wealthier, just changes the form of their wealth. The 16th Amendment requires a realization event and there wasn’t one here. There is also a liquidity problem, and the chance that the benefit could evaporate. However a cash dividend would be taxable: there would be no liquidity, valuation problems and no chance it could evaporate.
        5. STRENG: The language *derived from* indicates an event must occur – cannot constitutionally tax stock dividends here. Stockholder took nothing.
     3. **Helvering v. Bruun** (208)
        1. FACTS: TP, owner of land, leased it to renter in 1915; in 1929 renter demolishes building there, builds a new one. In 1933 renter defaults, lease is abandoned.
        2. LEGAL DISPUTE: IRS says TP has income as a result of 1929 improvement, as the abandonment of the lease was a realization event.
        3. HOLDING: abandonment was a realization event and TP should be taxed on income from improvement to land in 1933.
        4. **Legislative response to Bruun**
           1. **§109:** rule of exclusion: lessor’s gross income doesn’t include value of improvements to property by a renter when that lease ends.
           2. **§1019:** companion provision—basis won’t change on account of income excludable under §109.
           3. These rules cut in favor of the TP, allowing more control over when they will pay the tax.
     4. **Woodsam Associates v. Commissioner** (213)
        1. FACTS: Wood bought property for $296,400, incurring a recourse loan. Then Wood refinanced with a $400K nonrecourse mortgage. Wood then donated property to TP, her company. In 1933 Wood defaulted on the loan.
        2. TP/Wood ARGUMENTS: When she got another loan from recourse to nonrecourse, it was a realization event
        3. HOLDING: the change in mortgages was not a realization event—she was the owner of the property before and after the refinancing. Court is using ownership, rather than policies arguments, as the test.
        4. *Cf Inaja* – don’t realize gain until sure gonna realize gain
     5. **Cottage Savings Association v. Commissioner** (216)
        1. FACTS: TP is an S&L that holds mortgages. It holds many mortgages less valuable than they used to be b/c of high interest rates. TP sells its mortgages and buys others from other banks to get a loss for tax purposes, but at the same time trying to avoid reporting losses to retain certification by bank regulatory board. TP is selling 90% participations of their mortgages and buying 90% participations of other mortgages, because unlike selling whole mortgages this is an invisible transaction.
        2. HOLDING: The test of whether an exchange is a realization event under **§1001(a)** is whether the mortgages TP received were materially different from those it gave up. Here they were, b/c the mortgages and houses under the mortgages were different and subject to different legal entitlements and obligors.
        3. STRENG: This case creates a hair trigger test for realization of losses – touch it and the event occurs – materially different very small to trigger event
     6. **Debt Modification as a Disposition**: Reg. §1.1001-3 states that a “significant modification” of a debt instrument is an “exchange” for FIT purposes. This includes a change in (1) length of term, (2) interest rate, (3) another element (eg priority)
        1. Exception for a “unilateral option” or a change in an “index rate” where a variable rate obligation
  2. **Recognition**
     1. **Recognition Rule: §1001(c):** the entire amount of a gain or loss on the sale or exchange of property under §1001 will be recognized uness a specific rule prohibits or limits recognition. ***A recognized gain or loss is a realized gain or loss that TP is going to take into account for tax purposes***.
     2. **Non-Recognition Rules** (examples):
        1. **Like-Kind Exchanges §1031**
           1. **§1031(a)(1):** if there is a like-kind exchange for property held for the productive use in trade or business or investment, no gain or loss recognized.

Two farmers who trade their farms, e.g.

Improved real property and unimproved real property are considered like kind if they are both held for productive use in a trade or business or for investment. Treasury Reg. §1.1031(a)-1(b).

* + - * 1. **Exceptions §1031(a)(2):** makes exceptions to §1031(a)(1). For example:

**§1031(a)(2)(A):** Doesn’t apply to stock in trade or other property held primarily for sale.

**§1031(a)(2)(C):** Doesn’t apply to securities or evidences of indebtedness or interests.

* + - * 1. **Use:** TP must have held ii intended to hold the property transferred for use in a trade or business, or for investment
        2. **Boot**

**§1031(b):** if an exchange is partially an exchange for like kind property and partially something else (boot) you recognize the gain to the extent of the FMV of the boot (or realized gain if realized gain is less).

**§1031(c):** if there is boot received along with like-kind property, a loss will not be recognized

Net relief of indebtedness is treated as boot under §1031, and it is additional to cash boot.

* + - * 1. **Basis §1031(d)**

**No Boot:** the basis of the property GIVEN is the basis in the property received in the exchange (i.e. each party keeps their old basis).

**Boot**

**TP who gets boot:** the basis of non-cash property TP gets will bethe basis of the property TP gave in exchange minus cash TP receives, plus the amount of gain or minus the amount of loss that is realized and recognized.

That basis is allocated among like-kind property and non-cash boot received by TP; the non-cash boot’s basis is its FMV.

**TP who gives boot:** the basis of the new property TP GETS in exchange will be the basis of the property TP gave plus any cash TP paid for the exchange.

* + - * 1. **PLR 200203033 (229)** – property subject to conservation easement being swapped for property subject to conservation easement qualifies as like-kind 🡪 assuming held for productive use in business or for investment
        2. **Multi-Party Transactions** (234)
        3. **Deferred Property Receipt:**

**Starker exchange (237) - §1031(a)(3)** property sold for cash, 45 days to ID like-kind property with purchase within 180 days OR before your next tax return

* + - 1. **Involuntary Conversion §1033 Deferral:** Postponement of realized gain occurs if gain is derived from an involuntary conversion of property (ie theft, casualty, seizure, imminent domain). When conversion is to dissimilar property, gain will be recognized but TP gets a period of time (close of 2nd taxable year) to buy like property so it won’t be. TP can always, however, recognize LOSS on involuntary conversions (generally in the amount of basis in the property).
      2. **Corporate Transaction §1032:** Corporation does not recognize gain on exchange of shares for shareholder’s assets.
         1. **§351** – no gain or loss shall be recognized if property is transferred by one or more person(s) to a corporation solely in exchange for stock and immediately after that person(s) takes control
         2. **§358 –** basis to TP - basis in original property carries over to her stock
         3. **§362(a) –** basis to corp. in contributed property - corporations basis in contributed property is same as original contributor
         4. **§357(c)** – transfer of property subject to debt – recognition of gain to the extent that liabilities exceed basis for TP – no basis left for shares of stock of the corporation
         5. **Tax-Free Reorganizations** (240) – we treat it like nothing changed for incorporation purposes, we see nothing under tax

**§354 –** no gain or loss is recognizedif stocks or securitiesin a corporation a party to a reorganization are exchanged solely for stock in another corporation party to reorganization

Nonrecognition rule does not apply to individuals

* + - 1. **§1035:** Gain/loss from exchange of life insurance policies or other annuities non recognized.
      2. **§1036:** Gain/loss from exchange of stock in same corporate not recognized.
      3. **§1037:** Gain/loss from exchange of US Treasury obligations for others
      4. **§1043:** Gain/loss not recognized when any officer or EE of executive branch of federal government has to sell property to comply w/conflict of interest laws
  1. **Boot and Basis** (231)
     1. **Example:** C has Property A with a basis of $50 and FMV of $90; D has Property B. They exchange.
        1. If B has a FMV of $90, it will just be a property exchange. C will realize a gain of $40 but it won’t be recognized b/c there was no boot and it was an exchange of like-kind property. Basis in B will be $50.
        2. If B has a FMV of $60 and comes with a $30 boot, C’s realized gain will still be $40, his recognized gain will be $30. Basis in B will be $50.
        3. If B has a FMV of $35 and a cash boot of $55, C’s realized gain is still $40; recognized gain will be $40 because it is the lesser of the boot or realized gain. Basis in B will be $35.
        4. This is basis doing what it should: keep track of what TP has been taxed on and what TP still owes in tax.
  2. **Deemed realization – Constructive Sales**
     1. **Short sale**: if believe stocks are going to decrease, borrow from someone and sell it when it is high, then when it depreciates buy back same # of shares to return to original owner and the profit is the difference btw sale and re-purchase.
     2. If want to get the cash now for minimal interest but don’t want realization event to happen until she dies bc then basis will go from $0 to FMV (*Estee Lauder*)
     3. **Legislative response - §1259** – realization event if doing short sale on stock you also own shares in bc essentially you have constructively sold your own stock
  3. **Original Issue Discount** (245)
     1. When a debt instrument does not provide for (1) any current interest or (2) adequate (market) interest then unstated interest income is accrued regardless whether the oblige is a cash-method or accrual-method TP
     2. §1273 The OID is the difference between the issue price and the redemption price. This amt is treated as interest accrued ratably over the time btw purchase and sale (for an accrual basis obligor)
     3. Policy: to avoid interest income postponement while enabling a current interest expense deduction
     4. If issue price cannot readily be determined, apply discount (interest) rates to the expected payments. The issue price is determined by discounting the expected payments to present value
        1. Unless expressly stated, the interest rate for this purpose is the applicable federal rate (AFR) §1274(d)
     5. Before OID rules: treat all this gain as capital gain when the obligation matures and is then paid
     6. Exceptions: does not apply to tax exempt obligations (state and local bonds), sale for deferred payments of a principal residence or farm for less than $1 million
     7. §483 – providing for the treatment of the discount portion (1) as interest income (and not as capital gain), but (2) only when the payment is received, ie a recharacterization rule, but not a timing acceleration rule for the cash basis seller
     8. §1276 *Market Discount*: gain on the disposition of any market interest bond shall be treated as ordinary income to the extent it does not exceed the accrued market discount on such bond
        1. Purpose and fxn was to prevent the conversion of ordinary income into capital gains
  4. **Open Transactions:**
     1. **Burnet v. Logan** (249)
        1. FACTS: TP owned 1K shares of mining co. stock with a basis of $180K. Co. bought TP’s shares for $120K in cash and a promise to pay her what they got from the ore (undetermined amount).
        2. TP ARGUMENT: TP should be allowed to recover basis before required to recognize income.
        3. IRS ARGUMENT: It is a closed transaction worth $220K, so TP has met her basis and got $40K in income.
        4. HOLDING: It is an open transaction, TP is correct; the promise for future money payments was not equivalent to cash b/c it is uncertain so the transaction is still open. TP is entitled to recover basis first.
     2. Treatment is available only in “rare and extraordinary circumstances” **Reg. §1.1001-1(a)**
     3. Other approaches: open transaction – all payments are tax basis components until full basis recovery, value the stream of expected payments as of date of sale and compare this amt with basis, or an open transaction but allocate basis to each expected payment (ie. An installment method)
     4. Why do TP’s want open transaction treatment?
        1. Postpone inclusion in GI
        2. All proceeds treated a capital (gains) while the transaction is “open.” No receipts are considered as being interest income.
     5. **Warren Jones**
        1. FACTS: TP sold a building for $153k, but only received $20k and a promise to pay the rest over 15 year period. Treated this as an installment K and deferred reporting gain until it recovered its basis. Allocated btw capital recovery and capital gain received on a proportionate scale.
        2. HELD: Closed transaction. If FMV received in an exchange can be ascertained, FMV must be reported as the amount realized.
  5. **Accounting Methods**
     1. **Installment Method** (250)*TP favorable position*
        1. **Objective:** Coordinate income tax reporting with the TP’s actual receipt of cash
        2. **§453:** where there’s an installment sale, TP can take amounts paid and allocate it b/w the basis and the income recognized.
        3. **§453(b)** installment sale means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs
        4. **Ratio:** gross profit divided by contract price creates a percentage to allocate how much of each payment is gain and how much is basis. So Payment X times (gross profit divided by contract price) is the amount of income TP recognizes each year they receive a payment. §453(c).
        5. **Installment Sale:** where payments straddle at least two taxable years. TP can opt-out of installment method for installment sales under §453(d).
           1. **Promissory Note Not a Payment Unless** it is payable on demand or readily tradable. §453(f)(3). Otherwise there are liquidity problems with calling it a payment. If you sell in Year One and just get a regular promissory note for a later year, not an installment sale.
        6. **§453(e)** provides if (1) 1st disposition or property is to a “related person” and (2) 2nd disposition is by the related person to another before all installments are paid on disposition One, then the 1st disposition is treated as closed when the related person sells. Prevents strawman loophole that was being exploited, but not completely bc narrow definition of related person
        7. **Limitations:** §453(b)(2) and (k) – installment sales provision is not available for (1) inventory sales or (2) sales of publicly traded securities; §453A – interest charge is applicable if aggregate obligations from $150k plus sales exceed $5 mill; §453A(d) – a loan is treated as payment if the obligation is pledged for a bank loan; §453(i) – no deferral for installment obligation when “recapture of depreciation” income arises
        8. **No §453 eligibility** where payment in the sale is made by the buyer with (1) demand notes or (2) publicly traded debt obligations.
        9. But no limitation applies where (1) the debt is guaranteed §453(f)(3) or (2) a bank guarantee with a “standby letter of credit” is provided by the buyer to seller. Reg. §15a.453-1(b)(3)(iii)
        10. **Sales with Contingent Payments**: apply §453 in this order: (1) allocate basis over max to be paid; (2) allocate tax basis over the max payment period; (3) allocate tax basis in equal annual amounts over a 15 year period
     2. **Cash Method:** TP generally will include an item in gross income when actually received or made available for receipt and will deduct an item when actually lost. Individuals almost always on this method.
        1. **Constructive Receipt**: a TP will be considered to have received items to which he or she had a right and the ability to claim but did not do so
        2. **Restrictions:** Some TP’s may not use the cash method of accounting, as Congress has determined that it would unreasonably accelerate deductions
     3. **Accrual Method:** Large business normally on this. Looks to when the right to receive is accrued and the obligation to pay is accrued; that determines timing of income and deduction.
  6. **Constructive Receipt and Related Doctrines**
     1. **Employee Deferred Compensation Arrangement:**
        1. Contract b/w ER and EE that ER will pay some or all of EE’s compensation after it is earned.
        2. Different than tax-qualified plan; often called *non-qualified plans*.
           1. Non-qualified plans cover only executive and HCEs; federal law forbids them covering rank and file.
           2. Tax difference is that assets going into qualified plans grows tax exempt (dividends, interest, etc not taxed as they accrue). Not for non-qualified.
           3. No monetary limit on the deferrable amount
        3. Immediate income recognition if the funds are paid into an escrow acct for the EE (ie. Funds are not controlled by ER
        4. §404(a)(5) – an ER can only deduct payments in the future when paid, even though an accrual TP
        5. §457 – dollar limitations on plans of state agencies; payor is not subject to tax
        6. §403(b) – tax-exempt charities and public educational agencies have limitations – lots of these kinds of plans out there
        7. **Example**
           1. If interest is at 6%: When an executive has earned $100 at Year 1 and is to be paid at Year 5, the ER really has to put down $111 at Year 1 in order to be able to pay EE $100 at Year 5. If it was in the hands of the EE from Year 1, then by Year 5 he would only have $79 after taxes.
           2. Therefore, the tax benefit in connection with deferred compensation is not funded by the government, but the ER. It’s just a way to increase compensation.
        8. If an EE has control over timing or security of the deferred compensation arrangement, then the compensation will be included in income when earned.
           1. **Constructive Receipt Doctrine:** a cash method TP must include in income an unpaid amount unless their rights in that amount are substantially restricted. Reg. §1451-2(a)
           2. **Economic Benefit Doctrine:** cash method TP must include an amount in income if ER has put the amount in a trust, or otherwise secured it for the benefit of TP beyond reach of ER’s creditors.
           3. **Cash Equivalence Doctrine:** cash method TP must include in income any unpaid amount if rights to that amount can be pledged/assigned for value.
        9. **Amend v. Commissioner** (253) et al
           1. FACTS: TP had a bumper crop of wheat. TP contracted to deliver it to customer in 1944 and be paid in 1945. IRS wanted to include income in 1944 return, but TP said it should be in 1945.
           2. HOLDING: TP is correct—by the time the contract was made, TP had no legal right to payment until 1945 and transaction didn’t happen until after the contract. No constructive receipt. No right to currently demand the funds & no GI inclusion currently.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Case** | **Facts** | **Legal Issue** | **Outcome** | **Rationale** |
| Amend | Sale of wheat in ’44; payment in ‘45 | Constructive receipt | Taxpayer wins. No GI inclusion | Deferral is pre-contractual, so the taxpayer had no legal right to payment in 1944 |
| Pulsifer (258) | Prize money; vested bank account; accessible | Economic benefit | Government wins. GI inclusion | Irrevocable trust, set aside for taxpayer’s benefit; taxed in year of award |
| Minor (268) | Doctor Deferred compensation held in trust, which buys annuities | Constructive receipt & economic benefit | Taxpayer wins. No GI inclusion | promise to pay in the future doesn’t trigger constructive rec; not secured from ER’s creditors—CR n/a bc not vested, benefit may evaporate |

* + - 1. Cases are looking just at TP who receives the money, not both sides of the transaction.
    1. **Legislative Response to Enron**
       1. At Enron, there was a “haircut provision”: 10% penalty for taking money out of the deferred compensation fund but it could be done any time. The analysis was that such a significant penalty meant EEs were not in constructive receipt of their unpaid compensation.
       2. **§409A:** meant to ban haircut provisions and clean up the law. TP ER; no EE deferral if election exists to accelerate benefits – even though based on an external condition
          1. **§409A(a)(2)(A):** deferred compensation can’t be distributed until end of employment, disability, death, specified time, change in ownership, or unforeseeable emergency.
          2. **§409A(a)(3):** there can be no acceleration of benefits—this is the part intended to ban haircuts.
          3. **§409A(a)(4)(C):** you can delay benefits, but only a year in advance and only for a period of more than five years from when originally earned.
          4. **Penalty**

If above rules aren’t followed, all deferred compensation in past years and current year will be includable in gross income under §409A(1)(A).

There will be an interest charge and penalty of 20% of income includable in gross income. §409A(1)(B).

If you know this, and do it anyway, nothing to stop the company from picking up your tax liability. So Enron could have happened even if this statute was in place. It’s not good.

* + 1. **Qualified Pension/Profit Sharing Plans**
       1. **Personnel objectives:** Enable EE loyalty and EE incentives (including investing in the ER’s stock
       2. **Defined benefit (DB) plan:** ER agrees to pay fixed retirement benefits based on (1) years of service and (2) final pay amount – pay in and know what you’ll get out in the end
       3. **Defined Contribution (DC) plan:** amount contributed based on formula (ie %5 of compensation) and the amt paid on retirement is based on investment returns
       4. **Tax results:**
          1. ER deduction for plan contributions
          2. NO current GI to the EE-participant; GI inclusion upon later distribution to retiree
          3. No GI for investment returns received by the intermediary holding entity (ie. Trust)
          4. Non-tax benefit – funds are protected from ER’s financial risks (altho possible actuarial underfunding for DB plans)
       5. **Limitations:**
          1. Non-discrimination rules – can’t favor highly paid EE
          2. Vesting – benefit becomes nonforfeitable; CF effect of termination before retirement
          3. Funding – infusion of contributions into a separate trust enables security of funds
          4. Limits on contributions made by ER
       6. **Special Retirement Plan Structures**
          1. Self-employed person use a Kogh plan when only one (or several) employees
          2. IRAs – indiv retirement accts – when ER not providing benefits §408
          3. Roth IRA – nondeductible contributions, but non-inclusion for accruals and distributions
          4. NOTE: penalty for early withdrawals & required minimum distribution (70.5)
  1. **Property Exchanged for Services**
     1. **§83(a):** if there is a transfer of property in exchange for performance of services, the person getting the property must include the FMV of the property minus the amount they paid for the property in their gross income at the time when the property is transferable or not subject to a substantial risk of forfeiture.
        1. **GI Inclusion** when stock option is issued with a “readily ascertainable” FMV
        2. **Property not vested:** when property is not vested , the above has not yet been triggered, but EE can elect to include it at the time of receipt and own it free and clear for tax purposes at that time to the extent of FMV. §83(b). No deduction by EE if forfeiture of the option subsequently occurs
        3. **Deduction:** ER can deduct the payment in property when EE includes the property in their gross income. §83(h).
        4. **No inclusion** when option os “nontransferable” and a “substantial risk of forfeiture” – inclusion when conditions lapse
        5. **GI Inclusion** when exercise for the difference btw exercise price and stock value
     2. **Stock Options**
        1. Right to buy stock at a specified price during a defined period of time
        2. **LoBue** (276) Company not giving away something for nothing and not motivated by detached generosity – EE stock options taxable
        3. **Timing and characterization Issues:**
           1. **Option One:** EE includes value of option in GI in year of grant of option 🡪 ER deducts amt as compensation in year of grant 🡪 EE increases tax basis for shares when exercising option at option price 🡪 EE has CG when subsequently selling shares at price above tax basis
           2. **Option two:** EE includes nothing in GI in year of grant 🡪 ER deducts nothing in year of grant, but later when exercised 🡪 EE exercises & compensation income for FMV of stock less option price 🡪 EE has CG when subsequently selling shares at price above tax basis
           3. **Option Three:** EE includes nothing in GI in year of grant 🡪 ER deduct nothing in year of grant, but later when exercised 🡪 EE exercises but no compensation income (for FMV of stock less option price) 🡪 EE has CG when subsequently selling shares at price above tax basis (and no compensation income)
        4. **Incentive Stock Option (ISO) Rules §422**
           1. Statutory structure permitting GI inclusion limited to CG upon sale of stock
           2. Rules

Stock retention reqs

Option price at FMV when granted

Granted under an option plan

$100k limit on option stock amt

No ER deduction for compensation

* + - * 1. Net benefit if ER loses immediate deduction but deferral of CG for EE
      1. **Nonstatutory Stock Options** – Stock is available to EE but is subject to restrictions on transferability and a risk of forfeiture.
    1. **Cramer v. Commissioner** (283)
       1. FACTS: TP founded a privately held company in 1972; b/w 1978 and 1981 it was neither publicly traded nor registered w/the SEC and it was held by 150-200 shareholders. In 1978 it issued TP an option to buy 50K shares at $50/share, as long as it was exercised only in 20% increments and only as long as he was still employed there; there were also some transfer restrictions. In 1979 the co. issued TP another option to purchase 4390 shares at $8/share, and some options to some other execs. The co. issued all of these options in recognition of services they provided to the co, and the delayed vesting was intended to induce their continued employment. None of them ever exercised the options. Then TP got bad tax advice from an accountant, who told him to file §83(b) elections with the IRS for the options. The TP declared $0 value on the options even though he thought they were worth something, because the tax attorney had advised him that §83(b) might not apply w/out a readily determinable FMV and he wanted them to have a readily available FMV. Wanted to enable CG. Reported option gain as LTCG & high basis
       2. HOLDING: Treasury Regulation §1.83-7 is valid and clearly the options in question did not meet the definition of readily ascertainable FMV (297). Therefore, §83 did not apply to the transfer and the gain from the sale of the options was ordinary income not capital gain. Serious penalties also applicable
  1. **Transfers Incident to Marriage & Divorce**
     1. **United States v. Davis** (292)
        1. FACTS: TP and his wife got divorced and as part of the settlement TP gave wife 1000 shares of stock of DuPont. Not a community property state, so all property during marriage not jointly owned by husband and wife.
        2. HOLDING: Transfer was taxable event (i.e. TP had to realize and recognize gain/loss) since they weren’t hers until Davis transferred them to her, and the exchange was for something of equal value (her marital rights).
     2. **Legislative Response to Community Property Disparity**
        1. **§1041:** (non-recognition rule) there will be (1) no recognition to the transferor on a property transfer in divorce and (2) a transferred tax basis for the property when held by the recipient. No deduction is available for the property transfer to the other (ex)spouse.
        2. **Basis** for property transferred is FMV
        3. **Limitations:** Rev. Ruling 87-112 – no tax free transfer of accrued interest income
        4. **Example:** Ignoring §1021, W buys house for $500K before marriage to H and is now giving it to H in their divorce when worth $1M.

|  |  |  |
| --- | --- | --- |
|  | **Davis Rule** | **§1041 Rule** |
| Tax treatment of wife | $500K realized & recognized gain | $0 recognized gain under §1041(a) |
| Tax treatment of husband | No taxable income, basis of $1M under §1012 | $0 recognized gain under §1041(b)(1), basis of $500K under §1041(b)(2) |
| Tax consequence of husband selling for $1.3M | $300K taxable gain at time of sale | $800K taxable gain at time of sale |

* + - 1. No special rule like with gifts—there is a carryover basis whether there is a gain or loss.
      2. Does not apply if the transferee spouse is a non-resident alien; in that case, the Davis rule applies. §1041(d).
      3. §1041(e): transfers where liability exceeds basis – to the extent of the debt
    1. **Farid-es-Sultaneh v. Commissioner** (296)
       1. FACTS: H transferred appreciated stock to his wife before they got married worth $800K with a basis of $0.15 and worth $10K/share at the time of transfer. This was a pre-nuptial agreement. W sells for $19/share after divorce.
       2. HOLDING: This is more like a sale than a gift b/c they were both getting something valuable. FMV
       3. STRENG: This should have been treated like a gift with a transfer of basis. Disappeared from tax base
    2. **Alimony**
       1. Generally alimony is taxable to the payee and deductible by the payor (§215), while child support and property settlements are not taxable to the payee or deductible by the payor.
       2. **§61(a)(8)**: TP receiving alimony must include it in GI, regardless of the label used under state law
       3. **§71 Rules governing Alimony and Separate Maintenance** (300)
          1. **§71(b):** defines alimony or separate maintenance as cash payments:

Cash payments (not property transfers) received under an instrument of divorce or separate maintenance §71(b)(1)(A)

Where the parties have not agreed that the payment will not be taxable to the payee and nondeductible by the payor (i.e. can’t waive rights to alimony beforehand). §71(b)(1)(B) Parties can opt out of alimony tax status (and agree on no deduction)

Where the parties are no longer living together. §71(b)(1)(C).

Where payments don’t continue after the death of the payee spouse (otherwise they are more like property settlements). §71(b)(1)(D)

Payments can’t be front loaded

* + - * 1. Alimony payments must not be for child support. §71(c).If the payor has custody of and supported the children, there would be no deduction for the cost of the support, so there is no justification for allowing the payor to deduct child support payments when they are not the custodian.
        2. **Excess Alimony Rules §71(f)**

The law really discourages front-loading alimony payments, so only payments that are substantially equal for the first three years will be treated as alimony

**Main provisions**

The amount of the excess (X) for the first year is the excess of alimony paid in the first year (a) minus the sum of the average alimony or maintenance payments made during the second year (b) reduced by the excess for the second year (Y). §71(f)(3). **First Year Excess (X) = a – {[b – y + c]/2 + $15K}**

The amount of excess for the second year (Y) is the excess of the alimony paid in the second year (b) minus the alimony payments made in the third year (c) plus $15K. §71(f)(4). Second **Year Excess (Y) = b – (c + $15K)**

X + Y (The excess amounts for the first two years) must be included in the payor’s income in Year 3 (and may be deducted from the payee’s).

**Rationale:** Deprives people of the opportunity and incentive to turn property settlements into alimony

The recapture rule is not required if either party dies or if the payee spouse remarries by the end of the calendar year which is two years after payments started and the payments end b/c of remarriage.

Excess of the front-loaded payments are considered income to the payor

* + - 1. **§215:** gives a deduction from income for alimony payments and incorporates the §71(b) definition as long as it is includable in the income of the payee.
      2. **Indirect Alimony Payments**: if H pays house note or life insurance premiums for a policy she owns, taxable alimony to W even tho she never receives the funds
    1. **Child Support Obligations**
       1. Child support is (1) not deductible by the payor and (2) not GI to payee
       2. **Diez-Arguelles v. Commissioner** (304)
          1. FACTS: Ex-H in arrears for $4500 in child support, ex-W deducted it and treated it as a non-business bad debt under §166(d)
          2. HOLDING: Deduction not allowed, because no basis in the debt—can only deduct bad debt if there’s basis in it.
          3. What does it mean to have basis in debt? There are two paradigms here:

Child support means an obligation to pay $3700 and she loans that to him, which he uses to support the kids, and never pays it back. Court would recognize THIS as creating basis in bad debt.

There is no court order; he just says he plans to give her $3700 and then he doesn’t. No investment in debt here, and therefore no basis.

* + - * 1. Court says it is more like 2nd paradigm—but this is absurd. Of course she is out of pocket, every dollar he owed and didn’t give is money she had to pay.
  1. **Consumption Tax**
     1. **Economic Definition**
        1. Income = Consumption plus savings
        2. Savings = Income minus consumption
        3. Consumption = Income minus savings
     2. **Public Policy**
        1. There have been proposals to move to a consumption-only tax. Arguments for:
           1. Would reduce the overall tax burden on saving money
           2. Will lead to economic growth by giving bigger return on investments
           3. Simpler and easier to administer

*However it is not that easy to draw lines b/w consumption and investment/savings as many might say*

* + - 1. Arguments against
         1. Equity

Horizontal equity: similarly situated people should be taxed the same.

Special tax preferences always disturb it—e.g. marriage penalty.

Consumption tax would define ability to pay not by income but by what they spend—is that the best way?

Vertical equity: those with a greater ability to pay should pay more.

Flat tax on consumption raises some issues with this

Not progressive

Burdens those at the low end who spend a higher portion of their wealth

Even a progressively structured consumption tax would have the second problem

Not everyone cares about vertical equity, though.

* + 1. **What does consumption tax look like?**
       1. There are many countries w/national consumption tax, but they also tax income
       2. Sales tax
       3. Wage tax
       4. VAT (levied at each stage of production on value-added; European thing) – transaction tax similar to a retail sales tax, but imposed on the national level (in all OECD countries except US)
          1. Applies to each stage of production with an immediate credit for the VAT taxes previously paid in the chain of supply as attributable to the manufacturing of that specific item
       5. X tax on net cash flow of business and wages people earn: this one allows for a progressive structure
    2. **Transition Issues**: a transition to consumption only tax would affect basis.
    3. **Major reason we don’t:** businesses and old people don’t want their basis wiped out.
    4. ***Cf.*** *Accounting Methods: accrual basis TP*
  1. **Accrual Method TP**
     1. **Fundamentals for TP:**
        1. Income inclusion for amounts earned (even though not received) and
        2. Deduction for obligations incurred, even though not paid
     2. **FIT exceptions:** 
        1. Not permitting deferral of prepaid income or
        2. No accrual of estimated future expenses
     3. **Delay in the Receipt of Cash** (313)
        1. **Georgia School Book Depository** (313)
           1. FACTS: Publisher sold books to state under funding scheme based on alcohol sales. When payments came due, the school had insufficient funds. Publisher continued to sell books and accrue debt to school – postponed FIT reporting until paid.
           2. HELD: Broker had economically accrued all the commissions – knew the payment would occur at time of sale.
        2. **Hallmark Cards** (316)
           1. FACTS: Hallmark shipped Valentine’s cards to retailers in December, but retailers did not want owner ship at COB for personal property tax purposes. (cards in inventory)
           2. HELD: Hallmark held title until January 1st and income did not accrue until title transferred. Transfer of title was recognition event
     4. **Prepaid income §455**
        1. **American Automobile Assoc v. US** (317)
           1. FACTS: One year membership fee for club paid in advance. IRS argued immediate accrual to GI. TP argued it should be a ratable allocation to each month with partial deferral of unearned income to nxt year.
           2. HELD: IRS wins, immediate GI inclusion. Method of treatment of dues is “purely artificial.” Ratable reporting is not permitted
        2. **More prepaid cases:**
           1. **Schlude**: prepaid dance lessons; inclusion at time of receipt of payment bc not sure when events will occur
           2. **Artnell:** deferral until baseball games played for prepaid tickets to sporting events bc know exactly when each game is played – recognition at time of event
           3. **Boise Cascade**: consistently reporting income when services rendered (not requiring any earlier reporting if advance receipt.
           4. **Revenue Ruling 2004-34** (reporting in the current or subsequent year if consistent with financial acting and **Regs. §1.451-5** (sales of goods) & similar treatment as services

# PERSONAL DEDUCTIONS, EXEMPTIONS AND CREDITS

* 1. **Synopsis on p. 333 with corresponding subsections** 
     1. **General rule:** personal expenses generally are not deductible. §262. Many exceptions.
     2. Taxation of business enterprises on the net accrual of wealth necessitates enabling deductions for the cost of producing the income of that business
     3. **Personal Dependency Exemptions**
     4. **Non-Itemizers:** Roadmap to taxable income for non-itemizer
        1. Gross income
        2. Minus deductions allowed under §62 = adjusted gross income
           1. These are “above the line” deductions
        3. Gross income minus standard deduction
           1. This is a flat amount indexed for inflation
           2. Intentionally set higher than most would have if they itemized to encourage administrative ease
        4. Minus personal exemptions
           1. This is a deduction for the TP and each of her dependents

**Personal Exemption §151**

Rationales:

Basic living expenses should be taken into account in determining ability to pay (i.e. they should be removed from the picture before such determination)

Expenses increase as the size of the household increases

Administratively it is easier to give a standard number than try to determine in each given circumstance what a family’s cost of living is

Effects

Increases threshold at which lower income people don’t pay taxes

Contributes to overall progressivity by creating a larger zero-bracket

Phaseout: TPs lose 2% of the personal exemption for every $2500 of income over the threshold (currently $214,050 for marrieds)

**Dependents (children, grandchildren, other qualifying relatives, or siblings who are under 19, or full time students under 24). §152**

To be a dependent, must:

Live w/TP for at least 50% of the year if the TP’s child (though temporary absences to attend school do not count toward being away from home)

Have at least 50% of support paid for by TP

Does not provide half of own support

Scholarships do not count as “providing your own support” so a child going to school on a scholarship full time can usually be a dependent

**Weird:** a non-relative can be a “qualifying relative” under §152(d) if they are not a qualifying child of the TP and

Has the same principal place of abode as TP

Has gross income less than the personal exemption amount

Gets more than half of support from TP

* + - * 1. Combining this w/standard deduction means many families pay no tax

Last year, the first $22,800 was not taxable and the personal/dependent deduction was $3200.

* + - * 1. Phase out as income level rises above certain thresholds §151(d)(3), §68
      1. Equals taxable income
    1. **Itemizers:** Taxpayers who do itemize have the same roadmap but (c) is minus itemized deductions instead of standard deduction.
       1. They can take any deduction allowed in the code except the standard deduction.
       2. Must deal with §67 and §68.
          1. §67 sets a floor on miscellaneous itemized deductions: you can only deduct them to the extent they are more than 2% of adjusted gross income.
          2. §68: if your adjusted gross income exceeds a certain amount, you lose some of your itemized deductions (those equal to 3% of the amount of adjusted gross income greater than the threshold amount). Last year the income amount trigger was $145,950.
          3. There are no similar phase-outs or conditions for the standard deduction.
       3. Itemization generally more valuable for people with higher marginal tax rates—on exam?

1. **Casualty Losses**
   1. §165(c)(3): an individual tax payer is allowed a deduction for purely personal loss if it arises from fire, storm, shipwreck, other casualty, or theft.
      1. Each casualty is allowed a deduction only to the extent it exceeds $100. §165(h)(1).
      2. Net casualty losses in a year are only allowed to the extent they exceed 10% of adjusted gross income. §165(h)(2). These provisions limit the # of cases brought.
      3. §165(a): it is only the net loss that can be deducted (anything covered by insurance, etc. can’t be deducted, and it can’t be deducted if it reasonably might be reimbursed—that is it can’t be deducted until its clear it won’t be reimbursed or further reimbursed).
      4. §165(b): the deduction for individuals is the lesser of the adjusted basis of the property, or the value at destruction; therefore if insurance covers the basis, there will be no casualty loss deduction.
      5. §165(h)(5)(E) – insurance claim is required to be filed in certain cases to receive deduction
         1. **Business Casualty Loss:** This is a §165(c)(a)-(2) loss, and is not subject to the $100 or 10% AGI limits. Such uninsured losses are allowed equal to the adjusted basis of the property, even if it is greater than the FMV.
      6. **“Suddenness requirement”** – TP must equate situation to the suddenness associated with the above catastrophes
         1. **Termites**:not sudden, no deduction – destruction over time
         2. **Lost Rings Cases** (337)
   2. **Dyer v. Commissioner** (336)
      1. FACTS: family cat started having fits; in first fit it broke a $100 vase. TPs claimed $100 casualty loss deduction.
      2. HOLDING: the breakage was of ordinary household equipment by negligence or family pet. If they had allowed the deduction it would have caused evidentiary problems in future cases. Led to imposition of threshold statutes.
   3. **Chamales v. Commissioners** (338)
      1. FACTS: TPs bought home next to OJ Simpson and the Brown-Simpson murders happened when the house was still in escrow. TPs went through with the sale. Realtors and brokers told them it was very devalued and TPs claimed a deduction for loss of property value.
      2. HOLDING: IRS is correct—there can be no deduction, it doesn’t fit w/in §165(c)(3) because it was not sudden, permanent, and didn’t involve physical damage (reqd by circuit). Not a loss contemplated by the code. However, the IRS-imposed negligence penalty was not upheld by the court.
   4. **Blackman v. Commissioner** (345)
      1. FACTS: There was a domestic disturbance; H found out W was cheating, broke some windows, and burned her clothes on the stove which eventually destroyed the house by fire. HE was sentenced to community service. He then claimed a deduction for casualty loss of the house and its contents.
      2. HOLDING: although the damage was sudden, permanent, and involved physical damage and was from fire which is specifically mentioned in the statute, it would frustrate the state’s public policy against domestic violence and arson to allow the deduction, so it is disallowed.
      3. The IRS challenges casualty loss cases as much as possible.
2. **Extraordinary Medical Costs** (349)
   1. **§213(a)** is the actual deduction
      1. Covers medical care for TP, spouse, and dependents to the extent they exceed 7.5% of AGI. §213(a). Obamacare increased this floor to 10% for ppl over 65 §213(f)
      2. Medical care includes everything but controlled substances, veterinary fees, cosmetic surgery. §213(d).
      3. Doctor’s recommendation not required, but helps
   2. **What is medical care?**
      1. §213(d)(1)(A): includes cost of diagnosis, cure, mitigation, treatment, or prevention of disease
      2. §213(d)(1)(B): transportation primarily for and essential to medical care
      3. §213(d)(2): not lavish and $50 per night limit
      4. §213(d)(1)(D): medical insurance premiums – deductible – (d)(10) covers long term
      5. Psychiatric treatment costs are deductible Treasury Reg §1.213-1(e)(1)(ii).
      6. Cosmetic surgery to repair a congenital defect IS deductible. §213(d)(9)
      7. Dental work
      8. Capital improvements for medical purposes are deductible to the extent they cost more than they add value.
      9. Federal system cannot give a deduction for something that’s federally illegal
      10. Reg. §1.213-1(e)(1)(iii): improvements to home (capital improvements) are deductible if necessary to medical care but only to the extent they do not add value to the home
      11. NOT:
          1. NOT health maintenance like aerobics lessons for someone who isn’t sick (except annual diagnostic checkup costs are deductible)
          2. NOT food and lodging while away for outpatient medical care (but travel costs and doctors fees are)
      12. Major issue in these cases is a line b/w things people would only spend money on if they were sick.
      13. **Taylor v. Commissioner** (351)
          1. FACTS: TP’s doctor told him not to mow his lawn for health reasons. The TP then claimed a medical expense deduction for the cost of his lawn care.
          2. HOLDING: Doctor recommended activities are not medical expenses where the expenses are not “medical care.” There is no showing here that other family members couldn’t perform the activity. TP does not carry the burden the proof to show it’s a medical cost. Just bc doctor recommended does not mean medical care.
      14. **Ochs v. Commissioner** (352)
          1. FACTS: A cancer patient, is told that having her children around might cause a recurrence of her cancer. Her husband, the TP, sends the kids to boarding school and deducts it as a medical expense.
          2. HOLDING: This was a general family expense, personal in nature, and not deductible as a medical expense under §262. If they had sent the WIFE somewhere for rest and relaxation away from the family, that might have been deductible as a medical expense. But people send their children to boarding school all the time for no medical reason.
          3. DISSENT: These expenses fall w/in the category if mitigation and treatment of disease; the deduction could be limited to the expense of the care of the children when they would otherwise be around their mother (e.g. not the expenses during school hours, but the room and board?).
3. **Charitable Contributions §170** (356)
   1. Appropriate donees for deductible contributions listed in §170(c)
      1. Must be a domestic entity
      2. Must be religious, educational, charitable, scientific, literary, etc.
      3. NO part of the earnings of the entity can go to a shareholder (no private inurement)
      4. Cannot be a political organization
      5. Specific types of organizations:
         1. Support of native Alaskans engaged in subsistence whaling is deductible under §170(n)
         2. There is a deduction for 80% of any amount paid to an institution of higher learning if the deduction would be allowable but for the fact that TP receives as a result of paying such amount the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution. §170(L).
         3. Just because something is a §501(c)(3) doesn’t mean that it is also a charity for purposes for deductible donations
   2. Limits on the deduction in §170(b)
      1. 50% of the contributions base when public charities are recipients. §170(b)(1)(B)
      2. 30% (or a lesser percentage) when appreciated property is contributed or to a “private foundation”
      3. These limits are “ceilings” and not “floors.” No floor is applicable to the charitable contributions deduction
      4. Core group with a higher limit in §170(b)(1)(A), 50% of AGI is deductible if donated to these groups
      5. Outer group of donees where the deduction limit is EITHER 30% of AGI, OR the balance of of the part of the first 50% not used on a charity in the core group.
      6. Contributions in excess of the deduction limitations can be carried over and deducted for the next five years. §171(d)(1).
      7. Payments to a charity as a result of a court order do not qualify for the deduction.
   3. **Substantiation:** There is a substantiation requirement for some contribution, wherein the donee organization has to provide the donor with a written substantiation of the donation for the donor to claim the deduction when gift over $250. Must be contemporaneous. Must include info that no goods or services provided as QPQ. §170(f)(8).
   4. **Donations of capital gain property §170(e)** (357)
      1. When TP makes a gift of property whose sale would produce long-term capital gain, the amount allowed as the deduction is the full FMV of the property.
      2. In the case of a gift of property whose sale would produce short-term capital gain or ordinary income, the deduction is limited to the TP’s basis in the property.
      3. Use by the donee must be related to purpose of property gifted
   5. **Donations with private objectives or benefits**
      1. **Ottowa Silica v. United States** (360)
         1. FACTS: TP claimed a charitable deduction for a donation of land to a local school district; it did so knowing that a school in that location would mean that roads would have to be built through its property which would provide TP with benefits. The IRS assessed a deficiency on the grounds that the TP got a “substantial benefit” from the transfer of property, which exterminated the charitable nature of the transfer.
         2. HOLDING: Quid prop quo received. A substantial benefit that will exterminate the charitable nature of a donation is one that is greater than the benefit that inures to the general public from a transfer for a charitable purpose (i.e. if the TP gets a better benefit than the general good, they have received a substantial benefit.) Here, the TP made that donation with full knowledge that it would be receiving a substantial benefit; it made the donation expecting an increase in the value of the rest of its property. The charitable nature of the donation was here extinguished and no deduction will be allowed.
      2. **Quid Pro Quo:** For any quid pro quo contribution over $75, the charity must provide the donor with a written statement that the entire amount of the donation is not deductible and must provide a good faith estimate of the value of the goods received (e.g. a tote bag from a PBS fund drive). §6115.
         1. Measure the value to donor as FMV of the items received by the donor
      3. **Overvaluation:** There is a major problem with overvaluation of works of art that are donated. There is a substantiation requirement for donations of property with a value of greater than $5K.
      4. **Religious Benefits and Services**
         1. **Hernandez** – Scientology case – disallowance of charitable contribution deduction for amounts paid by members of Church for “auditing sessions” – some involuntary component in these payments
            1. Dissent (O’Connor): been allowing fixed payments for other religions for 70 years – avoided discussing whether other religious payments were truly obligatory
            2. IRS entered a settlement agreement allowing Scientologists to deduct on the indiv tax returns these fees as donations – allegations of unfairness and inconsistency
         2. **Sklar** (368) – denied deduction for religious private school bc TP failed to show the total tuition paid was greater than the value of the secular education children received – avoided addressing the Establishment clause claim asserted due to *Hernandez*
   6. **What is “charitable”?**
      1. **Bob Jones University v. Commissioner** (369)
         1. FACTS: TP/school discriminated on the basis of race in admissions and inter-racial dating. Claim that segregation is part of religious understanding. IRS Revenue ruling says racial discrimination in education is against public policy and thus schools who do it don’t get tax exempt status.
         2. HOLDING: BJ “sincerely held religious belief” do not supersede the overriding national interest. the school not entitled to tax exempt status because of public policy and the IRS’s authority through the revenue ruling. To get tax exemption, a group must meet one of the eight categories in §501(c)(3) AND serve a charitable purpose. Also, the government should not give a subsidy to racially discriminatory organizations. To be considered charitable, org could not have a purpose that is contrary to public policy. Reg. §1.501(c)(3)
         3. DISSENT: the “ors” in §501(c)(3) [see below] are disjunctive and meeting any one category is enough to get tax exemption.
      2. **§501(c)(3)** gives the basis for being a tax exempt organization—very similar to list in §170 of groups of to whom TP can donate and deduct those donations. There are eight, EXCLUSIVE categories:
         1. Religious
         2. Charitable
         3. Scientific
         4. Public safety testing
         5. Literary
         6. Or educational purposes
         7. Or amateur sports
         8. Or prevention cruelty to children or animals
      3. **§501(c)(4)** Exemption from tax for corporations: superPACs ($$ raising org for political purposes)
4. **Deductions for Interest**
   1. **General rule:** §163(a): there shall be a deduction allowed for all interest paid or accrued within the taxable year on indebtedness
      1. There are no deductions for personal interest paid or accrued during the taxable year. §163(h)(1).
   2. **Exceptions:** found in §163(h)(2).
      1. Interest allocable to a trade or business: cost of producing income from the trade or business and therefore a business expense, unless it is an expense allocable to the business of being an EE.
      2. §163(h)(2)(d): TP can deduct interest when borrowing to buy or improve a home, or borrowing against TP’s home (like a mortgage). This is a subsidy to home ownership lobbied for by national association of realtors.
   3. **Qualified Residence Expense** (377): §163(h)(3) permits interest expense deduction:
      1. **Acquisition indebtedness** – up to $1 million borrowing limit
      2. **Home Equity Indebtedness** – up to $100,000 limit (but limited to equity value)
      3. No limit on application of these funds
      4. Qualified Residence – The principal residence and one other home §163(h)(4)
   4. **§265(a)(2):** there can be no deduction for interest where income is exempt from taxes b/c that would be double tax avoidance. A little weird b/c it treats tax exempt bonds as though the subsidy goes to the TP, where in fact it goes to the municipality.
   5. **§163(d):** when investment interest debt is in excess of income, TP can carry the interest deduction allowance forward to future years. Deduction can’t be taken until it starts to produce income.
5. **Deductions for Taxes** (380)
   1. Deductions are allowed for state and local income taxes and personal property taxes. §164
      1. Includes taxes for (1) business purposes, (2) investment property, and (3) personal purposes
      2. Also includes (1) property taxes (on the owner and not on the renter), (2) state income taxes, not in TX (but not FIT -§275), but (3) not sales taxes
      3. State and local sales taxes can be deducted but only if the TP gives up the deduction for state and local income taxes
      4. User fees are not treated as taxes and are not deductible
      5. Foreign income taxes are treated as credits under §901 – provides a dollar for dollar credit against US income tax liability for foreign taxes paid
      6. Only deductible for person upon whom tax is imposed (even if not paying the tax)Reg. §1.164-1(a)
   2. **Revenue Sharing**: indirectly deflecting money to states bc ppl can spend more if they pay less in taxes (supported by Nixon)
   3. **Policy:** Should certain outlays be treated as reductions in arriving at proper definition of net income and, if not, is a deduction a sensible device for achieving some desirable goal extraneous to the tax system?
      1. **Strongest argument FOR deductions:** taxes are involuntary and do not buy personal consumption, so they should be deductible
      2. **Main Arg FOR deduction:** Different states rely on different forms of taxation and residents of those states that choose to raise revenues through property or sales tax should not be worse off than those who rely on income tax.
      3. **Arguments against:** Property taxes are sort of voluntary. The CB says they add no value to the house, but is that true?
6. **Other Personal Deductions/Exclusions**
   1. **Sale of Personal Residence** §121: allows qualifying TP to permanently exclude from income up to $250K from sale or exchange of principle resident
      1. TP must have owned and occupied the property as a principal residence for at least two of the five years prior to the sale or exchange. §121(a).
      2. TP can qualify for the exclusion only once every two years. §121(b)(3).
      3. TP who does not meet both above requirements may qualify for a reduced exclusion under §121(c) if TP had to move b/c of a change in place of employment, health, or other unforeseen circumstances.
         1. If TP can’t satisfy occupancy requirement, may exclude $250K times [(the period of time in the five years before the sale during which the TP did own and use the residence as a principal residence) divided by two years.]
         2. If TP has already excluded gain under the section w/in the past two years, the TP can exclude $250K times the period of time b/w the sale and exchange of the previous principle residence for which the exclusion was recently used divided by two years.
   2. **§151** provides each TP a “personal exemption” & two exemptions for a joint return if married.
      1. Includes an exemption for each dependent §151(c)
      2. Dependent – *See* (1) qualifying child and (2) qualifying relative (provides over 1.2 support for the calendar year §152(c)-(d)
      3. Multiple support agreement - §152(d)(3)
7. **Tax Credits**
   1. **Definition:** A tax credit is a subtraction from the net tax due (as opposed to a deduction, which is a subtraction from the income to be taxed)
      1. Formulas:
         1. **Gross income minus deductions = taxable income**
         2. **(Taxable income times tax rate) minus tax credit = total tax due**
      2. Almost always a true tax preference—based on policy, not just definitions of income (like exclusion for amounts borrowed, deduction for business expense are about definition of income, charitable contributions and interest on state and local bonds is purely about policy).
   2. **Worth more than exclusions or deductions**
      1. At 50% tax rate, $100 exclusion or deduction worth $50
      2. At 50% tax rate, $100 credit worth $100, because credits come after application of the tax rate.
      3. Can be **refundable** to those in the 0% tax bracket, so they actually GET $$
      4. Don’t hinge on marginal rates, so they have a uniform effects on TPs, unlike deductions and exclusions, which really matter more at the margins.
   3. **Earned Income Tax Credit §32**
      1. Operates as a federal wage subsidy to single or married TP, with or w/out kids
      2. “refundable credit” – file an income tax return and receive a rebate
      3. Amount depends on number of dependents and income limitations/phase-outs
      4. Not available to TP with more than $20K or $27K in investments.
      5. Maxes out at $4400 (for a two parent-family with two or more kids making $11K a year in earned income).
      6. Largest anti-poverty program the government runs.
      7. **Single w/two kids:**
         1. Income at or above $35.3K, $0 EITC
         2. Decreases after $14.4K--$35.2 income
         3. Plateau from $11K to $14.4K
         4. Peak at $11K income ($4400 EITC)
         5. Must be earning income to get the EITC
         6. A single person with two children therefore has no federal tax liability when they earn less than $14.6K; $5K deduction and $9.6K credit.
      8. **Married w/two kids** don’t pay taxes if combined income less than $22.8K
   4. **Credit for Elderly and Disabled** (386)
      1. **§22** provides a tax credit for the elderly and the disabled – up to 15% of the §22 amount
      2. **Reduction** as the amount increases above $7500 for single persons and $10k for joint returns
   5. **Child Tax Credit:**
      1. $1000 for each qualifying child under §24(c) (under 17, dependent, name and SSN)
      2. Phases out at higher levels of income under §24(d). Credit is partially refundable
      3. §24(e) No credit unless name of child and ID are included on the return
      4. **Incentives:** better characterized as relief to those with children than an incentive to have children. But if you are on the margins of having earned income for not, then you are incentived to push to get more earned income
      5. Largest federal child relief program, more than 2.5 times what we provide through TANF.
      6. Good for the middle class:

# Mixed Personal and Business Deductions

* + 1. **Remember General Rules** 
       1. The general rule under §262 is that personal deductions usually are not allowed
          1. But §213 and §165(e)(3) and anything that carve out personal exemptions trumps this.
       2. **§212** allows deductions for expenses incurred in investments
       3. The general rule under §162 is that the expenses of carrying on a trade or business are deductible
          1. **5 requirements:** ordinary, necessary, expense, trade or business, and carrying on
          2. §67: 2% floor on itemized deductions: this means that the deductions must exceed 2% of adjusted gross income to be deductible (and are only deductible to the extent they exceed 2% of AGI).
          3. §68: The threshold is currently $100K GI for an unmarried person. People w/incomes above $100K must reduce their otherwise allowable deduction by either:

3% of the excess of AGI over $100K OR

80% of otherwise allowable itemized deduction

* + - * 1. This general §162 is not an itemized deduction; it’s included in §62, however the “if you are an EE” exception (which allows deductions for different stuff) is an itemized deduction
      1. **Activities not for profit §183 (Hobby Losses):** allows a deduction for activities not done for profit, up to the gross income of the activity that is engaged in not for profit**.** 
         1. This is an itemized deduction; TP subject to §§162 or 212 are not subject to this deduction.
         2. Does not alter deductions for expenses that are deductible w/out regard to whether the activity is personal. §183(b)(1)., so only comes into play if gross profits are greater than those deductions.

|  |  |  |  |
| --- | --- | --- | --- |
| **Type of Expense** | **Is it deductible** | **Is it itemized** | **Limits on deductibility** |
| (1) Trade/business expense of non-EE | Yes, b/c of §162 | No, b/c of §62 | None \*\* (not really) |
| (2) Trade/business expense of EE | Yes under §162 | No under §62 | 2% floor under §67; adjusted gross income phaseout under §68 |
| (3) Production of income not trade/business | Yes under §212 | Yes under §62 | 2% floor under §67; adjusted gross income phaseout under §68 |
| (4) Activity not engaged in for profit | Yes under §183 | Yes under §62 | Deductible to extent of income from activity under §183; 2% floor under §67; adjusted gross income phaseout under §68 |
| (5) Personal | No under §262 |  |  |

* + 1. **Hobby or Business?** 
       1. **Nickerson v. Commissioner** (p. 403)
          1. FACTS: TP bought a dairy farm; IRS says it was used for leisure rather than for profit. TP grew up on a farm but went into advertising, then at age 40 branched out and tried to make the farm productive, and incurred losses in doing so. TP was trying to say he was in Row (1) on the above chart as to the farm: business expense of a non-EE. IRS says it was Row (4). This would mean that his expenses would only be deductible as to his income from the farm and could not offset his advertising job income.
          2. HOLDING: they expected to make a profit, so it was a trade/business expense. ***The legal test is whether TP has a sincere profit motive for engaging in the activity***.
          3. *Cf.* §183 for limitations on deductions for activities not for profit
       2. **§183(d)** says that an activity that is profitable in 3 out of 5 consecutive years is presumed to be engaged in for profit.
          1. Even if it doesn’t meet this test, TP can show profit motive for trade/business/for profit treatment using nine factors in Reg. §1.183-2(b). (395)

Manner In which the TP carries on the activity

The expertise of the TP or his advisors

The time and effort expended by TP in carrying on the activity

Expectation that assets used in activity may appreciate in value

Success of TP on carrying on other similar or dissimilar activities

TP’s history of income or losses with respect to the activity

Amount of occasional profits which are earned

Financial status of the TP

Elements of personal pleasure or recreation

* + - 1. **Benefit of avoiding “hobby loss” treatment**
         1. Losses are deductible against other income.
    1. **Home offices & Vacation Homes** (invitation to audit claim)
       1. **§280A: Vacation homes:** (1) no personal use, (2) rented >14 days, but <14 days personal use, (3) under 15 days rental use: income and deductions both ignored §280A(g)
       2. §280A: TP can deduct home office expenses if self-employed, but not if just someone else’s EE who works at home.
          1. §280A(c)(1) is the filter: TP must have a trade or business under §162 to qualify for this deduction (production of income, hobby doesn’t count) – exclusively used on a regular basis
          2. §280A(c)(5) limitation on deductions. So:

**Home office expense:** Income from trade or business use of home minus [personal expenses otherwise deductible (like mortgage and real estate tax) plus business expenses not attributable to the business use of the home]. The result is what TP may deduct for home office expenses.

What you get to deduct under §280A is basically what you haven’t been able to deduct yet.

Deduction is limited to offsetting the GI from that activity

First deductions are those allocable to statutory deductions

Additional deductions allocated to the business use

Possible carryover of unused deductions

* + - 1. **Popov v. Commissioner** (402)
         1. FACTS: TP shares a 1 bedroom apartment with her husband and child. She is a chamber orchestra and symphony musician. She practices her instrument in the living room. TP claims her living room is her principle place of business.
         2. HOLDING: TP gets the deduction; the test is from Commissioner v. Soliman, and involves the relative importance of the activities performed at each business location and the time spent at each business location to determine the primary place of business. Here the first test is inconclusive, because practicing and performing are both integral to her job; but the second part really weighs in favor of the living room being the principle place of business.
      2. **Moller v. US** (407)
         1. FACTS: TP tried to deduct two home offices (bc had summer/winter homes). They had large personal portfolios and spent substantial time managing them, but not for others.
         2. HELD: TP were not conducting a trade or business when investing. To be traders they must be doing short-term trading. TP here were looking for long-term growh. Managing one’s investments is not carrying on a “trade or business”
      3. **Personal Expenses in the Office Henderson v. Commissioner** (p. 429)
         1. FACTS: TP buys a plant, framed picture, and parking space at her office for decorating her office.
         2. HOLDING: Those are personal expenses, they don’t affect trade or business. If buying a plant for your office isn’t a personal expense, nothing is
    1. **Listed Property: Automobiles, Computers** (414)
       1. **§280F(a):** specific limit on depreciation for luxury automobiles
       2. §280F(d)(4): Limited depreciation allowance where other listed property not predominantly used I a qualified business, including property used for entertainment and computers
          1. But not 4 wheeled vehicles exceeding 6000 lbs.
    2. **Travel & Entertainment - Deductible Business Trip or Compensation?**
       1. §162(a)(2): Transportation expenses are deductible when traveling for business purposes
          1. Primary purpose of this travel must be for business purposes
          2. *Cf* travel for personal purposes as reimbursed by employer – treated as compensation payment
          3. *Cf* commuting cost as a nondeductible personal cost
       2. **Rudolph v. United States** (417)
          1. FACTS: An insurance company provided a trip for its agents and their wives to NYC.
          2. HOLDING: Disposed of under clearly erroneous rule. The trip is taxable on the full value—it has to be all or nothing. It is both income for services and personal expenses. The court says it can’t be a personal and business trip and deduct some but not all. He was not an “entrapped organization man,” as there was no compulsion to go on the trip, so it doesn’t get out of income or personal expense on a “convenience” or requirement of ER argument.
          3. **DISSENT:** Business sessions conducted in NYC and on the train. Wife’s expenses are also deductible. She is part of the “community property” team
       3. **Gifts to Clients:** TP may take a business deduction for the first $25 per year of untaxed gifts made to each client. §274(b)(1). This generally just applies to small gifts given to customers to bolster goodwill.
       4. **Spouses:** for a business expense for an EE’s spouse to be deductible nowadays, the spouse also has to be an EE of the same ER and there must be a good business reason to send the spouse. §274(m)(3).
    3. **Deductions for Travel, Entertainment, Food**
       1. **General Rules**
          1. **Entertainment** expenses associated w/business and directly precede or follow a substantial and bona fide business discussion deductible under §274(a)(1)(A). It must be “directly related” to business

Ie. Expenses for Houston Texans/Astros/Rockets tickets

Dues or fees to a club only deductible to the extent the TP ACTUALLY uses it primarily for business purposes. §274(a)(2). NO dues that are “membership dues” in a club organized for business, pleasure, recreation, or other social purpose are ever deductible. §274(a)(3).

* + - * 1. **Travel** expenses deductible if they directly relate to or directly precede or follow a substantial and bona fide business discussion, including meetings. §274(a)(1)(A).

**Foreign travel:** you have to separate the business costs from the personal benefits and can only deduct the business purpose costs when the travel is out of the country. §274(m)(3). Only deductible if it is reasonable for the meeting to be held outside North America. §274(h)(1).

**§274(c)** – possible expense limitation if combining business and pleasure and more than one week trip.

**§274(h)(2) –** US port limitation – seminars and conventions on cruise ships

**§274(m)(1)** – limit on “luxury water transportation” - limited to what airfare costs

**§274(m)(2) –** travel as education – no deduction

* + - 1. **Only 50% of any of these costs are deductible by ER §274(n):** removes half the food, beverage, entertainment deduction. This was a later amendment. Once TP passes §162 primary business purpose and §274 direct relation to trade or business tests, TP still loses half of the deduction for food, beverages, or entertainment. *Cf.* Churchill Downs
      2. **§274(d) Substantiation Requirements** (422)
         1. No deduction for T&E unless substantiation:

The (1) time, (2) place, (3) business purpose, (4) amount of expense, and (5) the relationship to the recipients of the entertainment

Contemporaneous records are required

Per diem reimbursement may be acceptable if time, place and business purpose are properly substantiated

* + - 1. **Lunches for EEs** **- Moss v. Commissioner** (440)
         1. FACTS: TP is a partner in a law firm, everyone in the firm meets each workday for lunch at a reasonably priced restaurant for a lunch meeting. Wants to deduct the price of the lunches.
         2. HOLDING: the lunch costs were not deductible; there is no showing that there needed to be lunch every day AT the restaurant for them to get their business done. Losing under §162. It’s an inappropriate subsidy for people who are able to combine personal consumption and business when many can’t and those are often lower income.
         3. To avoid inclusion in EEs income, lunches should be provided on the premises and mandatory for the convenience/necessity of ER
      2. **Extravagance:** no deduction for lavish or extravagant food/beverages. §274(k).. Of course “business related” first class travel and nice hotels are not extravagant.
      3. **Exceptions:** see §274(e) and (f), e.g. ER can deduct items covered by a reimbursement arrangement.
      4. **Churchill Downs, Inc. v. Commissioner** (427)
         1. FACTS: Park hosted dinners and receptions as part of the press tour for the Kentucky Derby.
         2. HELD: These were entertainment events and not publicity events for products (horse racng). Not for the benefit of the target clientele and so not in the course of business. No §274(n)(1) deduction (50%).
    1. **Childcare**
       1. **Smith v. Commissioner** (456)
          1. Childcare costs are not deductible whether or not the parents were working; child care is the essence of a personal expense. It is not an ordinary and necessary expense in carrying on a trade or business
       2. There is a line drawing problem: why allow deductions for childcare but not commuting, or not for clothes?
       3. **Childcare deductions today**
          1. Personal exemptions under §151 **&** Child Tax Credit under §124

Above available to single or married TP with children

Do nothing to correct the work disincentive

* + - * 1. Credit under §21 for employment-related child and dependent care expenses (both parents have to work to claim this). You back b/w 20-35% of your employment-related childcare costs up to the cap.

$3k cap for one child, $6K for two or more or if the actual cost is lower the income of the secondary spouse is the cap

Using above numbers, TP can take the full $3K credit so $3K times 20% = $600 (there is a chart in §21 about what percentage of the credit you get at what income level)

* + - * 1. Care assistance exclusion under §129

Using above numbers, TP can take the $5K exclusion so $5K times 50% equals $2500

Under the above numbers, this means the exclusion is the better election as it usually is for higher income families.

Disincentive: TP only saves $2500 on childcare if both work, but save $10K if secondary earner just stays home.

* + - * 1. TP can take both the exclusion and the credit—may run whatever is left from the credit through the exclusion.
    1. **Commuting**
       1. Special rule in §162(a)(2) says travel expenses away from home and meals are deductible.
          1. “Home” may not mean real home, but location of business.
          2. **Examples:**

TP lives in Greenwich but works in NYC, traveling from NYC to Greenwich each day. Not deductible, just commuting/personal under §262. e.g. **Flowers**.

TP above goes on a day trip for a photoshoot for her magazine; to/from the photoshoot is covered by the general rule of §162(a). The meals there may or may not be under the **Moss** primary purpose test.

TP above goes to LA for two days for some consulting; travel and meals are both deductible under §162(a)(2)’s special rule.

* + - 1. **Commissioner v. Flowers** (459)
         1. FACTS: TP lives in Jackson, hired by a law firm client in Mobile to go in house, but made arrangements to keep living in Jackson.
         2. HOLDING: Travel from Jackson to Mobile not deductible travel expenses. Three conditions must be satisfied before a travel expense deduction can be made under §162(a)(2): [1] reasonable and necessary traveling expense [2] incurred away from home [3] incurred in the pursuit of business.
      2. **Hantzis v. Commissioner** (465)
         1. FACTS: TP was a law student who couldn’t get a job after her 2nd year at a Boston firm, she and her H lived in Boston. Instead she a got a job in NY. She tried to deduct cost of travel as well as the apartment she rented in NYC.
         2. HOLDING: Not deductible; her “home” for the purpose of §162(a)(2) was her place of employment. The dispositive thing was “away from home” in the Flowers test.
      3. If temporary job away from home then deductibility for travel & living costs at destination location.
         1. Not if indefinite stay at new location – treated as if a permanent job
         2. §162(a) temporary may not exceed one year
         3. **PARKING**: §132(f) – excluded if you’re reimbursed, limited to $175/month
    1. **Moving Expense Deduction**
       1. §132(a)(6) & (g) – GI exclusion is available for “qualified moving expense reimbursement” received from the employer
       2. §217 permits a deduction for certain moving expenses if moving 50 miles to a new job(ie. For self-employed and partners)
       3. §82 inclusion in GI for moving expense reimbursement unless excludible under §132(a)(6)
    2. **Clothing Expenses**
       1. Sometimes deductible as a business expense if [1] required for work [2] not adaptable for general use [3] not USED for general use
       2. **Pevsner v. Commissioner** (475)
          1. FACTS: TP wanted to use a subjective test for above factors. She worked at an haute couture store and had to wear their clothes at work, but didn’t want to or think she could wear them when not at work (too fancy and expensive for her taste and purposes).
          2. HOLDING: The test has to be objective; otherwise it would be un-administrable and unfair; two people with different taste and income would have different deductibility for the same clothes.
    3. **Legal Expenses**
       1. **United States v. Gilmore** (478)
          1. FACTS: TP tries to deduct legal expenses re: divorce proceeding on the theory that if he’d lost the case, ex-wife would have taken much of his stock interest in the business he owns, and he would have lost it. Therefore he says it is maintenance of income-producing property under §212(2).
          2. HOLDING: This is not deductible as a business expense; the litigation does not arise from profit-seeking activities—the underlying claim is divorce which is personal. The test for deductibility of legal expenses which emerges is the ***origin of the claim test*** under §212. It applies here to deny income tax deduction for attorney’s fees

The nature of each of these legal claims grew out of the TP’s professional capacity

* + 1. **Education Expenses**
       1. **Carroll v. Commissioner** (484)
          1. FACTS: TP was a police officer who was going to college to get a BA, wanted to deduct the tuition as a business expense.
          2. HOLDING: Not deductible; it would only be appropriate to deduct education expenses when maintaining or improving skills necessary to the job you already have. TP here wanted to get the degree to go on to law school, so it didn’t pass the objective test. They merely improved his general competence. Reg. **§**1162-5
       2. **Other Educational Credits**
          1. HOPE Credit: can only claim for two years, never after sophomore year, phases out for incomes b/w $42-52 for singles and twice that for marrieds. Claimable by student or anyone who can claim student as dependent. Student must be enrolled at least half-time in degree program.
          2. Lifetime Learning Credit: up to $2K for post-secondary ed. Unlimited years, same phaseout as HOPE, same people can claim as can claim HOPE, student can take as little as one course if improving job skills (need not be degree prog.)
          3. Neither credit is refundable—can’t get a check through it. One student can’t do both credits together.
       3. **Other Educational Deductions**
          1. **§222** (expired) deduction for post-secondary ed. $4K cap if TP has up to $65K income, or $2K cap if over $80K income. Not itemized. Same requirements for claiming as credits. Can’t claim if claiming either credit. Not a phase-out but a “notch” and “cliff” provision
          2. Coverdell Education Savings Account under § 529: basically a tax-free savings account for anyone under 18. Amounts contributed not deductible, but accumulates tax free and distributions for ed. expenses not included in gross income. $1K/yr total contributions, can be used any level of ed. Phaseout of eligibility to use this at $90-110K. Can claim either credit in the same year you get a distribution from Coverdell as long as don’t count same ed. expenditures twice.
          3. Qualified Tuition Program under §529: must be sponsored by state or ed. institution. No income limits on who can contribute; can’t exceed amount to be used for ed. expenses. Growth/dist. for ed. expenses not taxed. Can claim either credit in same year as getting distribution from this, and getting distribution from Coverdell, as long as no ed. expense claimed more than once. Donor controls the investment policy and can change beneficiaries

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* + - 1. **Policy**
         1. Why not just give a deduction for money TP puts into savings plan for ed?

That would show up with cost to government today but giving same value at the back end doesn’t do that, making budget look more balanced than it is

* + - * 1. Who is benefiting?

Nominally students and parents

Real benefit to colleges and universities in higher tuition.

# Deductions for the cost of earning income

1. **Capital Expenditures**
   1. **Definition of a capital expenditure:** any expenditure made to acquire an asset that has a useful life of more than one year**.** In other words:
      1. If a business asset is spent/consumed in one year, we allow a deduction for it
      2. IF a business asset lasts and produces income for longer than a year, it is a capital expenditure
      3. Not a precise definition
   2. Cannot be deducted currently **§263**
   3. Included in and made part of the basis of the asset, recovered when TP starts to make subtractions in basis (depreciation, sale of property)
   4. **What must be capitalized**
      1. **§263(a)(1) & (2):** any amount paid for new buildings or improvements to increase the value of any property, or restorations to property or making good exhaustion of property, can’t be deducted. Must be capitalized.
      2. **Examples of buying a vineyard to make wine:**
         1. Must be capitalized:
            1. Land
            2. Building
            3. Equipment
            4. Grapes
            5. Wine
            6. Goodwill of former owners
         2. May be deducted
            1. Utilities
            2. EE Salaries
            3. Office supplies
   5. **Encyclopedia Britannica v. Commissioner** (466)
      1. FACTS: TP, a publisher, paid another publisher to make a book, but contracted to hold the copyright and publish it themselves. Wanted to deduct the entire price of the contract.
      2. HOLDING: Not deductible, and that would be an easy decision if the 10th Circuit hadn’t given some contrary cases. The manuscript was an income-producing asset for more than one year and is therefore a capital expenditure. Expenses should be matched with income so both will happen over some years.
      3. A background issue here is the difference in treatment b/w internal and external expenses. Congress ultimately passed the Uniform Capitalization Rules under §263A, to erase the difference in current deductibility b/w internal and external costs of businesses
   6. **Uniform Capitalization Rules §263A: Allocation of what is capitalized**
      1. All allocable costs of acquiring the asset must be capitalized §263A(a)(1)
      2. Allocable costs include direct costs of the property and the property’s proper share of indirect costs. §263A(a)(2)
      3. Capitalization rules apply to property produced by TP in-house or property acquired for resale (e.g. this would apply to a book manuscript produced in-house). §263A(b)
         1. Includes salaries of the people writing the manuscript
         2. Indirect expenses include allocable share of supervisory and administrative salaries also
         3. Retailers are excluded if their gross receipts are less than $10M. §263A(b)(2)(B).
      4. There is an exception for farmers in §263A(d); the definition of farming business is in §263A(e)(4).
         1. There is also an exception for retailers and wholesalers with annual gross receipts <$10 million
         2. §263A(h) Freelance writers, artists and photographers
      5. The Encyclopedia Britannica decision is now codified, defining production as construct, build, install, manufacture, develop, or improve. §263A(g).
      6. The regulations carry this rule farther
         1. All costs of manufacturing inventory/goods to be sold, including items like insurance on the manufacturing plant, must be added to the cost of inventory and deducted when inventory is sold
         2. Costs that DO NOT need capitalization include marketing, advertising, and general and administrative expenses not related to sale or production
   7. **INDOPCO v. Commissioner** (501)
      1. FACTS: TP incurred investment banking fees in connection w/a merger w/another firm. No separate or identifiable asset had been created to which the outlays could be allocated, so the TP deducted the banking fees as a current expense.
      2. HOLDING: Substantial Future Benefits Doctrine. The Commissioner wins; the banking fees must be capitalized. Although the mere presence of an incidental future benefit may not warrant capitalization, a TP’s realization of benefits beyond the year in which the expenditure is incurred is very important (i.e. if the benefits of a cost would not be realized until future years, the cost must be capitalized.)
         1. PROF: The “future benefits” rubric is very broad and not that helpful. The rules might leave the TP with a capitalized item (like banking fees) without a determinable of finite useful life, so that there is no amortization or depreciation deduction.
2. **Repairs & Maintenance Expenses**
   1. There is a crazy distinction; repairs deductible under §162, while replacements or improvements must be capitalized. No bright line rule so highly litigated.
      1. **Repair:** doesn’t add value or prolong life of property, just keeps it in good operating condition over useful life
      2. **Replacement:** substitution, materially increases value or increases life, usefulness, strength, capacity of property. (Problem is that any good repair does this!)
   2. **Midland Empire** (476)
      1. FACTS: TP had oil leaking into the basement of his meat packing business. Meat inspectors said he had to fix it in order to keep the business open. He put concrete lining in the basement and that was successful. The TP deducted the expense as an ordinary business expense under §162(a).
      2. HOLDING: basement wasn’t enlarged, wasn’t made more attractive or stronger, and just brought basement back to the position (Value-wise) where it was before the oil started leaking. Not improved relative to its position before the problem arose.
   3. *See* Reg §1.162-4T – provided new rules defining repairs
      1. Identify the “unit of property” to which expense relates
      2. Does the expense produce a betterment,” a “restoration,” or an “adaptation to ne or different use”?
      3. These expenses are to be capitalized
   4. **Revenue Ruling 2004-18** (480)
      1. FACTS: Remediation mandated by various environmental requirements for cleanup of hazardous waste.
      2. HELD: These costs are not repairs, but are to be capitalized, here into the cost of inventory being produced in the manufacturing plant
3. **Inventory** 
   1. Inventory Accounting is mandated for the seller of goods who either (1) purchases the goods sold for resale §471 or (2) manufactures the goods for sale to customers. §263A
   2. §263A(a)(1)(A) specifies that for a TP’s having inventory the costs for this inventory shall be included in “inventory costs”. These costs include both “direct” and “indirect” costs
      1. Exception for TP with gross receipts of $10 million or less. §263A(b)(2)(B)
   3. GI from a business selling inventory is computed as follows:
      1. Gross receipts – inventory cost = GI or
      2. Opening inventory + additions to the inventory during the tax year (whether purchased goods for resale or goods are produced) – Closing Inventory = CGS (cost of goods sold)
   4. FIFO – the remaining inventory consists of goods most recently added to inventory (the “conveyor belt” approach)
   5. LIFO – the remaining goods are those first going into inventory (those goods still held are at the “bottom of the barrel”) – goods sold thru year were those most recently acquired
   6. §472(c) & (e)(2): Booking Requirement – if TP uses LIFO for FIT purposes this method must also be used for reporting to shareholders and creditors
      1. To change reporting methods, must seek permission from IRS
   7. **Inventory Accounting** (518)
      1. **Rationale:** There is a need to match income w/expenses
         1. Not feasible to keep track of how much TP paid for each item in its inventory when holding a large volume of goods acquired at different times
         2. **Gross Profit** equals gross receipts minus costs of goods sold.
         3. **Problem** is determining the price of goods sold
      2. **Inventory Accounting definition**
         1. **Cost of goods sold =** value of inventory at start of year plus new purchases made during the year minus value of the inventory at the end of the year.
            1. **Example:** retailer sells coffee mugs. Year I buys 1000 for $10/each and sells 900 for $15/each. Year 2 buys 1000 at $14/each and sells 1000 for $20/each.

Year 1: $10K minus $1K = $9K (cost of items sold). $13.5 (gross receipts) minus $9K = $4.5 gross profits.

* + - * 1. **FIFO Method** (First in, first out)

**Example from above**

Year 2: beginning inventory = $1K (left over from year 1). New purchases = $14K. Under this accounting method, the 100 left over at the end of Year 2 are considered to be out of the ones bought in Year 2; so the value of ending inventory is $1400. So ***cost of goods sold is*** $1K plus $14K minus $1400 = $13.6K.

* + - * 1. **LIFO Method** (Last in, first out)

**Example from above**

Year 2: beginning inventory = $1K (left over from year 1). Under this accounting method, all of the mugs sold in Year 2 are considered to be sold first so the value of ending inventory is $1K (what was left over from year one). So ***cost of goods sold*** is $1K plus $14K minus $1K = $14K.

* + - 1. Difference in taxes paid is whether LIFO or FIFO is used.
         1. Must pick one method and stick w/it through course of business.
         2. Generally LIFO better if TP expects prices to rise.

1. **Rent Payment v. Installment Purchase**
   1. **Starr’s Estate** (485)
      1. FACTS: Sprinkler co. leased a sprinkler system to TP; lease payment was the same for five years, and then renewable after that for nominal amount. TP treats the payments as deductible rent but IRS says it is an installment sale. If it is a sale, then the sprinkler co. should be able to include the difference b/w basis and amount they received; if it is a lease, the full amount of the lease payment is income to them.
      2. HOLDING: It is obvious that this was a sale since the sprinkler system was tailored to TP’s building; the nominal payments in years 5-10 represented just maintenance fees
2. **Ordinary And Necessary** (489)
   1. **Categories of expenditures:**
      1. **Personal expense** (no deduction, unless statutory exception)
      2. **Ordinary & Necessary Expense** (current deduction)
      3. **Extraordinary** (capital)  **Expense** (future deductions or frozen cost)
   2. **Goodwill and other assets**
      1. **Welch v. Helvering** (525)
         1. FACTS: TP was employed by a co. that went bankrupt and found a new job, then paid off some of the debts of the old co. in order to enhance his own standing in the business community and cultivate customer relationships. He wanted to deduct those payments under §162 as ordinary/necessary business expense.
         2. HOLDING: The cost of goodwill is not deductible, so no deduction allowed here. The payments are akin to the capital acquisition of goodwill. “Ordinary” means that, from experience, we know that the payments are common and accepted in the general community; it doesn’t have to do with regularity, just commonality. People don’t ordinarily in the normal course of business pay the debts of others.
      2. **Historical Problem:** Goodwill was considered to have an indefinite life**.** You buy assets with a useful life, but there was no definite time for depreciation deduction for an intangible.
      3. **Congressional Response:** §197 gives people an arbitrary 15 year period to amortize goodwill, but only goodwill that is purchased not any that TP creates internally.
      4. **§263A** allows for deduction of some things that might be considered “intangible” like marketing, selling, advertising.
         1. **Advertising**: *Cf. INDOPCO* – Current deductions for advertising, marketing, and selling are not disallowed under §263A. See Reg §1.263A-1(e)(3)(iii)(A) – repetitive cost with a repetitive nature – still allow a deduction
      5. **Education Expenses that relate to production of income**
         1. Objective test is to rely on the distinction b/w capital expenditures and current expenses
         2. NO deduction allowed for the expense of meeting minimum education requirements for qualification of a job. Reg. §1.162-5(b)(2)(i) – includes law school
         3. NO deduction for expense of program being pursued by someone which will lead to qualifying in a new trade or business
         4. There are TWO MAIN overlapping categories of (income producing) education deductions. Reg. §1.162-5(a)(1)
            1. Education that maintains or improves skills required by individual in his employment or other trade/business (CLE fits here)
            2. Education that meets the requirements of the individual’s employer or requirements of applicable regulations as a condition of retention of the EE
      6. **Job Hunting** (494)
         1. **Reg** §1.212-1(f) denied current deductions (under §212) for expenses incurred in seeking employment
         2. **Rev. Ruling 77-254**: expenses in IDing a specific opportunity are to be capitalized and amortized. However, general search expenses are “personal” and are not deductible.
         3. **Rev. Ruling 77-16**: Deduction if looking for a new position in one’s current trade or business
   3. **Extraordinary Behavior**
      1. **Gilliam v. Commissioner** p. 530
         1. FACTS: TP is on a plane on a business trip from DC to Memphis; he takes Dalmane pills and they make him go crazy on a flight attendant and a few passengers. He is arrested for assault and battery upon landing and put on trial. TP wants to deduct his legal fees for the civil and criminal trials resulting from this case.
         2. HOLDING: No deduction. Even though it occurred during business travel, the going crazy and assaults were not ordinary business expenses. Him beating ppl up was not ordinary. The three prong test of §162(a) is not satisfied: ordinary, necessary, in connection w/trade or business. Not a cost in generating his income.
   4. **Other examples of ordinary expenses** (501)
      1. **Friedman:** lawyer’s client does not fulfill commitment to fund an agreed settlement, so lawyer then does. No deduction for lawyer. Payment was voluntary and not ordinary
      2. **Trebilcock**: cost paid to religious minister to pray for success of the business and for the EEs of the business – personal benefits, not deductible.
   5. **Reasonable Compensation**
      1. §162(a)(1) provides for deduction for reasonable allowance for salaries and other compensation for personal services actually rendered
         1. Originally intended to permit TP to deduct reasonable amounts for salaries even if not paid
         2. NOW relied on by IRS for denying deductions for unreasonable salaries, usually when it is a sham salary and is really a nondeductible dividend
      2. §162(m): publicly held corporations (i.e. were management and ownership are not the same) cannot deduct more than $1M/year to pay the CEO and the other four highest paid officers of the corporation.
         1. This limitation does not apply to commissions or performance-based compensation or attainment of performance goals determined by the board of directors.
      3. **Golden Parachute Rule §§280(g), 4999**
         1. A company loses deductions from a golden parachute payment if it is deemed excessive.
         2. The recipient of the golden parachute is subject to an additional 20% excuse tax on such payments
   6. **Costs of Illegal or Unethical Activities** - §162 and public policy deductions (502)
      1. **Tank Truck Rentals**: no deduction to trucking company for weight limit violations
      2. **Sullivan:** deduction permitted for rent and wages paid by illegal gambling operation
      3. **Tellier**: deduction to securities dealer is permitted for lawyer’s fees paid for unsuccessful defense in securities fraud case
      4. Statutory deduction disallowances
         1. §162(c)(1) disallows deduction of any bribe or kickback paid to a government official
         2. §162(c)(2) disallows deduction of any bribe or kickback that would subject TP to criminal prosecution
         3. §162(c)(3) special rules for bribes, rebates for Medicare/Medicaid
         4. §162(f): no deduction of any fine or penalty paid to federal or state government for violation of any law.
         5. §162(g): no deduction for 2/3 of the amount paid for treble damages for violation of antitrust laws
         6. §280E – no deduction for drug trafficking expenses; but, deduction for inventory costs of a drug dealer – in order to deduct, he must report his income
         7. Very narrow
3. **Depreciation** (504)
   1. **Depreciation Generally**
      1. TP gets a deduction each year for anticipated decline in the value of the property on the theory that there should be an offset against revenues for the cost of a wasting asset that has a life beyond the current year that is used for the production of revenue – associating the cost of the assets with the income productivity from the particular asset
         1. §167(a) deals w/depreciation of property that is used in a trade or business or for the production of income.
            1. The idea is if the TP invests in property for income production, TP can deduct the yearly decrease in value due to wear and tear, etc.
            2. TO essentially recovers basis over the useful life
      2. **Choices:** 
         1. Deduction for the entire cost in the acquisition year
         2. No deduction until disposition of the asset
         3. Determine actual value decline during year
         4. Allocate some amount of the acquisition cost to each year of assset’s anticipated usage
      3. **Example:** TP pays $10K for machine. Deducts $2K depreciation per year. At year 7, sells for $100.
         1. Original basis would be $10K under §1012
         2. Adjusted basis under §1016(a)(2) (adjustment would be $10K, because he took $2K depreciation deductions for 5 years, the maximum time he could do so) would be $10K - $10K = $0.
         3. So gain/loss is $100 gain. $0 minus $100.
      4. **Building Blocks of Depreciation**
         1. Determination of useful life
         2. Accounting for salvage value
         3. Application of a method of allocating costs in excess of salvage value over the useful life.
      5. Basis is reduced as long as TP had the option to take a depreciation deduction, even if they didn’t take the deduction.
      6. Component Depreciation (for building, etc): divide parts of a building into its various components and allocate useful lives for each.
      7. **Recapture Rule**
         1. Gain in the disposition of personal property is treated as ordinary income to the extent of prior deductions for depreciation. §1245.
         2. Gain on the disposition of real property is the excess of accelerated depreciation over straightline depreciation if acquired before 1986, or just straightline depreciation if acquired after 1986.
   2. **Theory v. Reality**
      1. **Theory:** depreciation is a limited exception to the realization requirement
         1. If TP invests in property as part of trade or business, TP can deduct the yearly value that comes from yearly downgrading of the property rather than waiting for a realization event to recognize
      2. **Reality:** more complex; depreciation deductions are allowed at a much faster rate of return that actual deterioration of items.
         1. This is on purpose, to encourage investment
         2. **Accounting (Recovery) methods** that allow larger deductions in earlier years lead to even greater frontloaded depreciation deductions §168(b)
            1. **Example:** machine w/ cost basis of $100K and a useful life of 5 years

**Straight Line** (cost basis divided by useful life) §168(b)(3) – items that don’t decline rapidly in first year

Year 1: Depreciation $20K, Adjusted Basis $80K

Year 2: Depreciation $20K, Adjusted Basis $60K

Year 3: Depreciation $20K, Adjusted Basis $40K

Year 4: Depreciation $20K, Adjusted Basis $20K

Year 5: Depreciation $20K, Adjusted Basis $0

**Declining balance method:** straight line percentage is determined and then increased by a specified factor; the resulting percentage is applied to the cost of the asset reduced by the amounts previously deducted. When the straight line deduction exceeds the declining balances amount, TP switches to straight line.

**Double declining balance method** (twice adjusted basis divided by recovery period then switch to straight line when favorable)

Year 1: Depreciation $40K ($100K times 2 divided by 5), Adjusted Basis $60K

Year 2: Depreciation $24K, Adjusted Basis $36K

Year 3: Depreciation $14.4K, Adjusted Basis $21.6K

Year 4: Depreciation $10.8K (switching to straight line because more favorable: $21.6 (current basis) divided by 2 (years of useful life)), Adjusted Basis $10.8K

Year 5: Depreciation $10.8K, Adjusted Basis $10.8K

**Income Forecast**: current year’s depreciation deduction is derived from a projection of future income

* + 1. **Basic Rules**
       1. **Recovery Period** for most goods is the useful life, determined in §168(e)
          1. There are 6 classes of personal property
          2. For real property, the recovery periods are 27.5 years for residential and 39 years for non-residential property
       2. An individual who gets more than one asset in a single transaction must allocate a portion of the purchase price to each asset on the basis of the FMV of each asset at the date of purchase
          1. i.e. the purchase of a business is seen as the purchase of all the different parts of the business
       3. **Placed in service conventions** §168(d)
       4. **Limited expensing –** without regard to the rules above **-** §179
       5. **Methods for different types of assets**
          1. **Personal Property**

Double-declining balance for 3,5,7,10 year property

1.5 Declining Balance Method for 15, 20 year property

First year: rate is half of what it would be for the full year unless the asset was acquired in the last quarter of the first year and qualifies for a mid-quarter convention”

For the last year, a half-year’s deduction is allowed

* + - * 1. **Real Property**

Straightline method is the basic method

For the first and last years, a full deduction is prorated according to the number of months during the year that the property was in service

Component depreciation is not permitted.

* + - * 1. **Recapture Rules** are complicated

Not eligible for the installment method

The amount of recaptured gain reduces the amount of deduction in the case of a gift of property to charity

* + - * 1. **Intangible assets** are subject to §167 and must use the straightline method

**15 year amortization of intangible assets §197**

Goodwill

Going concern value

Value of in-place workforce

Value of current relationship with customers/supplier

Patents/copyright

Films, sound recordings

Newark Morning Ledger: successful in convincing SCOTUS the could amortize their customer list over 7 years

* 1. **Depletion for Oil & Gas and Minerals** (512)
     1. **Cost** depletion for (1) oil & gas and (2) hard minerals properties is allowed under §611
     2. **Basis** is allocated over the estimated recoverable units for the property
     3. **Alternative Method:** §613 – Percentage depletion enables a deduction for a percentage of the GI derived from the production (except for major, integrated oil companies).
        1. **But,** no limitation on deduction amount applies even after cost basis equivalent recovered
     4. **Percentage limit** for 50% of the taxable income from the property
     5. **Cannelton** (514): entitled to a percentage depletion only on the value of the clay up to the cutoff point of processes used by a nonintegrated miner before sale
        1. **For oil & gas:** “cutoff point” is at the wellhead
     6. **Economic interest:** to qualify for a percentage depletion deduction the TP must have an “economic interest” in the property.
        1. **“Economic interest”** can include a royalty interest, working interest, carved-out interest
        2. Big oil companies are excluded from the working interest – limited to independent producer – big oil is fully integrated so they own everything
     7. **Intangible drilling costs & G&C Costs** (514)
        1. §263(c) authorizes regulations to enable current expensing for “intangible drilling and development” costs.
        2. Economic effects – availability of this deduction – drill a dry hole = loss deduction – entitled to recover it once, can’t deduct it twice – no basis here
        3. Consider the tax benefit of the combination of (1) the IDC deduction (no cost basis is established), and (2) percentage depletion deduction (no cost basis is necessary)
        4. *Cf* hard minerals: See §616 (development) and §617 (exploration)

1. **TAX AVOIDANCE**
   1. **Tax shelter** – an investment unrelated to TP’s normal business/investment activities & having an objective to produce a tax loss (but not an economic loss)
      1. **Basic premises**: usually rely on some combination of (a) deferral, (b) conversion, (c) tax arbitrage, (d) misattribution of income, and (e) aggressive interpretation of a governing statute or regulation
      2. *Cf. Tufts* – large depreciation deductions were available for property investment when the TP’s tax basis is increased with non-recourse debt – but no economic risk
   2. **Tax Shelter Limitations Provisions**
      1. **Passive activity loss rules** §469 – deduction limit on loss incurred on investment where investor does not “materially participate.” Defined as spending at least 500 hours per year on the activity. Special real estate investment tax deduction of $25000. Only deductible to extent of passive income.
      2. **Deduction of interest is limited when “investment indebtedness”** §163(d). Limitation on current interest expense deduction to amount of “net investment income.”
      3. **At risk** rules - §465. Losses are disallowed when in excess of the TP’s amount “at risk” in that investment. Nonrecourse debt is not included in the amount of risk. Amount at risk includes: (a) cash investment by TP, plus (b) recourse debt, or debt where other property is pledged as collateral.
         1. Non-deductible loss can be carried forward for later deduction. Exception for real estate with qualified nonrecourse financing. *But Cf****.*** §465(b)
   3. **Estate of Franklin v. Commissioner** (523)
      1. FACTS: a group of physicians formed a partnership, entered into a purported sale to purchase a hotel from the Romneys. Partners buy the hotel for $75K and $1.2M non-recourse 10-year note (debt) secured by the hotel upon which they will make $9K monthly payments to the Romneys. Then they lease the hotel back to the Romneys, who pays them $9K monthly rent. Therefore no money actually changes hands monthly, it is a wash cash-wise and tax-wise. TP claim deduction for the interest payments of $9K and depreciation deductions.
      2. HOLDING: This is a sham, no one may take deductions. The disparity b/w the FMV of the property and the amount of the debt is the major kicker.
      3. STRENG: The fact that the land and motel were only worth $600K made the $1.2M mortgage look fishy from the get-go. The point of the scam was this: any amount a TP pays in nonrecourse debt to acquire property becomes part of the basis, so the basis is inflated to $1.2M from which they partners could calculate depreciation deductions. The plan was to not pay off the debt after ten years and allow the hotel ownership to revert back to the Romneys.
   4. **Passive Activity Losses and Credits**
      1. **§469(a)(1)** disallows passive activity losses and passive activity credits
      2. **A Passive Activity** under **§469(c)(6)** is conduct of any trade or business in which TP does not materially participate, including §212 activities
         1. generally **material participation** is regular and substantial activity §469(h)
         2. §469(g)(1) when TP finally disposes of their interest in the passive activity, TP can take advantage of the full loss associated with it (the intent is to create a rule that defers what Congress believes are non-economic losses
      3. **A Passive Activity Loss** under **§469(d)** is the excess from aggregated losses of all PA activities minus al aggregate income from PA
         1. TP must “basket” all losses against all income from PS
         2. Cannot be used to offset regular income
         3. A disallowed loss or credit may be carried forward to the next year and treated as allocable to the same activity in the next year §469(h)(2)
   5. **At Risk Loss Limitations §465**
      1. For certain activities, your loss from that activity can be deducted only to the extent that you or the company is “at risk;” but those losses can be carried forward and run through the rules each year until deducted. §465(a).
      2. **Amounts considered at risk** under §465(b):
         1. Amount of money and the adjusted basis of other property contributed by the TP to the activity
         2. Amounts borrowed re: such activity
         3. May include FMV of a security recourse debt
         4. DOES NOT include non-recourse debt if financed by a third party
      3. **Applicable Activities** under §465(c)
         1. Production of films and videotapes
         2. Farming
         3. Leasing of §1245 property
         4. Exploring for or exploiting oil and gas
         5. Exploring for geothermal deposits
         6. And any activity for production of income after 1978 (this kind of means everything)
      4. **Example:** TP buys a $2M motion picture, but only pays $200K in cash for it, and the rest with non-recourse debt, TP can only deduct $200K in losses if the whole thing turns out to not make any money on release.
   6. **Limitations on Deductions of Interest on investment indebtedness §163(d)**
      1. Restrict deductions of interest on debt tied to any investment like stocks, bonds, and real estate
      2. Amount allowed as a deduction for investment interest shall not exceed the net investment income of TP for the year
   7. **Policing** 
      1. This is a self-assessment system where TP are supposed to police themselves and comply
      2. Penalties are what will really affect behavior, so if its behavior for which there is no possible penalty
      3. **Role of Lawyers**
         1. Advise clients where they stand
         2. Maximum penalty is disbarment
         3. Ethical rules:
            1. Same ethical rules as everybody else, plus special IRS rules
            2. tax layer can’t advise client to take a position unless there’s a realistic possibility of success on the merits (1 in 3 chance of winning in litigation

# Assignment of Income

Rules at first came from the Court, not Congress, to protect progressive rate structure

**Arguments for progressive rate structure**

Tax should be measured by ability to pay: one limitation of this is that if it’s the real objective, should be taxing wealth and not income

People with more money value random dollars less: limitation is that you can’t measure actual happiness levels/significance of money to them

Implicates a work/leisure trade-off: for additional increments of work, steepness of rate structure will affect the choice of whether to work for that extra money or just spend time on recreation

1. There have always been attempts to shift income from people in higher brackets to people in lower brackets (relatives, etc)
2. **Summary**
   1. Generally income is taxed to person who receives it
   2. Assignment of income doctrine is an anti-abuse rule, an exception to the general rule above, to preserve the progressive rate structure
   3. First prong:
      1. Assignments of ***income from services*** generally not valid for tax shifting unless assignment is ***involuntary***
      2. Assignments of ***income producing property*** generally are valid for tax shifting purposes ***unless the transferor retains a reversion interest*** in the property
   4. Second prong?
   5. **§1(g)** provides that unearned income of minor children to be taxed at parents’ marginal tax rate
   6. Assignments of income from property created by services may or may not be valid; it depends on how strong the property interest is.
3. **Assignments of Income and Community Property**
   1. **Lucas v. Earl** (554) *Assignment by private agreement*
      1. FACTS: H and W in California have a prenup in which they consider all income they both acquire during and before marriage as community property. They divide income in half and file separately each claiming half of his wages.
      2. HOLDING: a valid state contract does not have this affect for tax purposes. Income is taxable to the person earning the wages (and not the “legal” owner for local property law purposes). No anticipatory assignment is permitted.
      3. STRENG: to make a Const. argument – arising under the DPC – trying to determine authorization to tax. This case says that a voluntary agreement can’t pre-empt federal law even if entered into before income earned
   2. **Gratuitous Performance of Services**
      1. Typically, professional services provided by parent to child are income to the child
      2. **Hundley** (555) – TP successfully deflected income for value of father’s coaching skills
   3. **Poe v. Seaborn** (557)
      1. FACTS: Similar to Earl, except in Washington state where the law designates most property as community property.
      2. HOLDING: Separate taxation is permissible; here the money has always belonged half to the wife by operation of state law; in Earl the money was always originally the H’s but he gave half to the wife through a contract.
      3. AFTERMATH: This case was important in the development of marriage tax laws
         1. This case gave marrieds in community property states a huge advantage
            1. Marrieds in other states were mad
            2. 1948 Congress decided to treat all married couples as though they were individuals who took in half of what the total couple had taken in during the year – joint return opportunity
         2. This created a marriage bonus: giving each member of the couple a start at the bottom of the progressive rates structure w/half the couple’s $$
            1. Single individual w/ the same income as a whole married couple only got one start at the bottom
            2. Rich singles got upset, especially some women who said they couldn’t find husbands because of all the WWII deaths
         3. Congress scaled back the tax burden on singles, so now there is sometimes a marriage penalty too
            1. The progressive rate structure requires this
            2. You can’t have a single person making $100K be taxed the same as a single person making $50K
            3. Can’t have a progressives structure, treat all married people the same, and get rid of the bonus/penalty
   4. CCA 201021050 (564)
      1. 2007 change in Cal. La re registered domestic partners – that earned income is to be treated as community property for state income tax purposes, and also for Cal. Property law purposes.
      2. HELD: Federal tax law respects state property law characterizations. Therefore, FIT treatment of community property law applies to registered domestic partners in CA. Each must report ½ of total community income
      3. Avoided the DOMA issue by bowing to state law
   5. Income from property is taxed to the owner
      1. A gift or property itself will shift the post-transfer income received from the property to the transferee
      2. A gift of ony income to the property (while the transferor retains a remainder interest in the property) will not shift (for FIT purposes) the income to the recipient of that income. The ransfer can be, however, a completed gift for contract/property purposes
4. **Impossibility/Illegality of TP Receiving Income**
   1. **First Security Bank of Utah** (560, notes case)
      1. FACTS: One TP was the holding co., then there was a bank and a life insurance co ownerd by the TP. The bank was selling life insurance, underwritten by the life insurance co. The IRS said that part of the premium that goes to the life insurance co. should be taxed to the bank.
      2. HOLDING: No, it is illegal for the bank to receive insurance commissions, so since they are not receiving them they should not be taxed for them.
5. **Assignment of Income to Kids**
   1. **Blair v. Commissioner** (570)
      1. FACTS: Father assigned his rights to benefit from a life estate in a testamentary trust to his kids (taking his own right to receive money during his life and giving slices of it to his kids).
      2. HOLDING: the kids are taxable for the monies, b/c father actually fully divested himself of that portion of the money. What he transferred was actually property that generated income. He kept no remainder interest or ownership in the property.
   2. **Helvering v. Horst** (572) *Fruit and Tree*
      1. FACTS: TP gave coupon bonds (where they give you the bond and some coupons to turn in for interest payments) to his son. TP kept the bonds but gave his son the coupons.
      2. HOLDING: TP (dad) is taxable on the interest income. This is a gift just of the income, not the income-generating property as in Blair. The power to dispose of income is equivalent to the ownership of the income
   3. **Current Question:** though Horst and Blair are still both good law, the question is now ***whether what has been transferred is the right to all or part of the income from the property with no reversion to the transferor, or a right to all or part of the income from the property with a reversion to the transferor.***
   4. **Stripped bonds - §1286**
      1. Separation of the bond and the right to the interest payment
      2. Each instrument is treated as a separate OID bond (ie. Discounted at applicable discount rate)
      3. Supercedes Horst
      4. Allocation of basis in each part and parcel
6. **Services Transformed into Property**
   1. **Helvering v. Eubank** (578)
      1. FACTS: a life insurance agent assigned back several renewal commissions to his insurance company at retirement so he could get the income over several years instead of one. He assigned it to a trust that would pay to his children.
      2. HOLDING: TP was assigning future income streams, so he is taxable on it in the present year. Horst controls. The income has already been earned even if not received, unlike in Earl where it had not.
      3. **Separate opinion:** can not be income from “services” if services already performed; permitted assignment of property interest
   2. **Heim v. Fitzpatrick** (579)
      1. FACTS: TP had a series of patents that he assigned to a company that was owned by his immediate family and income from the patents was paid to the company and divided among the owners. The patents are subject to a contract which TP is free to cancel if royalties weren’t paid, etc. It is out of that holdback that he is making an assignment to his wife and kids.
      2. HOLDING: The rights TP assigns are substantial enough to constitute property, so the income is taxable to wife and kids not TP. He is transferring income producing property interest, not just income. It is not just a royalty stream that he has assigned; there is bargaining power, etc. Governed by Blair.
      3. STRENG: effectively this case says that you can transform services into property
   3. **Olmsted Incorporated Life Agency** (581)
      1. Agent surrenders renewal commission rights for 15 year annuity
      2. HELD: not a taxable disposition of rights under the commission agreement. Accepted the TP extending the time for the receipt of taxable income by the TP
      3. In Earl, Horst and Eubank the TP had effectually received the income in that by assigning it, he took dominion over it, converted it to his own use, and treated it as a property right, thus realizing its full economic benefit
7. **TRUSTS** (582) **§§641-668**
   1. A property law concept where legal and equitable ownership are separated (btw owner and trustee), with distributions (income and/or corpus) payable to one or more beneficiaries
      1. Equitable owner has a right to the beneficial usage of the property and the income stream
   2. **§671** – owner is taxable for income
   3. **Multiple Trusts Rule**
      1. Tax planning attempts to use multiple trusts for the same beneficiaries to enable several “runs up the bracket ladder” and get the benefit of the $100-$300 exemption per trust
      2. **§643(f)** prevents people from dividing up the trusts to get multiple runs up the tax ladder
         1. 2 or more trusts have substantially the same grantors and same primary beneficiaries
         2. The principle purpose of such trusts is the avoidance of FIT
   4. Simple Trusts – True Conduit Treatment (583) **§641**
      1. If trust is required to distribute all income currently, and no corpus distribution
      2. All income is taxed to the beneficiary **§§651-652.** No income is taxed to trust or grantor.
      3. A conduit analysis applies to determine the attribution of trust income to the beneficiary
         1. **§651**: if income can be pushed out to beneficiary, taxed to beneficiary. If held in trust, taxed to trust
         2. Income reqd to be distributed currently is subject to deduction – tax pops up somewhere else (hands of beneficiary)
      4. Pass-through of the character (eg capital gains or tax-exempt) of the distributed income
      5. **§641(1)(e)**: if trustee doesn’t distribute appropriately and subjects trust and beneficiaries to much higher tax bracket, a cause of action accrues
         1. Trustee cannot supercede the dictates of the trust creator (mandated income distribution)
   5. Complex Trusts (584)
      1. Trust may be subject to income tax (at a steeply progressive rate) on its taxable income.
      2. Deduction is permitted to the trust for current income distributions to the beneficiaries
      3. The beneficiaries are subject to income tax on the distributed amount, as limited to the “distributable net income” or DNI **§643(a)**
         1. Income reqd to be distributed currently is subject to deduction – tax pops up somewhere else (hands of beneficiary)
         2. Income reqd to be distributed currently is subject to deduction – tax pops up somewhere else (hands of beneficiary)
      4. **§661** deduction allowed for payments to children and Gchildren, but rest taxed to trust
      5. **§662** if push it out of the trust, pops up in hands of beneficiaries – maintaining checks and balances of system
   6. Irrevocable trusts (“genuine” trusts)
      1. No retention of controls by the trust grantor
      2. Subject to rules for dividing income (for FIT purposes) between (1) the trust and (2) the beneficiaries. Subchapter J, **§§641-668**
   7. Grantor Trusts (586)
      1. Trusts where the grantor has retained certain significant power
      2. Taxation of the income of the trust to the grantor/owner **§§671-677**
      3. **Circumstances in which income is allocable to the grantor:**
         1. Trust is revocable §676 requires income attribution of a revocable trust to the grantor**.**
         2. For the benefit of the grantor**. §677(a)** attributes income to grantor where income can be used for grantor or spouse. **§677(b)** – also where income used to fund a support obligation
         3. Reversions – income attribution to the grantor where grantor’s reversionary interest is greater than 5% of the value of the trust **§673.** Exception when reversion after the death of minor descendant
         4. Powers of control – grantor as owner where holding a “power of disposition.” **§674.** Certain exceptions for retained powers. **§674(b), (c) & (d)** 
            1. Also, dependent upon who is the trustee**. §674(c)** permits a “spray or sprinkle” power granted to an independent trustee (pwr to choose which of several beneficiaries will receive income or corpus
            2. **§674(b)** – exceptions for certain pwrs regardless of who holds them
         5. Certain unusual “administrative powers” can cause grantor trust treatment. **§675** (like the pwr of the grantor to buy property from the trust, subject to exceptions)
            1. If grantor can reclaim the trust, they are the owner
            2. If grantor can borrow from the trust = owner
            3. If grantor borrows and hasn’t repaid by end of tax year = owner
            4. These pwrs cause trust to be treated as defective
         6. **§677** – income for the benefit of grantor.
            1. **§677(a) –** distribution to grantor or spouse – presently or delayed; or payment of insurance premiums
            2. **§677(b)** – Satisfaction of support obligation. “support” definition a state law matter (like payments for education)
   8. Mallinckrodt trusts – person who has the right to get the income or corpus of the trust on demand may be taxed as substantial owner of the income - **§678** 
      1. Must have the pwr to vest income or corpus in oneself
      2. Power cannot be subject to a limitation (ie. A “support” trust)
8. **Other Choices for an Investment Entity**
   1. **Options:**
      1. Partnership (including an LLC) – conduit treatment for FIT purposes, including a “family partnership”
      2. S corporation – modified conduit treatment
      3. Qualified retirement plans
      4. Other techniques? (gift leaseback or sale-leaseback)
   2. **Family Partnerships** (592)
      1. **§704(e)** – about making family members part of a partnership where capital is a “material income-producing factor” for the partnership
         1. Capital is a material-income producing factor – excludes law firms – gotta have a real investment
      2. If you’re a partner, income is equally allocable based on your share of the business
      3. Can use a partnership instead of a trust to manage investment property but it must actually be transferred to partnership in order to deflect income to the partnership
      4. Sometimes psychological trauma in shifting ownership when generations change
   3. **Gift and leaseback** (non-trust)
      1. **Brooke v. US** (593)
         1. FACTS: Father/donor transferred real property to children, including where parent had business (medical practice) office. Father appointed as guardian of children. Father paid rent for use of medical offices in that transferred property.
         2. HELD: Sufficient property interest passed by gift to children to enable **§162(a)(3)** business expense deduction to father for rent. Payments to children were not for support obligations(ie. Not the father’s income)
      2. **Van Zandt** (596) – tells us to be real careful about documenting the transaction
   4. **Qualified Retirement Plans** (Pension Trust)
      1. **US v. Basye** (599)
         1. FACTS: Physicians in Permanente limited partnership and partner/physicians contribute to a medical care plan. Beneficiaries of the trust were physiciain partners and other non-partner doctors. Possible payment after retirement, but forfeiture of interest is employment at Permanent terminated before retirement. Only provided for top guys, not all employees
         2. HELD: Payments to the trust were compensation for the doctors.

# CAPITAL GAINS AND LOSSES

* 1. §1(h)(1)(C) provides for (1) a preferential 15% rate for net capital gains & (2) special treatment (for individuals) for net capital losses
  2. §1222 specifies a netting process of:
     1. LTCG & LTCL
     2. STCG & STCL
     3. Net LTCG or net LTCL against STCG or STCL to obtain net capital gain
     4. If net capital gain (§1222(11)) is produced a preferential rate is imposed for that income
  3. Varying Capital gains rates – Individuals (611)
     1. Usual rate for net LTCG is 15% (20% in 2013) – not limited, but critical
     2. Gain from small business stock – 14%
     3. Low ordinary income tax bracket of 15% - then cap. Gains rate of zero §1(h)(1)(B)
     4. §408(m): Collectibles (art, rugs, etc) – 28% on gain. See §1(h)(4) - own basket
  4. **Corporations**: capital gain rate is 35% (same as the rate on ordinary income) §1201
  5. **What is a capital asset?** (615)
     1. § 1221(a) **Something that is property held by the TP (whether or not connected with a trade or business) but NOT**:
        + 1. stock in trade of TP or other property included in inventory of the TP (things TP is selling in ordinary course of business)
          2. property used in his trade or business subject to deprecation under §167

**Exception that swallows this rule**

A §1231 gain is a gain from sale or exchange of depreciable or real property held for more than a year used in trade or business but not for sale to customers in ordinary course of business §1231(b)

If §1231 gains exceed §1231 losses, they are treated as long-term capital gains and losses. If these losses exceed gains, treated as ordinary. §1231(a)(1).

Always good for the TP

* + - * 1. self-created IP
        2. accounts or notes receivable
        3. supplies used in the ordinary course of business
        4. certain other items
  1. **Depreciable Property Treatment**
     1. **NOT** a capital asset - §1221(a)(2)
     2. But, property used in a trade or business (see §1231(a)(3)(A)(i)) can produce §1231 gain. (615)
     3. Net §1231 gains are treated as LTCG. §1231(a)(1)(A)
     4. But, if applicable gain is attributable to prior depreciation, this deduction can be recaptured as ordinary income. §1245
  2. **Current Rates Preference Capital Gains §1(h)**

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| --- | --- | --- | --- | --- | --- |
| **Ordinary Income Rates (%)** | **Long Term Capital Gain Rates** | **Short-Term Capital Gain Rates** | **Gain on real estate held more than one year to the extent of depreciation** | **Gain on collectibles held more than one year** | **Gain on certain small business stock after 50% exclusion** |
| 35 | 15 | 35 | 25 | 28 | 28 |
| 33 | 15 | 33 | 25 | 28 | 28 |
| 28 | 15 | 28 | 25 | 28 | 28 |
| 25 | 15 | 25 | 25 | 25 | 25 |
| 15 | 5 | 15 | 15 | 15 | 15 |
| 10 | 5 | 10 | 10 | 10 | 10 |

* + - * 1. Right now long term capital gains rate is preferential for everyone
        2. Short term capital gains rate preferential for no one
        3. Gains held on real estate preferential for those at or above 28% income bracket
        4. Gains on collectibles preferential for those at or above 33% income bracket
      1. **Dispreference for Capital Losses:** can be netted out against capital gains, but can only offset $3K of ordinary income in a year. Corporations can’t deduct ANY capital loss.
         1. **Ordinary losses and capital gain:** ordinary losses can offset any kind of gain, including capital gain.
  1. **Policy for/against LTCG Treatment** (616)
     1. There are strong feelings on both sides of the issue
     2. Congress is always changing the way they are taxed
        1. b/w 1986 and 2008 Congress has been at both extremes
        2. Preference eliminated in 1986
        3. In 2008 some people will get a 0% taxation bracket on long term CG
     3. **Arguments FOR CG preferences**
        1. Realized capital gains are accumulated over several years but bunched into one year when ‘realized’ and to be recognized
        2. Reduce the Lock-in effect
           1. TP who hold appreciated assets reluctant to sell them b/c of the tax on gains

Bad for flow of capital, reduces liquidity

Government benefits by raising some tax instead of none if people never sold anything but ratchets down applicable tax rate as years go by

* + - * 1. **Counter arg:** The step-up in basis at death is a bigger lock-in issue; TP likely to be responsive to the fact that if they hold an asset until death, no one will pay tax on it.
        2. Lock-in does distinguish b/w assets people hold for investment and those they hold for sale in the ordinary course of business.

It would make sense to have no capital gain treatment for people in the business of selling things b/c they will sell them anyway

* + - 1. To reduce the impact of inflation (but consider 13 months vs. 13 year holding period)
      2. To encourage capital investment
      3. BUT the benefit of tax deferral is realized
      4. Corporate double tax at corporate and then shareholder level.
         1. Counter-arg: capital gains rate applies to all capital assets, not just shares of stock; otherwise this argument would be more compelling for encouraging movement of the stock market.
    1. **Arguments AGAINST CG preferences**:
       1. a dollar of capital gains is the same dollar as one coming from a trade or business.
       2. CG taxation too complex
       3. Benefits tend to go to those at higher end of the distribution level
  1. **Net Capital Gains and Losses**
     1. **Net Capital Gain** is net long term capital gain minus net short term capital loss (see chart for more detail). §1222(11).
        1. **Net Long Term Capital Gain or Loss:** Excess of long term capital gain minus long term capital loss. §1222(7)
           1. Long term capital gain = gain from selling or exchanging a capital asset held for more than a year if and to the extent the gain taken into account in computing gross income (that is, it must be recognized and realized). §1222(3)
           2. Long term capital loss = loss from selling or exchanging a capital asset held for more than a year if and to the extent the loss taken into account in computing gross income §1222(?).
        2. **Net Short Term Capital Gain or Loss:** amount of short term capital gains minus short term capital losses if negative. §1222(6)
        3. §1211(b): Net capital loss can offset ordinary income up to $3000 per year for an individual
           1. Only if you end up with excess losses after offsetting capital gains
        4. For individuals, excess losses can be carried forward to offset future capital gains or to offset ordinary income up to $3000 for any subsequent year, until exhausted. §1212(b)
     2. Corporation are subject to 1212(a): may only carryback losses for 3 years and forward 10, with current year that’s 14
     3. **Limitation on Capital Loss Deductibility**
        1. Prevents TPs from cherrypicking losses
           1. Realization is in TPs control; they would just realize losses and not gain if they could
           2. Example: TP makes $1M investment with 50/50 chance of $25K gain or loss, then enters into a transaction that perfectly hedges the first. W/no loss limitation, TP is unchanged financially but would liquidate the loss and hold the gain investment, realizing a big loss and no gain
        2. Limit the impact of these losses on tax revenues derived by US Treasury Dept.

1. **Application**
   * + 1. Long Term Capital Gains and Losses: where capital assets has been held for more than one year
          1. §1223 has special rules for determining holding period of property

Includes time during which TP holds asset

Sometimes includes time other than when property held, or time when another person held it

§1223(9): holding period of property from a dead person includes the time they held it—step up holding period

if there is appreciation after death, beneficiary automatically deemed to hold asset for more than one year (is this different from above?)

* + - 1. Short Term Capital Gains and Losses: where capital asset has been held for less than a year.
      2. Net Long Term Capital Gains against Long Term Capital Losses
      3. Net Short Term Capital Gains against Short Term Capital Losses (§1222 separates long and short term and nets them separately)

|  |  |  |
| --- | --- | --- |
|  | **TP has Net Short Term Capital Loss** | **TP has Net Short Term Capital Gain** |
| **TP has Net Long Term Capital Gain** | 1. if the long term gain is greater, the excess of the net long term capital gain minus short term loss will be taxed at preferential rate long term capital gain rate 2. If short term loss is greater, the loss will eat up the gain and if there is still loss after the $3K of ordinary income, you can carry the short term loss forward | Long term gain gets preferential rates and short term gain gets the non-preferential rates. |
| **TP has Net Long Term Capital Loss** | The losses are deductible against $3K of ordinary income and the unused parts carried forward. The short term is used up first against the $3K of ordinary income. | 1. If more gain than loss, the excess will be treated as short term gain meaning no preferential treatment—ordinary rate 2. If more loss than gain, the loss will eat up the gain, the next $3K can eat up ordinary income, and the rest can be carried forward as long-term capital loss for the next year |

* 1. **Property Held Primarily For Sale to Customers**
     1. **Bielfeldt v. Commissioner** (620)
        1. FACT: TP wanted to offset his trading losses; he was betting on treasury bonds, buying them in large quantities from deals in order to re-sell when there was a shortage. He got burned, and wanted to characterize his losses as ordinary (giving him a refund of $85M instead of offsetting only $3K/yr of ordinary income). Dealer realizes gain from sales commissions; trader realizes gain from market speculation.
        2. TP ARGS: He is a dealer, not a trader. A dealer buys and sells for someone else’s account and therefore stocks and bonds are their inventory, which is not a capital asset under §1221(a)(1).
        3. HOLDING: TP a trader; clearly doing it for himself. The stocks and bonds were property he was buying and hoping to sell himself. He makes no money off providing the service to others, he is just a private speculator. These are capital assets.
     2. Mark-to-Market transactions §475 (623)
        1. For securities held by dealers in securities, inventory must be held at FMV, non-inventory shall be recognized as sold at FMV on the last day of the taxable year
        2. Securities dealers are required to mark-to-market securities not treated as inventory or held for investment.
        3. Treatment as if sold at end of year – gain or loss as ordinary gain/loss
        4. *Cf*. §1236 permitting a securities dealer to segregate securities into an investment account treated as capital assets
     3. **Biedenharn Realty Co. v. United States** (624)
        1. FACTS: TP was a corporation that bought a plantation as an investment. Eventually they improved it and sold off parcels for subdivisions. IRS said the income they got from such sales were ordinary.
        2. TP ARGS: they are capital gains, b/c the original intent of purchase was an investment and they are just liquidating an investment.
        3. HOLDING: The TP clearly engaged in the sales as a part of its trade or business; the intent to invest had already been abandoned. There are a variety of factors to consider re: whether income was from investment or trade/business:
           1. Frequency and number of sales
           2. Significance of improvements – streets, utilities, etc
           3. Solicitation and advertising efforts
           4. Brokerage activities – attributable to owner
           5. Importance of the activity in relation to TP’s other activities
     4. Standard of Review: dealer/trader status is a question of fact subject to the clearly erroneous standard
     5. **Gangi v. Commisioner** (631 – notes)
        1. FACTS: apartment building was converted from rentals into condominium units.
        2. HELD: units not primarily for sale – but, rather, a liquidation of their investment. Partly attributable to disintegration in the business relationship btw two partners. Here, (1)limited advertising and (2) improvements were not made made for the primary purpose of sale
  2. **Transactions Related to TP’s Business**
     1. **Corn Products Refining Co. v. Commissioner** (635) *Cf. Hedging Transactions*
        1. FACTS: TP was in the business of producing corn products. It had problems storing enough corn to meet demand, so started buying corn futures to avoid spot market fluctuations.
        2. NOTES ON FUTURES:
           1. Futures contract is entered into today with a promise to buy at a specified date at a specified price. Protect against increase in price, but not decrease

Example: TP sells product for $200 bushel, contracts to buy corn gutures for Jan. 1 delivery at $100/bushel. On January 1 corn sells at $150/bushel on the spot market. TP could

Take delivery, make a profit of $100: this would be all ordinary income, from sale of inventory

Buy on spot market and sell futures contract, make $100 profit: this would be half ordinary income from sale, half capital income b/c sale of the contract which is a capital asset (courts says no to this)

* + - 1. HOLDING: To hold that the income from sale of the futures contract is a CG would allow those engaged in hedging transactions to transmute assets from CG to ordinary or vice/versa. The TP’s actions were not those of an investor; they were taken on just as a cheap substitute for storage facilities. ***This doesn’t fit w/in the inventory exclusion, but to allow CG treatment would go against the Congressional purpose***.
    1. **Arkansas Best Corp v. Commissioner** (638)
       1. FACTS: TP bought more shares of a failing bank to help its business image. Later it sold them as a loss. TP claims ordinary treatment on the theory that it held the stock as part of ordinary business operations. The Tax Court held that the sale of the stock purchased before the bank’s financial troubles were investments and produced capital gains treatments, while the sale of the stock purchased after the financial troubles produced ordinary income because the stock was bought for a business purpose—preservation of good will.
       2. HOLDING: TP was over-reading Corn Products; that case was actually just a broad reading of the inventory exclusion. Motivation for purchase not relevant. There is no ordinary business transaction exception to the capital asset rule; unless TP is a dealer in stock or the stock is part of inventory, it is considered a capital asset. TP motivation is irrelevant as to whether the asset is property held by the TP. All of the TP’s stock was a capital asset and had to be treated as a capital loss
    2. Source of Supply Cases (642)
       1. **Booth Newspapers** – buys stock in paper manufacturing corp. to assure source of supply and then sold at a loss. See Reg. §1.1221-2(c)(5)(ii)
  1. **Current Treatment of hedging transactions**
     1. A capital asset excludes a hedging transaction if the TP identifies it as a hedging transaction when entering into it. §1221(a)(7).
     2. If TP chooses ordinary treatment by marking it as a hedging transaction, it takes that hedging transaction out of the mark to market rules (which make TP take account of gains and losses that have not been realized §1256).
     3. The distinction b/w capital and ordinary income is artificial; someone has to police the line and TP has to know in advance what kind of transaction they are entering into and that is problematic.
  2. **Substitutes for Ordinary Income**
     1. **Hort v. Commissioner** (642) *Payment for cancellation of a Lease*
        1. FACTS: Office building left to TP after his father’s death. Office had a lease on it and a sublease; the rent was above market then. Tenant wants out and negotiates to pay $140K as consideration to cancel the lease. TP says this payment to him entitles him to a CL on the theory that he was entitled to much more than $140K under the lease and the difference is capital loss.
        2. HOLDING: the $140K is ordinary income; TP was relinquishing the right to the rest of the rent and simply got pre-payment of rent it agreed to be entitled to. Rent is ordinary income.
        3. BOTTOM LINE: where a TP is taking a stream of income that would be ordinary if received in the stream but converted it to a lump sum that was just a substitute for the stream, it retains its character as ordinary income.
     2. Premium Lease (646)
        1. §167(c)(2) specifies NO allocation of tax basis to a lease when property is acquired. Therefore, only the physical property itself is depreciable
        2. If lease has a price higher than building is currently worth, that has value
     3. **McCallister** (647) *Sale of Interest in a Trust*
        1. FACTS: Widow transfers her life interest in a testamentary trust for receipt of a cash payment. She reports a CL of $8790 (amount received less basis – established under “uniform basis” rules). TP claims the trust was a capital asset and transfer resulted in a CL.
        2. HOLDING: Sale of entire property interest (capital) and not income stream (treated as income). CG treatment works here. Blair controls. ***Transfer of income producing property generally results in CG treatment unless transferor retains reversion interest in the property***. Same as assignment of income.
     4. **§1001(e)** – where life tenant sells life interest the tax basis for the life interest is zero – unless the remainderman sells at the same time, in which situation the tax basis is proportionately allocated. Capital gains treatment to te selling life tenant.
        1. Under Uniform Basis Rules the original basis is allocated btw the life interest and the remainder interest. Basis is gradually shifted from life tenant, based on life expectancy tables
     5. **Womack v. Commissioner** (651) *Lottery Winnings*
        1. FACTS: TP transfers entire remaining annual payments for winning lottery in exchange for a (discounted) lump sum amount.
        2. HELD: Payment was a substitute for ordinary income stream and, therefore, all constituted ordinary income. Lottery rights were never a capital asset.
     6. **Oil Payments**
        1. **Commisioner v. PG Lake** (656)
           1. FACTS: Corp. has 7/8 working interest in 2 O&G leases. Assigns $600,000 oil payment (plus 3% interest payment) to its president to pay a debt owed to him. Corp. reported this transfer as a sale of property producing a $600,000 LTCG.
           2. HELD: Proceeds were ordinary income (but, subject to depletion deduction – 7.5% at this time). Treated as essentially a substitute for the future receipt of ordinary income.
        2. §636 – carved out production payment – treated as a mortgage loan on the property (ie. Payment periodically by the oil producer for the property owner made to production payment holder). Not an economic interest to the recipient under production payment but to the seller (who gets depletion). Taxed periodically when payments actually made.