**TABLE OF CONTENTS**

1. **General Tax Background 6**
   1. Family Tax Issues 8
      1. For married couples 8
      2. Effect of divorce 9
      3. For Children/“Kiddie Tax” 9
   2. Entity Taxation 10
      1. Corporation 10
      2. Partnership 10
      3. Trusts 11
   3. Methods of Accounting 12
      1. Cash 12
      2. Accrual 13
         1. Special Income Items 14
         2. Special Expense Items 14
      3. The Taxable Year 15
      4. Method must “clearly reflect income” 15
2. **Income 15**
   1. Gross Income 16
      1. Items specifically INCLUDED in income 16
         1. Compensation 16
         2. Gross Income Derived from Business 16
         3. Gains from Dealings in Property 16
         4. Interest 17
         5. Rents 17
         6. Royalties 17
         7. Dividends 17
         8. Alimony 17
         9. Annuities 17
         10. Income from Life Insurance 18
         11. Pensions 18
         12. Income from Discharge of Indebtedness 18
         13. Distributive Share of Partnership Gross Income 18
         14. Income in Respect of a Decedent 18
         15. Earnings and Prizes from Game Shows 18
         16. Income from an Interest in an Estate or Trust 19
         17. Unemployment Compensation 19
         18. Social Security Benefits Received 19
      2. Items specifically EXCLUDED from Gross Income 19
         1. Proceeds of Life Insurance Payable by Reason of Death 19
         2. Gifts and Inheritances 19
         3. Interest on State and Local Bonds 19
         4. Compensation for Injuries or Sickness 20
         5. Amounts Received Under Accident and Health Plans 20
         6. Contributions by Employer to Accident and Health Plans 20
         7. Rental Value of Parsonages 20
         8. Certain Income from Discharge of Indebtedness 20
         9. Improvements by Lessee on Lessor’s Property 21
         10. Recovery of Tax Benefit Items 21
         11. Certain Combat Zone Compensation 21
         12. Income of States, Municipalities 21
         13. Qualified Scholarships 21
         14. Contributions to the Capital of a Corporation 21
         15. Meals or Lodging Furnished for Convenience of Employer 21
         16. Exclusion of Gain from Sale of Principal Residence 21
         17. Cafeteria Plans 22
         18. Educational Assistance Programs 22
         19. Dependent Care Assistance Programs 22
         20. Certain Personal Injury Liability Assignments 22
         21. Certain Fringe Benefits 22
         22. Income from US Bonds to Pay Higher Ed Tuition 23
         23. Disaster Relief Payments 23
         24. Private Activity Bonds; Qualified Bonds 23
         25. Exempt Facility Bonds 23
         26. Qualified Bonds 24
         27. Arbitrage Bonds 24
         28. Welfare Type Gov’t Payments 24
3. **Deductions 24**
   1. Calculations 24
   2. Items DEDUCTIBLE 25
      1. Standard Deduction 25
      2. Personal Exemption Deduction 25
      3. Qualifying Child Deduction 25
      4. Business Expenses 26
      5. Expenses to Remove Barriers to Handicapped and Elderly 29
      6. Reasonable Allowance for Salaries 29
      7. Domestic Production Deduction 29
      8. Vacation Homes 30
      9. Depreciation for Luxury Automobiles 30
      10. Expenses for Preserving Assets 30
      11. Cost of Environmental Clean-Up 30
      12. Job Seeking Expenses 30
      13. General Education Expenses 30
      14. Interest 30
      15. Losses 32
      16. Bad Debts 35
      17. Tax Payments 36
      18. Charitable Contributions 36
      19. Medical Expenses 39
      20. Alimony Payments 39
   3. Items NOT Deductible 39
      1. Capital Expenditures 39
      2. Illegal Drug Trafficking Expenses 39
      3. Violation of the Law Expenses 39
      4. Lobbying Expenses 40
      5. Start-Up Expenses 40
      6. Dividend Payments 40
   4. Option to Deduct or Capitalize 40
      1. Circulation Expenses 40
      2. Research and Experimental Expenses 40
      3. Organizational Expenses 40
   5. Caps/Floors on Deductions 40
   6. Multi-Year Tax Implications 41
      1. Tax Benefit Concept 41
      2. Claim of Right Income 42
4. **Tax Credits 42**
   1. Qualifying Child Care Expenses 42
   2. Adopting Parents 42
   3. Earned Income Tax 42
   4. Elderly and Disabled Credit 42
   5. Education Credits 43
      1. Hope Credit 43
      2. Lifetime Learning Credit 43
5. **Valuation for Tax Purposes 44**
   1. For Financial Contracts/Options 44
6. **Capital Expenditures 44**
   1. What counts as a capital expenditure? 44
      1. Tests for determining whether it is an capital asset 44
      2. CAPITAL EXPENDITURES list 44
         1. Financial Assets 44
         2. Real Estate 44
         3. Tangible Personal Property 44
         4. Intangible Assets 45
         5. Cost of Acquiring Asset 45
         6. Cost of Constructing Assets 45
         7. Cost of Raising Capital 45
         8. Cost of Company Reorganization 45
         9. Cost of Disposing of Property 45
         10. Cost of Property Demolition 45
         11. Cost of Defending/Perfecting Title 45
         12. Start Up Expenditures 45
         13. Pre-Paid Insurance 45
      3. Capital Expenditures ARE NOT 46
         1. Stock in Trade or Inventory of Business 46
         2. Property held primarily for sale to Customers 46
         3. Property subject to Sect. 167 Depreciation 48
         4. Literary or Artistic Property Held by Creator 48
         5. Accounts or Notes Receivable 48
         6. Commodities Derivative Financial Instruments/Hedges 48
         7. Supplies Regularly Consumed in Business 48
         8. Advertising Expenses 48
         9. In-House Compensation 48
         10. Costs to Defend Business 48
         11. Author’s Expenses 49
         12. Letters, Memoranda, etc. 49
   2. Basis of Property 49
      1. = Cost 49
      2. When Basis ≠ Cost 49
         1. Bargain Purchase 49
         2. Acquired by Gift 49
         3. Acquired from Decedent 49
      3. Adjustments to Basis 49
   3. Depreciation 50
      1. General Rule 50
      2. MACRS Depreciation Schedules 50
         1. Type of Depreciation Used 50
         2. Classification and Applicable Recovery Period 51
         3. Timing Convention 51
   4. Amortization 51
   5. Depletion 51
   6. When Property is Sold or Exchanged 52
      1. Definition of Sale or Exchange 52
      2. Times Where No Recognition of Gain/Loss 52
         1. Like-Kind Properties 52
         2. Involuntary Conversions 53
      3. Allocation of Basis 53
      4. Gift-Leasebacks 54
7. **Capital Gains/Losses 54**
   1. General Rules 54
   2. Netting Process 55
   3. For Corporate Taxpayers 55
   4. Depreciable Property Used in Trade or Business 55
   5. Patents 56
   6. Qualified Small Business Stock 56
   7. Conversion Transactions 57
   8. Sale of a Going Business 57
   9. Short Sales Against the Box 58
   10. Installment Sales 58
   11. Original Issue Discount Bonds 60
   12. Market Discount on Bond 60
   13. Interest-Free or Low-Interest Loans 61
   14. Term Loans 61
   15. Deferred Compensation 62

**TAX OUTLINE**

* **General Tax Background**
  + **Taxation = process by which govt. transfers resources private 🡪 public sector**
  + **FUNDAMENTAL TAX CONFLICT = demand for govt. provision of services v. individual’s desire to minimize his tax burden.**
  + **GOAL OF TAX/FISCAL POLICIES = facilitate growth of economy + justly distribute burdens/benefits of tax system + raise revenues for govt. expenses**
  + History of Taxation
    - Initial = excise taxes on legal instruments, alcohol, sugar, etc.
    - Tariff Act of 1816 – tariffs on some imported and domestic goods
      * NOTE: Tariffs 🡪 higher prices for goods 🡪 burden on consumers
    - First Income Tax (1862)
    - **16th Amendment passed (1913) – permits Congress to tax income “from whatever source derived”**
    - **Internal Revenue Code of 1986 – imposes all federal revenue taxes**
    - Early 20th Century – Congress enacts estate tax, gift tax and Social Security (retirement, disability and unemployment insurance system)
    - Mid 20th Century – Income Tax begins to be paid by most Americans
    - Early 21st Century – tax cuts 🡪 federal deficits
  + **Types of Taxes**
    - **Federal Taxes**
      * **Corporate & Individual Income Tax**
      * **Payroll Tax** (note: has risen over past several years; has greatest impact on lower income workers b/c of tax cap)
      * Estate Tax, Gift Tax
      * Excise Tax (on things like liquor, cigarettes, playing cards, cars, etc)
        + Value Added Tax – type of excise tax – imposed on a stage basis, where tax = (total sale x rate) – refund for prior tax
    - **State Taxes**
      * **Major Sources of Revenue = sales tax + income tax**
    - **Local Taxes**
      * **Major Sources of Revenue = property tax**
    - Note: Taxes in US are lower as % of GDP than most other countries
  + **Basic Tax Terminology**
    - **INCOME TAX LIABILITY = [TAXABLE INCOME (gross income – deductions) X TAX RATE] – TAX CREDITS**
    - **Gross Income = “all income from whatever source derived”**
    - **Deductions = greater of standard deduction OR itemized deductions**
      * Note: some expenditures are not deducted in year accrued – they must be capitalized, and then annual deductions are made over a period of X years
    - **Tax Rate = based on table, which is based on income level 🡪 income tax is PROGRESSIVE (% increases as income increases)**
      * **Marginal tax rate = tax rate applicable to last dollar of income**
    - **Credit – directly reduces tax liability**
  + **Tax Policy**
    - **Current US federal tax system = part consumption tax & part income tax**
    - **Criteria for determining whether particular tax is “good” or “bad”: EQUITY + EFFICIENCY + SIMPLICITY**
      * Equity = requires that those with greater ability to pay tax do pay more tax, and those with equal ability pay equal tax
      * Efficiency = requires that tax interfere little with economic behavior
    - 3 types of tax system complexity:
      * RULE – problems of understanding + interpreting tax law
      * COMPLIANCE – complexity of complying with law
      * TRANSACTIONAL – occurs when taxpayers organize affairs to minimize taxes
    - Argument for progressive tax = based on ability to pay + reduces economic inequalities + necessary to make tax system proportional (b/c payroll, sales, etc taxes are more regressive)
    - Tax Expenditure Budget = measurement of reductions in income tax liabilities that result from tax provisions that provide benefits to groups of taxpayers
  + **Taxation Process**
    - Authorized by US Constitution (16th Amendment; plus Art. 1, Sect. 8).
    - Tax Bills: House 🡪 Senate 🡪 Conference 🡪 Final Bill 🡪 President
    - Administration of Internal Revenue Code
      * Internal Revenue Service facilitates tax process, led by Commissioner of Internal Revenue
      * **Revenue Rulings = Commissioner’s official interpretation of tax law 🡪 is generally binding on IRS officials**
        + Note: taxpayers can usually rely on revenue rulings, both in dealing with the IRS and in Court
      * **Private Ruling/Determination Letter – written statement issued to taxpayer that interprets and applies tax law to taxpayer’s individual set of facts.**
    - Role of Judiciary in tax matters:
      * When the administrative process fails to result in agreement between IRS and taxpayer, taxpayer may litigate…
        + District Court 🡪 Circuit Court 🡪 SCOTUS
        + Court of Federal Claims 🡪 Court of Appeals for Federal Circuit
        + Tax Court 🡪 Court of Appeals 🡪 SCOTUS
  + Taxation of International Income
    - Issue: How do we define federal “jurisdiction to tax”?
    - US Tax Code § 61 – “income from whatever source derived”. This is limited by:
      * US Tax Treaties,
      * Foreign tax credits (for foreign taxes paid).
  + **Family Tax Issues**
    - **For Married Couple**
      * **Marriage = Between Man and Woman (Federal Defense of Marriage Act) + Valid Marriage recognized by State**
      * **Effect of Marriage on Taxes**
        + **Where taxpayers earn nearly equal income 🡪 marriage penalty (pay more taxes)**
        + **Where one taxpayer earns substantially more than the other 🡪 marriage bonus (pay less taxes)**
      * Spousal Liability:
        + Where income and deductions are REPORTED CORRECTLY, spouses are jointly and severally liable for the tax liability when a joint return is filed.
        + In the case of INCORRECT REPORTING:

Where there is (1) an understatement of tax due to the omission of income or erroneous deductions by one spouse, (2) the “innocent” spouse did not know or have reason to know of mistakes, and (3) the “innocent” spouse did not benefit from omissions 🡪 “innocent” spouse is not responsible for liability from errors. (§ 6015)

Where there is (1) income received by one spouse, that is (2) not shared with the other spouse, the (3) unlearning spouse had no knowledge of the received income and (4) it would be inequitable to include the income in his income, and (5) NO JOINT RETURN FILED 🡪 unlearning spouse is relieved from tax.

* + - **Effect of Divorce:**
      * **Couple = No longer “married” for federal tax purposes if they are legally separated under a decree of divorce or separate maintenance. Determination made at close of tax year.** (§ 143)
      * **Alimony v. Child Support**
        + **Alimony = usually taxable to the payee, deductible for payor** (and deducted above the line).

Payments may be made directly to spouse or to other entity on behalf of spouse.

* + - * + **Child Support = non-taxable, non-deductible.**

Payment treated as child support if it will be reduced (§ 71):

Upon the occurrence of events relating to the child specified in the divorce instrument (marriage, graduation from school, etc) or attainment of a certain age or income level or

At a time “clearly associated” with such event.

* + - * + Delinquent payments by a former spouse applied to past-due child support first, then against past-due alimony. (§ 71(c)(3)).
      * **Property Settlements Incident to Divorce (NOT incidental to marriage):**
        + **No gain or loss recognized on (1) transfer of property between spouses or (2) transfer incident to divorce between spouses. Recipient takes carryover basis of adjusted basis of the transferor (loss/gain is transferred).**
        + Incident to divorce = occurs within one year after the marriage ceased or related to the cessation of the marriage.
      * **Dependency and Medical Deductions go to custodial parent, unless the parties agree otherwise.** (§ 152 and 213).
    - **For Children:**
      * **Generally: Child is considered a separate taxpayer and the child’s earned income is not aggregated with the rest of the family, even if income is pooled to pay household expenses.** (§ 73)
      * For personal/standard deduction: only parent or child can claim the personal exemption, not both. (§ 151)
      * **Kiddie Tax** (§ 1(g))  **- applies to UNEARNED INCOME**:
        + Applies to children under 19 or children 18-24 who are full-time students.
        + **A minimum of $1,000 of a child’s unearned income is not subject to the kiddie tax and is taxed at the child’s rather than the parent’s marginal rate.**
        + **Any greater amount of unearned income is taxed at the parent’s rate, eliminating the income-shifting incentive.**
        + If the child has income between $500-5,000 from interest and dividends, the parent may elect to report the gross income of the child on their own return, which excuses the child from filing their own return.
  + **Entity Taxation (i.e. not individual taxpayers)**
    - **Corp. v. Partnership:**
      * **Corporation = separate taxable entity, distinct from shareholders**
        + Differences than individual taxpayer:

Taxed on different rate schedule;

Must calculate capital and ordinary income separately, but taxed on all income at ordinary income rates.

* + - * + If Subchapter S Corporation, Corporation can elect to be taxed like a partnership. To qualify for S Corp, it may have no more than 100 shareholders, and only individuals, estates and certain trusts and tax-exempt organizations may hold stock, and only one class of stock can be issued.
      * **Partnership = conduit; income & deductions flow to various partners to be reported on individual tax returns.**
        + **LLC taxed like Partnership.**
        + **To be considered a partner, the individual must contribute to the partnership in either services or capital, or somehow own a capital interest. Cannot be partner in name only.** (Commissioner v. Culbertson)
        + **Each partner has a basis in her partnership interest:**

**Initial basis = sum of cash + adjusted basis of contributed property + gain realized when contributing property**

**↑ basis: from partnership income + liabilities**

**↓basis: from cash or property distributed from partnership + partnership losses**

* + - * + **Partner cannot deduct partnership losses > basis. Any excess losses will be deducted in future years.**
      * **The Commissioner has the authority to re-allocate income between two or more businesses controlled by the same interests where “necessary in order to prevent evasion of taxes or clearly reflect income”.** (§ 482)
    - **Trusts:**
      * **Multiple trusts will be treated as one trust if: (1) the trusts have substantially the same Grantor(s) and (2) substantially the same beneficiaries, and (3) the trusts are separated for the principal purpose of tax avoidance.** (§ 643)
      * **For Grantor Trust** (§ 671 and 679):
        + **In general, the Grantor is treated as the owner of the portion of the trust if they can control disposition of some or all of the trust income or principal.** (§ 274)
        + **Grantor is taxed if the grantor has:**

**A reversionary interest of 5% or greater in either the income or corpus;**

**Certain powers to affect beneficial enjoyment of income or the trust corpus;**

**Specified unusual administrative power; or**

**If the trust is a foreign trust with US beneficiaries.**

* + - * + Any powers of the grantor’s spouse are treated as belonging to the grantor if the spouse was living with the grantor when the spouse’s interest or power was created.
      * **Where someone other than the Grantor is treated as Owner:**
        + **If someone other than the grantor possesses sufficient control over the trust property, they will be treated as the owner for tax purposes.** (§ 678).
        + To avoid taxation, the person may renounce or disclaim that power within a reasonable time of learning of its existence.
      * **Income Not Taxable to the Grantor or Another Person as an Owner**
        + **If simple trust, trust = taxpayer and trustee must pay tax on income not distributed. See § 1(e) for tax rates.**

Simple Trust = (1) all income must be distributed currently to beneficiaries, (2) no distributions are made from the trust corpus, and (3) where there are no charitable beneficiaries.

* + **Methods of Accounting**
    - **Two basic methods:**
      * **Cash**
        + Most individuals and many small businesses use the cash method. A “qualified personal service corporation” can use the cash method, provided that they meet the requirements of § 448.
        + **Tax Treatment:**

**General: Items are included in income in the year in which the cash or equivalent is received; items are taken as deductions in the year in which they are paid.**

**For income:**

**Constructive receipt treated as = actual receipt.** (Reg. 1.446-1(c)(1).

**Constructive Receipt = When a taxpayer has the immediate power to receive the income.**

Receipt by Agent = Receipt by Principal

Cash Equivalent

Is:

Actual Cash or Change;

Check (when taxpayer has ability to cash);

Non-Negotiable Promissory Note.

Is Not:

Negotiable Promissory Note;

Accounts Receivable;

Other Debt Instruments.

**For Payments:**

Credit Card v. Bank Card:

Old - Deduction made on date of payment with bank card, but deduction not made until credit card purchase is repaid if payment made with credit card.

New – Payment by credit card = Paid.

If Accounts or Notes Payable are used, no deduction until the item is actually paid.

Dec. 31st payment = deduction in year 1, Jan. 1st payment = deduction in year 2 🡪 cash basis taxpayers have an incentive to pay deductible expenses on Dec. 31 and receive income on Jan. 1st, all else being equal.

* + - * + **Exceptions:**

**If the item is a capital asset, payment is not deducted immediately – still treated as regular capital asset.**

Items where cash taxpayer treated like accrual (i.e. payment allocated and deducted over time):

Prepaid interest payments (§ 461(g));

Prepaid insurance payments.

* + - * **Accrual**
        + Most corporations and some individuals, partnerships and trusts use the accrual method. **§ 448 requires that C Corporations, partnerships with a C corporation as a partner and tax shelters must use the accrual method.**

But, these entities are exempt from mandatory accrual accounting if they average less than $5 million in gross receipts annually over the period of 3 taxable years before the taxable year in question. (§ 448).

* + - * + **Tax Treatment:**

**Items are included in income in the year in which they are earned, regardless of when they are received, and items are taken as deductions in the year in which they are incurred, regardless of when they are paid.**

**“All Events” Test** (§ 461(h)(1&4)):

**Items of income and deduction accrue for tax purposes when they pass the “all events” test AND when there has been “economic performance”.**

**Test = met when “all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy” or “all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy” = TOTALITY OF CIRCUMSTANCES**

Transfer of possession/legal title may be indicative.

Special Income Items:

Credits to reserve accounts - are accrued income at the time of the credit and taxable at that time. (Commissioner v. Hansen).

A contingent receivable - (not included because it is unclear whether the taxpayer earned it) is NOT the same as a receivable with a mere doubt of collectability 🡪 mere doubt is not sufficient to prevent accrual.

Prepayments for services – Payments received in one taxable year that will be performed b the close of the subsequent taxable year can be included in income when earned, not received (Rev. Proc. 2003-34).

Security deposits – when there is an obligation to repay and it is not an advance payment for services – is not accrued income. (Westpac Pacific Food v. Commissioner).

Payments for goods – Advanced payments for goods sold to customers in the ordinary course of business may be deferred until the year in which the goods are shipped. (Reg. 1.451-5).

Special Expense Items:

Contested Items – Accrues no later than the date of payment. (§ 461(f)).

Obligation to Related Taxpayer – Deduction deferred until the year the income is includible by the cash method party. (§ 267(a)(2)).

Tort Liabilities – Deductions available ONLY as payments are made.

Recurring Items – Taxpayer may deduct expenditures as soon as the “all events test” is met, SO LONG AS (a) the economic performance occurs no later than 8.5 months after the close of the taxable year and (b) either the item is immaterial or the accounting results in a better matching of liability and income than would occur from accruing the liability when economic performance occurs. (§ 463(h)(3).

Payments arising out of breach of contract or violation of law, rebates and refunds, awards, prizes and jackpots, amounts paid for insurance, warranty and service contracts, taxes – economic performance, and therefore deduction, occur ONLY on payment. (Reg. 1.461-4(g)).

* + - **The Taxable Year:**
      * **Regardless of the method chosen, each tax year (period of 365 days) is viewed separately.** (Hershey Foods Corp. v. Commissioner).
      * The taxpayer can choose their tax year – either simply the calendar year or a fiscal year ending on the last day of any other month. Once the tax year is established, it can only be changed if the taxpayer establishes a substantial nontax business purpose for the change.
      * Short Taxable Year:
        + Returns may have to be filed on the basis of a short taxable year as a result of the taxpayer’s death, the creation/dissolution of a corporation, or change in accounting period. Treated as a full taxable year for all purposes. (§ 443).
    - **The taxpayer’s method will ordinarily determine when an item of income is taxed or a deduction is allowed, but only when the method “clearly reflects income”. The Commissioner is given broad authority to ensure that a taxpayer’s method “clearly reflects income” – if it does not, or if the taxpayer keeps no books, the Commissioner may select an accounting method.** (§ 446).
* **INCOME**
  + Haig-Simmons Definition of Income (Most widely accepted definition): Income = “accession to wealth” = market value of consumption + change in value of property rights
  + **Earned Income = taxable to the person who EARNS it**
  + **Income from Property = taxable to the OWNER of the property.** A gift of income from property does not shift the tax if the donor still owns the property – i.e. owner of the tree, not the fruit is taxed. (Helverling v. Horst)
  + **Gross Income = “all income from whatever source derived” (§ 61 Internal Revenue Code)**
    - **Items Specifically Included in Gross Income (§ 71 – 90):**
      * **Compensation from Services;**
        + **This includes compensation or other gains realized lawfully or unlawfully – includes larceny, embezzlement, gambling, and dealings in illegal goods.** (Collins v. Commissioner).
        + **This includes wages, salaries (including sick pay), fees, commissions, royalties, % of profits, tips, legal and medical fees, jury fees, stock or notes or other property transferred for services.**

For property – Income = FMV of transferred property.

* + - * + **Payment of taxes by employer for employee is consideration.** (Old Colony Trust Co. v. Commissioner)
        + **Includes fringe benefits (in-kind benefits) transferred to an employee.** Taxed at FMV.(BUT, SEE § 132 FOR EXCEPTIONS).
        + **Includes loan made from employer to employee.** Lender is treated as charging a market rate of interest and making a payment of some or all of the amount to the borrower, and that payment amount is taxable.
        + **For property given as compensation –**

Where the taxpayer is permitted to purchase property/services at a price below FMV, the purchaser has gross income for the amount of the discount. (§ 83).

* + - * **Gross Income Derived from Business;**
        + Damages awards – tax consequences of damages based on the tax treatment of the item for which the reimbursement/settlement is intended to substitute.

Ex. Damages are ordinary income when damages payment is for loss of profit. (Raytheon case)

Ex. Damages are a return of capital where there was a destruction of the business capital/goodwill.

* + - * **Gains Derived from Dealings in Property;**
        + **Gain = Sale Value of Property – Taxpayer Basis** (§ 1001).
        + Exchange of property gives rise to a realization event only if the properties exchanged are MATERIALLY DIFFERENT. (§ 1001).

Materially different = legal entitlements that are different in kind or extent.

* + - * **Interest;**
      * **Rents;**
      * **Royalties;**
      * **Dividends;**
        + Stock dividends NOT included. (Eisner v. Macomber)
        + Qualified dividends are taxed at a max rate of 15% 🡪 taxed like capital gains.
      * **Alimony and Separate Maintenance Payments;**
        + Alimony = taxable as long as:

Payments are made in cash, rather than property or services;

The parties do not earmark payments as nondeductible to the payor or nontaxable to the payee;

The parties do not live in the same household;

There is no liability for any payment after the death of the payee; and

The payments do not constitute child support.

* + - * **Annuities** (§ 72)**;**
        + What is an annuity? = person transfers money/other property and receives from transferee a promise to pay certain sums at intervals. Measured by a life or lives or fixed period of years.
        + Taxation of Payments: **Calculation Process:**

**1. Determine total income tax basis.**

**2. Determine expected return (i.e. the payment amount x anticipated number of payments).**

**3. Gross Income Included = (total basis/expected return) x each payment**

* + - * + Withdrawals before annuity start date:

Income = cash value of contract – owner’s investment.

Penalty of 10% of the amount includible in income. (§ 72(q)). Does not apply if withdraw made after annuitant has reached 89 ½ or by reason of death.

* + - * + Mortality Gains/Losses:

Mortality Gain = Taxed = When Annuitant outlives life expectancy of annuity.

Mortality Loss = Deduction = When Annuitant dies prior to life expectancy.

* + - * **Income from Life Insurance and Endowment Contracts;**
        + If the employer pays life insurance premiums on the life of an employee and the employee’s estate/family is the beneficiary, the **employer’s premium payments are income to the employee**. BUT, the employee can exclude the value of premiums on a limited amount of group term life insurance. (§ 79).
      * **Pensions;**
        + Employees are not taxed until they receive payments (usually in retirement), although employers receive immediate tax deductions for contributions. Interest accumulating on the account will also be tax-exempt. (§ 401-404, 410-416)
        + Retirement Plans can be divided into two main categories:

“Defined Benefit” Plans – the Employee is entitled to specified benefits and the employer makes whatever contributions are required to provide such benefits.

“Defined Contribution Plans” – the Employer makes a specific contribution, the contributions are credited to an employee’s account, and the retirement benefit is whatever amount that will be provided by the accumulated fund.

* + - * **Income from Discharge of Indebtedness;**
        + Usually, no income realized on receipt of loan and no deductions made when payments are made on loan.
        + BUT, **if debt is cancelled for less than face value, income results.**
      * **Distributive Share of Partnership Gross Income;**
      * **Income in respect of a Decedent;**
      * **Earnings and Prizes from Game Shows, etc.** (§ 74 & 274);
        + The finder of treasure-trove is in receipt of taxable income. (Rev. Rul. 61, 1953-1, Cum. Bull 17). Taxable income occurs in year when discovered/ “reduced to possession”.
        + NOT income if the prize is (1) given in recognition of religious, charitable, scientific, educational, artistic, literacy or civic achievement, (2) the award is not retained by the recipient, (3) the recipient took no action to enter the contest, (4) the recipient is not required to render substantial future services and (5) the prize is transferred to charity.
      * **Income from an Interest in an Estate or Trust;**
      * **Unemployment compensation** (§ 86); and
      * **Social Security benefits received (up to 85%)** (§ 86).
    - **Items SPECIFICALLY EXCLUDED from Gross Income (§ 101 – 150):**
      * **Proceeds of Life Insurance Contracts Payable by Reason of Death (§ 101);**
        + But, if policy is terminated before death, proceeds taxed. Taxed value = proceeds on termination – total cost of policy (cost of pure insurance protection, loading fee (writing of policy) and savings portion of premiums paid). Doesn’t apply to terminally ill taxpayers.
        + If life insurance policy is sold: gain to be taxed = sale value – premiums paid by transferee. UNLESS:

Gift 🡪 then basis carryover

Transfer to person who’s life is insured or person with a certain business relationship (see code) 🡪 no tax

* + - * + Note: Pre-Death loan made = not taxable.
      * **Gifts and Inheritances (Bequests) (§ 102);**
        + **Gift = “detached and disinterested generosity” (Commissioner v. Duberstein)**
        + **No tax for donee, no deduction for donor.**
        + Exclusion DOES NOT apply to any transfer between employer and employee – any external personal relationship is irrelevant.
        + Political contributions to candidate – not taxable to the extent they are used for a political campaign; any amount used for personal purposes is taxable.
      * **Interest on State and Local Bonds (§ 103);**
        + Exceptions:

Private activity bond which is not a qualified bond (under § 141);

Arbitrage Bond (under § 148);

Bond Not in Registered Form (under § 149).

* + - * **Compensation for Injuries or Sickness (§ 104);**
        + Excluded whether in the form of worker’s compensation, disability pensions, annuities, etc.
        + **Excludes from income “the amount of any damages received on account of personal physical injuries or illness”,** whether it is in the form of a structured settlement (periodic payment) or lump sum. DOES NOT include damages for emotional distress, or damages in sex/age/race discrimination cases.
        + ALL PUNITIVE DAMAGES ARE TAXABLE.
      * **Amounts Received Under Accident and Health Plans (§ 105);**
        + Benefits paid under health plan for medical expenses of employees and their families, as well as for permanent disfigurement are excluded.
      * **Contributions by Employer to Accident and Health Plans (§ 106);**
        + Cost of employer-provided disability or medical insurance is not taxable to employees whether the employee provides the protection through an insurance company or on a self-financed basis.
      * **Rental Value of Parsonages (§ 107);**
        + Excludes rental value of a house for a “minister of the gospel”.
      * **Certain Income from Discharge of Indebtedness (§ 108);**
        + Includes discharge made in Title 11 or other similar bankruptcy releases.
        + Includes purchase price adjustments. (§ 108(e)(5)). To qualify, these conditions must be met:

Debt must be that of a purchaser of property to the seller which arose out of the purchase price of that property;

The taxpayer must be solvent and not in bankruptcy when debt reduction occurs; and

Except for this provision, the debt reduction would otherwise have resulted in discharge of indebtedness income.

* + - * + Includes qualified principal residence indebtedness:

When home owner mortgage debt is cancelled (in whole or part), exclusion of debt discharge from gross income and reduction in property basis.

Limit = $2 million

Expires at end of 2012.

* + - * **Improvements by Lessee on Lessor’s Property (§ 109);**
      * **Recovery of Tax Benefit Items (§ 111);**
      * **Certain Combat Zone Compensation of Members of the Armed Forces (§ 112);**
      * **Income of States, Municipalities, etc. (§ 115);**
      * **Qualified Scholarships (§ 117);**
        + Exclusion is limited to the amount used by degree candidates for: (1) tuition and fees for enrollment or attendance by a student and (2) fees, books, supplies and equipment required for the course of study.
        + DOES NOT include scholarship money used for room and board.
        + DOES NOT include compensation – any portion of a “scholarship” received for teaching, research or other services required as a condition for receiving the scholarship.
      * **Contributions to the Capital of a Corporation (§ 118);**
      * **Meals or Lodging Furnished for the Convenience of the Employer (§ 119);**
        + To be excluded, meals must be furnished to the employee (1) by the employer (2) for the convenience of the employer and (3) furnished on the business premises of the employer.

“Provided by” - DOES NOT include cash payment or cash reimbursement for meals.

“On the business premises” – Court uses “functional rather than spatial test” (Adams v. US)

“Convenience of Employer” –

Requirement generally met if the employee:

Must be on-call after business hours OR

The employer has a policy that precludes employees from eating away from the employer’s business premises during reasonable meal hours.

If more than ½ the meals on the premises are provided for the convenience of the employer, all meals will be treated as such.

* + - * **Exclusion of Gain from Sale of Principal Residence (§ 121);**
        + Taxpayer may exclude $250,000 (or $500,000 if married filing jointly) of gain from the sale of principal residence, provided it was used as such for 2/5 past year.
        + Limitations:

A taxpayer can only have one principal residence. The property where he spends the majority of his time will ordinarily be considered the principal residence.

A failure to meet the 2/5 requirement due to change in place of employment, health or other unforeseen circumstances will still allow the taxpayer to exclude a fraction of the $250,000 of gain equal to the fraction of the time requirement met.

Taxpayer can use this provision no more frequently than every 2 years.

For married couples:

If a taxpayer marries a person who used the provision within the past 2 years, she can still exclude up to $250.000 of gain.

If spouses file jointly but do not share a residence, each may exclude up to $250,000 of gain.

If both spouses reside in the residence, they may exclude up to $500,000 of gain even if only one has met the time limit requirement.

A surviving spouse can exclude $500,000 of gain if the residence is sold within 2 years of the decedent spouse’s death.

* + - * **Cafeteria Plans (§ 125);**
        + Cafeteria plan = plan that allows employees to select from a group of employer-provided fringe benefits.
        + Certain nondiscriminatory cafeteria plans are excluded from employee income.
      * **Educational Assistance Programs (§ 127);**
        + An employee can exclude up to $5,250 a year for amounts paid by her employer.
      * **Dependent Care Assistance Programs (§ 129);**
      * **Certain Personal Injury Liability Assignments (§ 130);**
      * **Certain Fringe Benefits (§ 132);**
        + **Gross Income shall not include any fringe benefit which qualifies as a:**

**No additional-cost service;**

**Qualified employee discount;**

**Working condition fringe;**

**De minimis fringe;**

**Qualified transportation fringe;**

**Qualified moving expense reimbursement; or**

**Qualified retirement planning services.**

* + - * + Working condition benefits are usually regarded as for the benefit of the employer and are therefore not includable in the income of the employee. **Test looks at the primary purpose of the expenses and the intention of the payor.** (US v. Gotcher)
        + Frequent Flyer awards - when earned by employee doing business travel and then used for personal use, are NOT taxable income.
        + For spouse’s expenses – Excluded only if spouse is employee of taxpayer, where there is a bona fide business purpose, and expenses would have been otherwise deductible. (§ 274(m)(3)).
      * **Income from US Savings Bonds Used to Pay Higher Education Tuition and Fees (§ 135);**
      * **Disaster Relief Payments (§ 139);**
      * **Private Activity Bonds; Qualified Bonds (§ 141);**
        + Private activity bond = bond used (1) for government functions, (2) to assist private industry (by acting as intermediary).
        + Qualified Bond (§ 141(e)) – Means any private activity bond if such bond is:

An exempt facility bond;

A qualified mortgage bond;

A qualified veterans’ mortgage bond;

A qualified small issue bond;

A qualified student loan bond;

A qualified redevelopment bond; or

A qualified 501(c)(3) bond.

* + - * **Exempt Facility Bonds (§ 142);**
        + An “exempt facility bond” means any bond issues as part of an issue 95% of more of the net proceeds of which are to be used to provide –

Airports;

Docks and wharves;

Mass commuting facilities;

Facilities for the furnishing of water;

Sewage facilities;

Solid waste disposal facilities;

Qualified residential rental projects;

Facilities for the local furnishing of electric energy or gas;

Local district heating or cooling facilities;

Qualified hazardous waste facilities;

High-speed intercity rail facilities;

Environmental enhancements of hydroelectric generating facilities;

Qualified public educational facilities;

Qualified green building and sustainable design projects; or

Qualified highway or surface freight transfer facilities.

* + - * **Qualified Small Issue Bonds; Qualified Student Loan Bonds; Qualified Redevelopment Bonds (§ 144);**
      * **Qualified 501(c)(3) Bonds (§ 145);**
      * **Arbitrage Bonds (§ 148); and**
        + “Arbitrage bond” means any bond issued as part of an issue any portion of the proceeds which are reasonably expected to be used directly or indirectly –

To acquire higher yielding investments, or

To replace funds which were used directly or indirectly to acquire higher yielding investments.

* + - * **Welfare type government payments** (common law).
* **DEDUCTIONS**
  + **Calculations/How deductions factor in:**
    - **Corporations:**
      * **Gross Income – Deductions = Taxable Income**
    - **Individuals:**
      * **Gross Income – Deductions = Adjusted Gross Income 🡪 Adjusted Gross Income – (Standard Deduction OR Itemized Deductions) = Taxable Income**
  + **Items Deductible**
    - **Standard Deduction:**
      * **A taxpayer may deduct either itemized deductions, OR the STANDARD DEDUCTION (a flat amount).**
      * The standard deduction is not available to: (a) married taxpayers filing separate returns when either spouse itemizes deductions, (b) nonresident aliens, (c) US citizens with income from foreign possession and to (d) estates, trusts, common trust funds or partnerships.
      * **Amounts of standard deductions:**
        + **6,000 on a joint return;**
        + **4,400 for a head of household;**
        + **3,000 for unmarried individuals or married individuals filing separately.**
        + For being over 65 or blindness:

600 for married taxpayers;

750 for unmarried taxpayers

* + - **Personal Exemption Deduction:**
      * **Each taxpayer is entitled to a personal exemption deduction of 2,000.** (§ 151).
      * **Husbands and wives filing joint return get two personal exemptions, and taxpayers are entitled to a deduction for each dependent.**
      * Personal exemptions are phased out for taxpayers with income over threshold amounts.
        + Threshold amounts:

150,000 for joint return;

125,000 for head of household;

100,000 for single individual; and

75,000 for married individuals filing separate returns.

* + - * + If AGI exceeds threshold amount, exemption is reduced by 2% for each 2,500 by which the taxpayer’s AGI exceeds the threshold amount.
    - **Qualifying Child Deduction:**
      * **A parent is entitled to a deduction of $1,000 for each qualifying child under 17.** (§ 24).
      * Deduction is phased out for single taxpayers whose AGI exceeds 75k or married taxpayers whose AGI exceeds 110k.
      * A qualifying child is:
        + Someone who is:

A child of the taxpayer;

A descendent of a child; or

A brother, sister, stepbrother or stepsister of the taxpayer or their descendents

* + - * + Has the same principal place as taxpayer for more than ½ the year;
        + Is less than 19, or if a student, less than 24, and is younger than the person claiming the benefit; and
        + Must not have provided more than ½ his own support.
      * In the event of divorce – the dependency exemption is generally allocated to the parent who has custody of the child; however, a support agreement may otherwise allocate who gets the dependency exemption.
    - **Business Expenses** (§ 162);
      * **MUST BE ORDINARY AND NECESSARY in carrying on any TRADE OR BUSINESS;**
      * “Business” = “involved in the activity with continuity and regularity” and with the primary purpose of earning income or profit, even if there is no sale of goods or services. (Commissioner v. Groetzinger)
      * “Ordinary” = “normal, usual or customary” in the type of business involved (Deputy v. du Pont)
      * If the payor incurs an expense due to a moral obligation, there is no deduction. (Friedman v. Delaney)
      * **Specific Expenses:**
        + **For payment of legal expenses** – “origin of the claim” determines deductibility. Taxpayers can deduct ONLY the cost of legal expenses that stem from profit-seeking activities. (US v. Gilmore)
        + **For payment of professional expenses** – deductible. Includes supplies, dues to professional societies and unions, subscription to professional journals, and the expenses incurred in using an automobile to make business calls.
        + **For meals:**

For personal business meals and entertainment – deductible up to 50% of cost. This applies to meals while away from home overnight on business as well. Does not apply to meals taxed as compensation for the recipient, holiday party, etc. The 50% limitation applies to whoever makes the reimbursement if the taxpayer is reimbursed. (§ 274(n)).

For client’s meal – deductible if “directly related” or “associated with the active conduct of a trade or business”. (§ 274(a)).

For lavish or extravagant business meals – deduction limited. (§ 274(k)(1)(A)).

* + - * + **For luxury water travel** – deduction limited. (§ 274(m)(1)(A))
        + **For entertainment and sports event tickets** – deduction limited to face value and deductions for skyboxes are limited. (§ 274(l)).
        + **For clothes** – cost of clothing expenses deductible only if (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general usage as ordinary clothing (objective test), and (3) it is not so worn. (Pevsner v. Commissioner)
        + **For transportation** – generally deductible when the taxpayer is traveling on business, either the cost of traveling from one city to another (temporary work location) or from one business engagement to another within the same city. Does not include commuting from home to work and back.
        + **For travel expenses** – deductible when expenses (like food, lodging) are (1) incurred “while away from home in the pursuit of a trade or business”, (2) “reasonable and necessary”, and (3) necessitated by the exigencies of business. (§ 162(a)(2)). “Away from home” means a trip including “sleep or rest”. (US v. Correll). Test is for “duplicative expenses”.
        + **Foreign conventions** – deduction allowed only if it is “reasonable” for the meeting to be held outside North America.
        + **For home office expenses** (§280A):

**General Rule: No deduction allowed with respect to use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.**

**Exception: Deduction allowed to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer.** In the case of an employee, the deduction is only allowed if the use of the home as a business is for the convenience of his employer.

Factors to consider: individual circumstances of case, whether there is another fixed location of business, where the taxpayer meets with clients or delivers goods, the functions performed at each competing location, and the amount of time spent in the home office.

**If deductible, deduction limited to the gross income from use of home office – deductions that are allowable regardless of home use** (mortgage interest, real property taxes, casualty losses, etc) **– other deductible expenses attributable to the business** (supplies, wages paid to others, etc) **= net income from activity.**

* + - * + **Education expenses –**

Deductible if they “maintain or improve skills required by the individual in his employment or other trade or business” and the taxpayer must be “established in the trade or business” at the time he incurs the educational expense. (Income Tax Regs.)

Not deductible if:

The education “is part of a program of study being pursued by him which will lead him to qualify in a new trade or business.” (Reg. 1.162-5(b)(3)).

The education is an undergraduate degree or taking “college” courses generally.

The education expenses are travel expenses. (§274(m)(2)).

* + - * **Above v. Below the Line Deductions:**
        + **If the employer reimburses the employee or the employee is self-employed, the employee deducts the expenses “above the line”.**
        + **If the employer DOES NOT reimburse the employee, the employee deducts the expense only if included as an itemized deduction “below the line”.**
    - **Expenses to Remove Architectural and Transportation Barriers to the Handicapped and Elderly** (§ 190);
    - **Reasonable Allowance for Salaries** (§ 162);
      * **§ 162(m) denies a deduction for compensation in excess of $1 million paid to the CEO or the 4 most highly compensated employees of a publicly held corporation, UNLESS the compensation is performance based.**
      * Performance-based compensation standards:
        + = remuneration payable on a commission basis attributable to income generated by the applicable employee OR
        + = compensation paid for reaching performance goals, as long as (1) goals established by compensation committee comprised solely of two or more outside directors, (2) the terms are approved by shareholders, and (3) the compensation committee certifies that the goals have been met before the compensation has been paid.
      * Two different tests – “7 factor test” or “independent investor standard”
        + 7 factor test:

Type and extent of services rendered;

Scarcity of qualified employees;

Qualifications and prior earning capacity of employee;

Contributions of employee to business ventures;

Net earnings of employer;

Prevailing compensation paid to employees in comparable jobs; and

Any peculiar circumstances.

* + - * + “Independent Investor” standard
    - **Domestic Production Deduction** (§ 199);
      * **Deduction allowed for the lesser of taxable income or qualified production activities** (manufacturing, production and extraction, but not sales)**, and the deduction cannot exceed 50% of wages paid in the taxable year.**
    - **Vacation Homes (§ 280A) --- ???????????**
    - **Depreciation for Luxury Automobiles (where > 50% business use)** (§ 280F)**:** 
      * Deduction shall not exceed:
        + $2,650 for the 1st taxable year;
        + $4,100 for the 2nd taxable year;
        + $2,450 for the 3rd taxable year;
        + And $1,475 for each succeeding taxable year in the recovery period.
    - **Expenses associated with preserving assets or keeping them in efficient operating condition.** (Reg. 1.162-4);
    - **Costs of environmental clean-up attributable to manufacturing operations (soil remediation expenses).** (Rev. Rul. 94-38, 1994-1 CB 35);
    - **Job-Seeking Expenses in the “same trade or business”** (§ 162; Rev. Rul. 75-120):
      * Expenses must be “directly connected with the trade or business”.
      * NOT DEDUCTIBLE if it is a NEW trade or business, even if employment is secured. Court uses a “commonsense approach”. (Davis v. Commissioner).
      * If the individual is PRESENTLY UNEMPLOYED, his trade or business is the services previously performed for his past employer IF NO SUBSTANTIAL LACK OF CONTINUITY occurred between the time of past employment and seeking new employment.
    - **General Education Expenses:**
      * **General Rule: Taxpayer may deduct up to $4,000 for college tuition and related expenses for himself, a spouse or a dependent.** (§ 222)
      * Limitations:
        + If taxpayers AGI > $80,000 (or $160,000 if married filing jointly), they are not eligible to take a deduction.
        + If taxpayers AGI between $65-80,000 (or $130-160,000 if married joint), they may deduct $2,000.
    - **Interest:**
      * **Personal Interest – generally NO DEDUCTION allowed.** (§ 163(h)).
        + Personal Interest is any interest that is NOT:

Interest paid or incurred in connection with a trade or business;

Investment income;

Interest that would be deductible in connection with a passive activity;

“Qualified Residence Interest” or

Interest on certain deferred estate tax payments.

* + - * + **Exceptions (where deduction is allowed) –**

**Qualified Residence Indebtedness:**

“Qualified Residence Indebtedness” = interest which is paid/accrued during the taxable year on:

Acquisition indebtedness with respect to any qualified residence of the taxpayer, OR

Home equity indebtedness with respect to any qualified residence of the taxpayer.

**For Acquisition Indebtedness – Deductible up to $1 million of debt used to acquire or substantially improve property.**

**For Home Residence Indebtedness – Deductible up to $100,000, so long as the debt does not exceed the FMV of the home.**

**Interest on Education Loans** (§ 221)**:**

**Taxpayer may take an above-the-line deduction for up to $2,500 of interest paid on education loans, provided that the loans are incurred to pay for college expenses of the taxpayer, the taxpayer’s spouse, or a dependent.**

The deduction is phased out for single taxpayers with income of $50-65k and married taxpayers with income of 100-130k.

* + - * **Business Interest –** 
        + **Interest paid or accrued within the taxable year on indebtedness used to operate a trade or business is deductible.** (§ 163(a)).
        + This does not apply where interest is required to be capitalized. (§ 263(a)).
        + If the taxpayer’s activities do not rise to the level of a business, the interest is treated as investment income. Note: the management of one’s own securities investments is typically not a business.
      * **Investment Interest –**
        + **Investment interest is deductible up to the net investment income of the taxpayer for the taxable year.** (§ 163(d)).
        + **Carry-forward of Disallowed Interest - The amount of investment interest > net investment income in year 1 can be carried over into year 2, and so forth.** (§ 163(d)).
        + Interest incurred in connection with a “passive activity” is not treated as investment interest.
      * **Interest on Tax-Exempt Income –** 
        + **No deduction is allowed for interest on income exempt from taxation.** (§ 265).
    - **Losses**
      * **General: The taxpayer may deduct any loss sustained during the taxable year and not compensated for by insurance or otherwise.** (§ 165). **The loss is calculated by the adjusted basis, and is taken when the loss is realized.**
      * **In the case of an individual, the deductions are limited to bona fide:**
        + **Losses incurred in a trade or business;**

**(Where net operating loss = deductions allowed – gross income)**

* + - * + **Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and**
        + **Other losses that arise from fire, storm, shipwreck, or other casualty, or from theft.**
      * **Personal losses (with casualty/theft exception) are NOT deductible.**
      * Special Cases:
        + Trade/Business Losses:

Deductible from gross income (above the line).

Loss of anticipated income = generally no deduction.

* + - * + Transaction for Profit Losses:

Deducted above the line ONLY if they result from sale/exchange of property or attributable to property that produces rent or royalties.

Otherwise, deducted below the line.

* + - * + Investment Losses

The taxpayer may deduct losses on the investment only to the amount he is “at risk” with respect to that investment. (§ 465).

A taxpayer is “at risk” only to the extent of:

His investment of cash in the activity,

The adjusted basis of property contributed,

Debt on which he is personally liable for repayment, and

The net FMV of his personal assets that secure nonrecourse borrowings.

The taxpayer is NOT considered at risk with respect to losses for which he is guaranteed reimbursement.

* + - * + Losses on Sale of Property:

Between certain taxpayers - Deduction disallowed for losses from sales or exchanges of property between certain related people (family members or corporations and their majority shareholders). (§ 267). The seller’s loss is lost to him permanently. When the purchaser sells the property for a gain, the purchaser can increase his basis by the seller’s disallowed loss.

On wash sales of substantially identical securities – Deduction disallowed if sale made within 30-day period.

* + - * + Gambling Losses:

If gambler is engaged in the activity “with continuity and regularity” with the primary purpose of earning an income, loss is treated as a business loss.

Gambling losses are deductible only to the extent of gains. (§ 165).

Cohan Rule – deduction allowed based on estimates (i.e. no adequate records) where the court believes that an expense was actually undertaken.

* + - * + Hobby Losses:

Generally NO deduction, unless the activity rises to the level of business or a transaction entered into for profit. BUT, hobby losses are deductible only to the extent of gains. (§ 183).

If an activity engaged in produces profits for 3/5 consecutive years (ending with the taxable year in question), there is a rebuttable presumption that the activity qualifies as engaged in for profit. For an activity involving horses, requirement is 2/7 years.

Factors to consider in determining hobby v. for profit (Reg. 1.183-2(b) –

Manner in which taxpayer carries on the activity;

Expertise of taxpayer;

Time and effort spent carrying on the activity;

Expectation that assets used in the activity will appreciate in value;

Success of taxpayer in the activities;

Taxpayer’s history of income or loss with respect to activity;

Amount of past profits earned;

Financial status of the taxpayer; and

Whether elements of personal pleasure/recreation are involved.

* + - * + Casualty/Theft Losses

A taxpayer is entitled to take a deduction even if the casualty results from her negligence, but not if it is intentional or results from gross negligence. (Blackman v. Commissioner)

The amount of any prospective casualty loss is first reduced by insurance or any other recovery.

Casualty losses are allowed only to the extent that the loss arising from each casualty/theft exceeds $100.

Net casualty loss is allowed only to the extent that it exceeds 10% of adjusted gross income.

No deduction is permitted if the taxpayer does not file a timely insurance claim to the extent the policy would provide reimbursement.

* + - * + Losses from “Passive Activities”:

Aggregate deductions from “passive activities” may be used only to offset the aggregate income from these activities. (§ 469). Excess losses may be carried forward to subsequent years.

Passive activities are defined to include:

The conduct of a trade or business in which the taxpayer does not materially participate; and

Rental activities.

DOES NOT include “portfolio income” 🡪 passive losses cannot offset investment income.

* + - * **Carryback/Carryforward of Net Operating Loss (§ 172):**
        + **APPLIES TO BUSINESS LOSSES ONLY.**
        + **A taxpayer may apply a loss incurred in one taxable year against income earned in another taxable year.**

**May carry back a net operating loss back 2 years and forward 20 years.**

This means that no more business income will be taxed than the aggregate net income over the period.

In the case of spouses:

Married taxpayers filing joint returns may use the net operating losses from the business of one spouse to offset the income from the other spouse’s business during carryover years.

NOL carryover expires at the death of the taxpayer who incurred the loss, even where there is a surviving spouse.

If NOL in year of death, can be used in decedent’s final return or 3 preceding years. (Rev. Rul. 74-175).

* + - **Bad Debts**
      * **Whether or not the debt is classified as business or non-business impacts its deductibility. Test is whether the “dominant motivation” for the bad debt is business-related.**
      * **Business Bad Debts – deductible in full as an ordinary loss.** (§ 166). A partially worthless bad debt can be deducted to the extent charged off by the taxpayer on his books.
      * **Nonbusiness Bad Debt – deductible only as a short-term capital loss.** (§ 166). Only a fully worthless debt may be deducted.
      * Notes:
        + No deduction is allowed for a debt that was worthless when acquired.
        + No deduction is allowed for a claim of unpaid wages or rent b/c those debts are treated as having a zero basis.
        + **Loss from guaranteeing a loan is treated the same way as a loss from a direct loan.** But, payment of a loan guaranteed, whether business or non-business, based on personal motivation is not deductible – must be called to pay.
        + Debts owed by a political party are NOT deductible, UNLESS the debt results from a bona fide sale of goods or services in the ordinary course of trade or business. The exception is permitted ONLY if (a) the taxpayer made substantial efforts to collect the debt and (b) more than 30% of its total business for the year in which debt accrued was with political parties. (§ 271).
    - **Tax Payments** (§ 164):
      * Deduction for:
        + State and local, and foreign, real property taxes;

To get this deduction, the tax must meet the following criteria:

Tax must be ad valorem, or based on the value of the property;

The tax must be imposed on an annual basis even if collected more or less frequently; and

The tax must be on personal property.

* + - * + State and local personal property taxes;
        + State and local, and foreign, income, war profits, and excess profits taxes;
        + The GST tax imposed on income distributions;
        + The environmental tax imposed by sect. 59A;
        + Qualified motor vehicle taxes;
      * NO DEDUCTION for:
        + Federal income tax;
        + Payroll taxes;
        + Gift taxes imposed at the federal, state and local levels.
      * Deduction ONLY allowed to taxpayers who itemize.
    - **Charitable Contributions** (§ 170);
      * Deduction allowed for a transfer by the taxpayer of cash or FMV of property transferred, BUT NOT for a contribution of services.
        + For appreciated property:

Deduction = FMV. No gain recognition for donor.

BUT, if the property will NOT be used by the donee in its charitable function, the deduction = FMV – full amount of appreciation = BASIS.

Also, deduction = BASIS, if:

The property is worth > $5,000,

The charity sells the property in the year of contribution and

Cannot certify that the related use has become impossible or impracticable.

If the property is SOLD WITHIN 3 YEARS, the donor is subject to a recapture tax on the excess of deduction over basis in property.

* + - * + For patents/intellectual property:

Deduction = FMV – amount of gain (that would have been long-term capital gain).

Donor can take additional charitable deduction in the year of contribution and succeeding years of amount = to % of income generated by property.

* + - * **Transfer must be made WITHOUT “the expectation of any quid pro quo” to be classified as a charitable contribution.** (Hernandez v. Commissioner). **Courts apply the Duberstein test – “detached and disinterested generosity” – for what constitutes a charitable contribution.**
        + In the case of a business, the deduction can be taken where there is an INDIRECT business benefit, “such as one incidental to the public use or public recognition of its generosity”, but NOT where there is a direct economic benefit. (US v. Transamerica Corp.)
      * Contribution must be made to or for the use of:
        + A state, where the contribution is made for exclusively public purposes;
        + A corporation, trust, community chest, fund, or foundation –

Created/organized in the US;

Organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals (including public interest law firms - Rev. Proc. 71-39, 1971-2 C.B. 575);

No part of the net earnings of which inures to the benefit of any private shareholder or individual; and

Which is not disqualified for tax exemption under sect. 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in, any political campaign on behalf of (or against) any candidate for public office.

* + - * + A post or organization of war veterans (United States organized);
        + A domestic fraternal society operating under the lodge system (but only if used for the purposes listed for corps, etc.);
        + Certain cemetery companies.
      * Limitations:
        + Contribution cannot be made to an organization whose primary purpose is to carry on a business or make a profit, even if the organization pays all of its profits to another exempt organization.
        + Substantiation:

For gifts of > $250, the taxpayer must provide a written contemporaneous statement from the charity that includes information about any goods or services the taxpayer has received in exchange for the contribution.

For gifts of cash, the taxpayer must have a bank record or written record from the donee showing the date and amount of contribution.

* + - * + General Caps:

Individual - charitable contribution deduction limited to no more than 50% of AGI.

Corporation – charitable deduction limited to 10% of taxable income.

* + - * + In the case of college contributions:

The Code allows an 80% deduction whenever a contribution makes the donor eligible to obtain athletic tickets.

* + - * + In the case of donating blood – authority is split:

Rev. Rul. 53-153: Service held that the donation of blood is a contribution of services 🡪 no deduction.

Green v. Commissioner: Sale of good = sale of property, not transfer of services.

* + - **Medical Expenses** (§ 213);
      * **Deductions allowed for medical and dental expenses paid during the tax year for the taxpayer, her spouse, her children and other dependents. Deductible only if expenses exceed 7.5% of AGI.**
      * The deduction includes payments for:
        + Medical care – diagnosis, cure, mitigation, treatment or prevention of the disease;
        + Medical insurance;
        + Costs of transportation primarily for and essential to medical care.
      * Deduction DOES NOT include expenditures that are merely beneficial to the general health of an individual 🡪 must be (1) an essential element of treatment and (2) not otherwise incurred for nonmedical reasons. (Jacobs v. Commissioner)
      * Deduction only allowed for expenses that are NOT compensated for by insurance or reimbursed by employers.
    - **Alimony Payments** (§ 215).
      * Only if taxable to the recipient (the parties may agree for alimony payments to have no tax impact).
  + **Items NOT Deductible**
    - **Capital Expenditures (**§ 263);
      * Includes “any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate”. Amount spent is instead added to the property’s basis and recovered through depreciation or amortization deductions.
    - **Business Expenses related to illegal drug trafficking** (§ 280E);
      * Note: business expense deductions available for other types of illegal activities.
    - **Certain expenditures where there has been a violation of the law** (§ 162):
      * Fines or similar penalties paid to a government (not private party) for the violation of any law;
      * A portion of treble damage payments under the antitrust laws following a related criminal conviction;
      * Bribes or kickbacks paid to public officials;
      * Bribes or referral fees for Medicaid or Medicare patients;
      * Any other illegal bribe, kickback or payment under any law that subjects the payor to criminal penalty or loss of license or privilege to engage in a trade or business.
    - **Most lobbying expenses** (§ 162(e));
      * **Deductions NOT allowed for (1) lobbying federal legislators, (2) lobbying state legislators, (3) lobbying certain executive branch officials or (4) expenses incurred to influence the general public with respect to legislative matters, elections or referendums.**
      * **Deductions ALLOWED (1) for lobbying local government bodies or (2) for in-house lobbying costs under $2,000.**
    - **Start-Up Expenditures** (§ 195);
    - **Dividend Payments (of Corporations);**
      * Note: this leads to double taxation
  + **Expenses where the taxpayer has the OPTION TO DEDUCT OR CAPITALIZE:**
    - **Circulation Expenses** (§173)
      * Expenses to establish, maintain or increase the circulation of a newspaper, magazine or other periodical are deductible. BUT, the taxpayer may opt to capitalize and amortize over a 3-year tax period.
    - **Research and Experimental Expenditures** (§ 174)
      * Expenses may be deducted immediately or deducted over a 5-year period.
    - **Organizational Expenses** (§ 248 & 709)
      * Business may deduct up to $5,000 of organizational expenses.
      * The deduction is phased out and eliminated if expenses exceed $55,000.
      * The remainder is amortized over 15 years.
  + **Caps/Floors on Deductions**
    - **2% Floor on Miscellaneous Itemized Deductions (**§ 67)
      * A taxpayer can deduct “miscellaneous itemized deductions” only to the extent that, in the aggregate, they exceed 2% of the taxpayer’s adjusted gross income for the year.
      * **Miscellaneous Deductions = all deductions that are NOT:**
        + **Interest Deductions (§ 163);**
        + **Taxes Paid Deductions (§ 164);**
        + **Casualty or Theft Losses (§ 165);**
        + **Charitable Contributions (§ 170 and 642);**
        + **Medical, Dental, etc. Expenses (§ 213);**
        + **Impairment-Related Work Expenses;**
        + **Estate Tax in the case of income in respect of the decedent (§ 691);**
        + **Personal Property used in short sale;**
        + **Tax where taxpayer restores substantial amount held under claim of right (§ 1341);**
        + **Deduction where annuity payments cease before investment is recovered (§ 72);**
        + **Amortizable Bond Premium (§ 171); and**
        + **Deductions in connection with cooperative housing corporations (§ 216).**
    - **3% “Haircut” on Itemized Deductions** (§ 68)
      * Caps the total amount of certain itemized deductions for high bracket taxpayers – once the AGI exceeds $100,000, itemized deductions **(other than medical expenses, investment interest, gambling and casualty losses)** are reduced by 3% of the excess AGI, up to 80% of the value of the deductions.
  + **Multi-Year Tax Implications:**
    - **“Tax Benefit” Concept - Recovery of Prior Deductions:**
      * **Where a taxpayer deducts an amount from income in one year and recovers/fails to pay the item in a later taxable year, the amount recovered/not paid must be included in income in the later year. TEST IS WHETHER THERE HAS BEEN A “FUNDAMENTALLY INCONSISTENT” EVENT with the earlier deduction.** (Hillsboro National Bank v. Commissioner)
        + Amount of Inclusion = Amount of Deduction

But, where the taxpayer transfers property, takes a deduction, and the property is later returned, the inclusion = the lesser of the amount of the deduction or the FMV of the returned property. (Alice Phelan Sullivan Corp. case)

* + - * **This means that the opposite is true 🡪 where a deduction in a prior year produces NO “tax benefit”, subsequent recovery does not produce taxable income in the year of recovery/non-payment.** (§ 111).
    - **Claim of Right Income received subject to contingencies or liabilities:**
      * **General Rule: Amounts received under a “claim of right” must be included in income when received and may be deducted if subsequently repaid. The subsequent repayment does not affect the initial inclusion.** (US v. Lewis)
      * **Alternative: The taxpayer may recompute their taxes for the year of receipt. Taxes for the current year are reduced by the amount taxes were increased in the year of income receipt.** (§ 1341)
        + Note: voluntary repayments do not classify for § 1341 treatment.
* **TAX CREDITS**
  + **Credit for qualifying child care expenses (**§ 21);
    - **Taxpayers with adjusted gross income of $15,000 or less may offset tax liability by 35% of their employment-related dependent care expenses.**
    - Requirements for credit:
      * Limited to expenses incurred for dependents under age 13;
      * Expenses of sending child to preschool are deductible, but elementary school tuition is not;
      * The cost of overnight camp is ineligible for the credit, but the expense of day camp is creditable;
      * Expenses incurred must enable the taxpayer to work.
  + **Credit for Adopting Parents** (§ 23);
    - **Permits an adopting parent to take a credit up to $10,000 for expenses incurred in adopting a minor child who is not the child of a spouse.**
    - Taxpayers who adopt a “special needs child” are automatically entitled to the full amount of the credit regardless of how much they spend.
    - Credit fazes out once AGI is > $150,000.
  + **Earned Income Tax Credit** (§ 32);
    - **Provides a credit to low income individuals who have earnings. To be eligible, the taxpayers must be: (1) individuals with a qualifying child or (2) individuals between the ages of 25-65 who are not another taxpayer’s dependent.**
    - Credit = % of earned income. Phased out as income increases.
  + **Credit for the Elderly and Disabled** (§ 22(a));
    - **Individuals who are 65 or older or who are permanently and totally disabled may qualify for a credit of 15% of their income up to a specified maximum (Initial Amount – Reduction – Excess of AGI Amount):**
      * Initial Amounts:
        + $5,000 for a single individual;
        + $7,500 for a joint return where both spouses are qualified individuals; and
        + $3,750 for married individuals filing separate returns.
      * Reduction = sum of amounts received as a pension or annuity or as a disability benefit which is excluded from gross income and payable under:
        + Title II of the Social Security Act;
        + Railroad Retirement Act or
        + A law administered by the Veteran’s Administration.
      * Excess of AGI Amount reduction:
        + If the AGI exceeds:

$7,500 for a single individual;

$10,000 for a joint return; or

$5,000 for a married individual filing separately;

* + - * + The Sect. 22 amount is reduced by one-half the excess of AGI over that amount.
  + **Education Credits:**
    - **Hope Credit** (§ 25(b));
      * **The taxpayer may take a credit up to $1,500 of tuition paid for the first two years of college for the taxpayer, their spouse or dependent.**
      * Limitations:
        + Credit allowed for only 2 taxable years;
        + Credit allowed for year only if individual is at least a ½ time student for at least one academic period during the tax year.
        + Credit allowed only for first 2 years of postsecondary education;
        + Denial of credit if student is convicted of a felony drug offense.
        + Credits are phased out:

For single taxpayers with an AGI over $40,000; and

For a joint return with an AGI over $80,000.

* + - **Lifetime Learning Credit** (§ 25(c));
      * **The taxpayer can take a credit up to 20% of tuition and fees up to $10,000.**
      * Can be used for undergraduate or graduate education at any point in the student’s lifetime and can be taken for an unlimited amount of years.
      * Limitations:
        + Expenses must be incurred by student “at an eligible educational institution to acquire or improve job skills of the individual”.
        + Credits are phased out:

For single taxpayers with an AGI over $40,000; and

For a joint return with an AGI over $80,000.

* + - **Combination of Credits:**
      * **Taxpayer cannot take both the Hope and Lifetime Learning Credits.**
* **VALUATION FOR TAX PURPOSES:**
  + **For Financial Instruments/CONTRACTS/Options:**
    - **Holder must generally “mark to market” at year end, and gain or loss must be recognized at that time. (§ 1256).**
    - BUSINESS HEDGES THAT QUALIFY FOR ORDINARY INCOME TREATMENT ARE NOT SUBJECT TO MARK TO MARKET RULES.
* **CAPITAL EXPENDITURES**
  + **What counts as a capital expenditure?**
    - **Tests for determining whether it is an asset that should be capitalized:**
      * **Does it have a useful life of more than a year/ will the benefits be realized in the future beyond the current taxable year?**
      * **Does it “create or enhance a separate and distinct asset”?** (Indopco v. Commissioner)
      * **Is it a “nonrecurring expenditure”?** (Encyclopedia Britanica v. Commissioner).
      * **Is the asset a substitute for future ordinary income?** (Hort v. Commissioner; Lattera v. Commissioner)
      * **Has a vertical or horizontal slice of the rights been made?** (Helverling v. Horst and Lattera v. Commissioner; vertical = more likely to be capital and horizontal = more likely to be treated as ordinary income).
    - **Examples of capital expenditures include:**
      * **Purchase of financial assets;**
      * **Purchase of real estate;**
      * **Purchase of tangible personal property (machinery and equipment);**
      * **Purchase of intangible assets (contracts, patents);**
      * **Costs of acquiring an asset** (all expenses incurred in buying that facilitate the transaction) > $5,000 that occur after the “final decision to merge/acquire”;
        + Ex. litigation costs in setting the purchase price for an acquisition of stock. (Woodward v. Commissioner)
        + Ex. investigation fees; attorney, accountant or appraiser fees.
        + NOTE: IF < $5,000 COSTS DEDUCTED, NOT CAPITALIZED.
      * **Cost of constructing assets, like buildings**;
        + Ex. Includes all direct and indirect costs 🡪 includes wages paid to construction workers, construction related depreciation. (Commissioner v. Idaho Power Co.; §263A)
      * Costs incurred by a company in raising capital;
      * Costs incurred by a company of reorganizing the company’s capital structure;
      * Cost of entering a new trade or business (research & development);
      * Costs of disposing of property (ex. broker’s selling commission);
      * Costs of property demolition (§280B);
      * Costs of defending or perfecting title of property (provided the claim does not arise in connection with business/profit seeking activities) (Woodward v. Commissioner);
      * **Start-Up Expenditures** (of a new business) (§ 195):
        + Include: expenditures in connection with the investigation or creation of an active trade or business, as well as expenses accrued in anticipation of an activity becoming an active trade or business.
        + **General Rule: No deduction allowed for start-up expenditures.**
        + **But, taxpayer may make an election to deduct** the lesser of start-up expenditures OR $5,000 reduced by the amount by which start-up expenditures exceed $50,000. The remainder is deductable ratable over 15 years.
      * **Pre-Paid Insurance** (Commissioner v. Boylston Market Ass’n)
        + But, there is a “one-year” exception –

Payments may be immediately deductible if the benefits last 12 months after the taxpayer first realizes the benefit, or the end of the year in which the payment was made, whichever period is shorter.

* + - **Capital expenditures DO NOT include (§ 1221) (so any sale = ordinary loss/income):**
      * **Stock in trade or inventory of a business;**
      * **Property that is held primarily for sale to customers in the ordinary course of a trade or business;**
        + “Primary purpose” = purpose of holding as of date of sale.
        + **Factors to consider when determining treatment (Bramblett v. Commissioner):**

Nature and purpose of the acquisition of property;

Duration of ownership;

Extent and nature of taxpayer’s efforts to sell property;

**Number, extent, continuity and substantiality of sales (🡨 most important factor);**

Extent of subdividing, developing and advertising to increase sales;

Use of a business office for the sale of property;

Character/degree of supervision/control exercised by taxpayer over selling of property; and

Time and effort taxpayer habitually devoted to sales.

* + - * + Examples:

Sale of equipment to leasing customers by taxpayer who is regularly engaged in the dual business of renting and selling equipment = ordinary income treatment. (Rev. Rul. 80-37). BUT, if equipment is sold ONLY after its rental income producing potential has ended, may be treated as capital.

Real Estate:

Sale of subdivided portions of real estate - Courts are more willing to allow capital gains treatment where the taxpayer can show he subdivided merely to liquidate his investment more profitably.

May be able to take bifurcated approach and get capital gains treatment for part of profits of sale of land. (§ 1237).

To qualify, taxpayer must:

Have held the land for at least 5 years;

Must not have previously held the land primarily for sale to customers; and

Must not have made any improvement that “substantially enhances the value of the lot”.

If > 5 parcels in the same tract of land, gain on 6th parcel and thereafter, will be taxed as ordinary income to the extent of 5% of sale price.

For sales of securities:

Dealers:

= a person who purchases the securities with the expectation of realizing a profit not because of a rise in value during ownership, but because they hope to find a market of buyers who will purchase at a profit.

Dealers have customers for purposes of § 1221 – so sale usually 🡪 ordinary income.

If dealer identifies investment securities by end of day of acquisition, they can receive capital treatment.

Traders:

= sellers of securities who “depend on such circumstances as a rise in value or advantageous purchase to enable them to sell at a profit.”

Usually don’t have customers for purposes of § 1221, but they are still usually engaged in a trade or business 🡪 ordinary income treatment.

If trader identifies investment securities within 7 business days, they can receive capital treatment.

Investor:

Similar to a trader, but they make purchases usually “without regard to short-term developments that would influence prices on a daily market”.

They are not considered in a trade or business, so sales = capital.

* + - * **Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in Sect. 167, or real property used in his trade or business;**
      * **Literary or artistic property held by its creator** (limited to dispositions of property held by its creator or by a taxpayer who’s basis is determined by reference to the creator’s basis) (NOTE: ELECTION TO TREAT AS CAPITAL MAY BE MADE - § 1221);
      * **Accounts or Notes Receivable** (acquired in the ordinary course of the taxpayer’s trade or business);
      * US Government publications received from the government at a price less than that which the general public is charged;
      * **Commodities derivative financial instruments held by commodities derivative dealers;**
        + Commodities Derivatives Dealer = any person that regularly offers to enter into, assume, offset, assign or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.
        + Commodities derivative financial instrument = a contract or financial instrument with respect to commodities, the value or settlement price of which is calculated by reference to any combination of a fixed or variable rate, price, or amount, which is based on current objectively determinable financial or economic information.
      * **Hedging transactions;**
        + Corn Products Case – “hedging transactions that are an integral part of the business’ inventory-purchase system” fall within those items excluded from capital gains treatment.
      * **Supplies regularly consumed by the taxpayer in the ordinary course of trade/business;**
      * Advertising/promotional expenses;
      * In-house employee compensation;
      * Costs to defend a business. (AE Staley Mfg. Co. v. Commissioner);
      * Author’s expenses – including writers, photographers and artists – accrued in the trade or business. (§263A(h)).
        + The individual must (1) be self-employed or own substantially all the stock of a personal service corporation, and (2) the expense must be a “qualified creative expense”.
      * **Letters, Memoranda and others “similar property”.**
        + Includes drafts, speeches, manuscripts, research papers, oral recordings, personal or business diary, log or journal, corporate archive, office correspondence, financial record, drawing, photograph or dispatch. Reg. 1.1221-1(c)(2).
  + **Basis of Property**
    - **= COST, except as otherwise provided.** (§ 1012)
      * What is cost?
        + When taxpayer pays with cash, basis = amount of cash paid.

When part of amount paid is in the form of recourse or non-recourse debt, the amount of debt is a part of the basis of the property.

* + - * + When taxpayer receives property in exchange for services, basis = FMV.
        + When taxpayer exchanges property for property, basis = value of property received.
      * **Exceptions to basis = cost:**
        + **When taxpayer makes bargain purchase, basis = FMV.**
        + **When property is acquired by GIFT:**

**Basis for determining GAIN = transferred basis from donor.**

**Basis for determining LOSS = donor’s basis or FMV at time of gift, whichever is lower.**

**If no gain or loss results from above calculations, in “no man’s land” 🡪 no tax effect.**

If taxpayer can’t determine donor’s basis, basis = FMV.

* + - * + **When property is acquired from a DECEDENT:**

**Basis = “stepped up” = FMV at time of death.** (§ 1014).

* + - **Adjustments to Basis** (§ 1001(a), 1011, 1016)
      * **Occurs from the replacement of property or “permanent” improvements made to increase the value or prolong the life of property** (Reg. 1.162-4). **Expenses incurred as part of a “general plan of rehabilitation, modernization and improvement” to the asset are capitalized.** (Rev. Rul. 2001-4).
      * **May occur from capitalized expenditures, untaxed receipts, certain losses, depreciation.**
      * **DOES NOT occur from post-acquisition indebtedness UNLESS proceeds are used to add to or improve the property.** (§ 1016).
  + **Depreciation** (§ 167):
    - **General: Depreciation deduction may be made for a “reasonable allowance for the exhaustion, wear and tear (including obsolescence) of assets used in a trade or business or held for the production of income.” NO DEPRECIATION FOR ITEMS OF “PERSONAL USE” – MUST BE BUSINESS. Basis is reduced annually by the allowed amount of depreciation, and the depreciation deduction is taken against income.**
    - **But, taxpayer may elect to deduct immediately $25,000 of the cost of property, provided the taxpayer’s annual total investment is less than $200,000. The amount over $25,000 is depreciated normally.** (§179).
    - LAND IS NOT DEPRECIABLE. If land and buildings, etc bought together, purchase price/basis must be allocated based on respective fair market values.
    - For POST-1981 acquisitions – MACRS Depreciation schedules used (§168):
      * Type of Depreciation Used:
        + Property for which STRAIGHT LINE DEPRECIATION is used:

Nonresidential real property;

Residential real property;

Any railroad grading or tunnel bore;

Water utility property;

Qualified leasehold improvement property, restaurant property or retail improvement property;

Any property where the taxpayer makes the election.

* + - * + Property for which 150% DECLINING BALANCE METHOD is used:

Any 15 or 20-year property that doesn’t get straight line treatment;

Any property used in a farming business;

Qualified smart electric meter or qualified smart electric grid system.

* + - * + Property for which 200% DECLINING BALANCE METHOD is used:

3, 5, 7 and 10-year classes (everything else).

* + - * Classification and Applicable Recovery Period (see 168(e)(3) for classification of certain property):

|  |  |  |
| --- | --- | --- |
| *If property has a class life of:* | *Property treated as:* | *Applicable Recovery Period:* |
| 4 years or less | 3-year property | 3 years |
| 4 to less than 10 years | 5-year property | 5 years |
| 10 to less than 16 years | 7-year property | 7 years |
| 16 to less than 20 years | 10-year property | 10 years |
| 20 to less than 25 years | 15-year property | 15 years |
| 25 or more years | 20-year property | 20 years |
| Water Utility Property | N/A | 25 years |
| Residential Rental Property | N/A | 27.5 years |
| Nonresidential Real Property | N/A | 39 years |
| Any railroad grading or tunnel bore | N/A | 50 years |

* + - * Applicable Convention (timing):
        + GENERAL CONVENTION = ½ YEAR (i.e. the first and last years, you only do ½ depreciation, regardless of when bought)
        + In the case of: (1) nonresidential real property, (2) residential real property and (3) any railroad grading or tunnel bore, applicable convention = MID-MONTH
        + IF SUBSTANTIAL PROPERTY PLACED IN SERVICE DURING LAST 3 MONTHS OF TAXABLE YEAR, MID-QUARTER convention used.
  + **Amortization**
    - **Where the expenditure does not create a tangible, separate and distinct asset, but still must be capitalized, the taxpayer accounts for the cost by amortizing it over its useful life.**
    - **If the taxpayer cannot prove the appropriate useful life for amortization, a 15-year life will be used.** (Reg. 1.167(a)-3(b)). **Depreciation is straight line.**
  + **Depletion**
    - **In the case of mineral or oil and gas exploration/development, the capitalized costs of the income-producing property are recovered through allowances for depletion. Taxpayer with the “economic interest” in the minerals is entitled to the depletion deduction.**
    - **A “reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case” is allowed each year.** (§ 611).
    - **The “reasonable allowance” is the percentage of depletion allowed each year determined by the Code 🡪 a specified percentage of the gross income is deductible.**
    - Depletion is permitted only with respect to the amount received for extraction of the minerals, not the cost for processing or manufacturing the minerals. Regs. 1.613-2, 1.613-4.
    - Gross income for the depletion calculation does not include lease bonuses, royalty payments, etc.
    - Special Cases:
      * For water – cost depletion, not % depletion, allowed.
      * For intangible drilling costs
        + Taxpayer may either deduct immediately or capitalize and recover these costs through depletion.
        + For an integrated oil company – Can deduction immediately up to 70% of intangible drilling costs. The rest is deducted ratably over 5 years following expenditure. (§ 291(b))
  + **When property is SOLD OR EXCHANGED (giving rise to gain/loss calculation):**
    - **Definition of SALE OR EXCHANGE:**
      * **May be by actual sale or exchange.**
      * **May be by involuntary conversion. (§ 1231)**
      * **May occur when a stock or bond becomes worthless (§ 165).**
      * **May be by cancellation of a lease or distributor’s agreement. (§ 1241).**
    - **Occurrences where there is NO RECOGNITION of gain or loss from event:**
      * **Exchange of “Like Kind” Properties (§ 1031):**
        + **No gain or loss is recognized when certain property held for productive use in a trade or business or for investment is exchanged for property of a “like kind”.** Transaction must be made within 180 days after the taxpayer relinquishes property to qualify, and the property to be received in exchange must be designated as such within 45 days after the transfer. Provision is limited when exchange is between related parties.
        + This DOES NOT INCLUDE:

Stock,

Certificates of trust or beneficial interests,

Other securities or evidences of indebtedness,

Partnership interests,

Inventory,

Property held primarily for sale.

* + - * + **Calculation for New Basis:**

**If property values are equal, Basis of Property Received = Basis of Item Given Up**

**If property values ARE NOT equal, difference = BOOT**

**Boot Received = Gain, Boot Given = Loss 🡪 ONLY GAINS RECOGNIZED to the extent of boot received.**

When mortgage is assumed/property taken subject to mortgage, mortgage treated as = cash received, and recognized as boot.

* + - * + **Is mandatory.**
      * **Involuntary Conversions (§ 1033)**
        + **No recognition of gain resulting from involuntary conversions, such as where property is taken by eminent domain or destroyed by casualty, if the taxpayer uses proceeds to acquire “property similar or related in service or use” to the past property.** New property must be acquired by the end of the second year following the taxable year in which the involuntary conversion occurred (3 years for condemnations of real property).
        + **Is elective.**
    - **Allocation of basis: When a portion of property is sold, basis must be divided among parts and gain/loss from sale must be determined and taxed at time of sale.** (Reg. 1.61-6(a)).
      * For sale of securities:
        + If the taxpayer can’t identify the lot from which the stock sold/transferred was taken, the stock sold will be charged against the earliest lot to determine gain/loss.
        + A taxpayer that can adequately identify the assets can escape the FIFO rule.
      * For sale of unmatured coupons/naked bond:
        + Basis of bond is allocated between the retained portion and the portion sold.
        + The transferor and transferee are then subject to the original issue discount rules 🡪 taxation of interest based on who owned the income producing security. (§ 1286).
      * For transfer of patents/copyrights:
        + Whoever owns the patent/copyright is taxed. The original owner cannot just transfer right to receive royalties to avoid taxation. (Helm v. Fitzpatrick)
    - **Where a taxpayer disposes of property secured by debt, the cancellation of indebtedness income is included in the amount realized.**
    - Special Case – Gift-Leaseback:
      * Taxpayer places business property into a trust for the benefit of his children. Taxpayer then leases back the equipment from the trust and deducts his payments as an ordinary and necessary business expense.
      * Circuits are divided about whether family gift-leasebacks will give rise to business deductions:
        + Majority of circuits say the deduction is allowed if leaseback was motivated by a “business purpose”.
        + Other circuits – including the 5th circuit – allow the deduction only where the entire transaction was motivated by a business purpose.
    - **Capital Losses**
      * Occurs when sale value < adjusted basis.
      * **Capital losses are deductible by individuals only to the extent of capital gains + $3,000 of ordinary income.** (§1211). Any capital losses not allowed in the current tax year may be carried forward indefinitely by individuals. (§1212).
* **CAPITAL GAINS/LOSSES**
  + **Taxed at different rate than ordinary income 🡪 LOWER TAX RATE.**
  + **Capital taxation event occurs when the taxpayer “REALIZES” the gain or loss – the property must be sold or otherwise disposed of, not just change in value.**
  + **Capital gains and losses are divided into two types: SHORT TERM and LONG TERM 🡪 Dividing line = 12 months + 1 day**
    - In counting the holding period, the day an asset is purchased is excluded and the day the asset is sold is included. (Rev. Rul. 70-598).
    - Assets acquired by inheritance are exempt from the 1 year requirement 🡪 automatically treated as long-term. (§ 1223(11)).
    - A taxpayer who receives property by gift can “tack on” to her holding period the holding period of the donor. (§ 1223).
  + **Netting process for calculations of capital gains/losses:**
    - **Net SHORT TERM and LONG TERM gains against losses (SEPERATELY):**
      * **If gains > losses 🡪 net gain.**
      * **If losses > gains 🡪 net loss.**
    - **Net SHORT TERM gain/loss against LONG TERM gain/loss:**
      * **If net short-term gain > net long-term losses 🡪 excess gain taxable in full as ORDINARY INCOME.**
      * **If net long-term gain > net short-term loss 🡪 excess gain taxable as CAPITAL GAIN.**
      * **If both net short-term and long-term gains 🡪 short-term taxed in full as ordinary income, long-term taxed as capital gain.**
      * **If losses > gains (netted) 🡪 excess capital loss offsets up to $3,000 of ordinary income, with excess carried forward to future years.**
  + **For corporate taxpayers:**
    - Net capital gains and losses calculated the same way regardless of who the taxpayer. Difference is that corporations have no different tax rate for ordinary income and capital gains.
    - **Tax treatment:**
      * **Capital losses are only deductible to the extent of capital gains.**
      * **Corporations can carry BACK capital losses 3 years and carry FORWARD capital losses 5 years against past/future gains. Amounts carried back are treated as short-term capital losses.**
  + **In the case of Depreciable Property Used in Trade or Business (§ 1231)**
    - **Applies to some items excluded from the definition of capital asset by §1221 and HELD FOR AT LEAST ONE YEAR:** 
      * **Land;**
      * **Buildings;**
      * **Machinery;**
      * **Fixtures;**
      * **Livestock;**
      * **Timber, coal, minerals and unharvested crops sold with the land.**
    - DOES NOT INCLUDE:
      * Inventory or other property held primarily for sale to customers;
      * Copyrights;
      * Artistic compositions;
      * Letters produced by or for the taxpayer;
      * Government documents obtained below cost;
      * Commodities derivatives held by dealers;
      * Hedging transaction;
      * Supplies consumed in the business.
    - **Type of Dispositions that give rise to § 1231 treatment (all in trade or business):**
      * **Gain or loss from SALE AND EXCHANGE OF PROPERTY;**
      * **Gain or loss from CONDEMNATIONS AND INVOLUNTARY CONVERSIONS OF PROPERTY; or**
      * **Gain or loss from CONDEMNDATIONS AND INVOLUNTARY CONVERSIONS OF PROPERTY held in connection with a PROFIT SEEKING ACTIVITY.**
    - **Tax Outcome:**
      * **In year of initial gain/loss:**
        + **If disposed of at a NET GAIN 🡪 capital gain**
        + **If disposed of at a NET LOSS 🡪 ordinary loss.**
      * **BUT, if taxpayer utilizes § 1231 to enjoy capital gain treatment, the “recapture” of previously deducted depreciation is required as ordinary income. (§ 1245, 1250).**
  + **In the case of Patents:**
    - **Capital gain treatment allowed on the sale of a patent by the inventor when he is a “professional” who makes the sale in the ordinary course of business. (§ 1235).**
    - § 1235 requirements:
      * Inventor must transfer “all substantial rights” in the patent to qualify for capital gains treatment. (Reg. 1.1235-2(b).
      * Employer/Employee relationships (§ 1235):
        + Where the inventor is an employee who has contracted to assign any patents to her employer, payments from employer 🡪 employee will be treated as compensation.
        + If the employee HAS NOT CONTRACTED AWAY HER RIGHTS to the patent, payments she receives for assigning the patent to her employer may qualify for capital gains treatment.
  + **In the case of Qualified Small Business Stock (§ 1202):**
    - To qualify:
      * Stock must have been acquired at the stock’s original issue and must be held for at least 5 years.
      * Stock must be that of a corporation whose net worth at the time of stock issuance is $50 million or less, and 80% of the corporation’s assets must be used in the conduct of an active trade or business during substantially all of the taxpayer’s holding period.
      * The business conducted by the corporation must be something other than one where one of the principal assets is the reputation of employee(s).
      * The business cannot involve banking, insurance, leasing, and financing, investing, farming or operating a hotel or restaurant.
    - **Tax treatment:**
      * **An individual can exclude 50% of the gain on the sale or exchange of stock. This includible portion is taxed at a maximum 28% rate** (so the maximum effective tax rate on the gain is 14%).
      * **The amount of gain eligible for exclusion is the greater of:**
        + **10x the taxpayer’s basis in the stock OR**
        + **$10 million of gain.**
  + **In the case of Conversion Transactions (§ 1258)**
    - To qualify:
      * Transaction consists of two or more positions taken with regard to the same or similar property;
      * Where substantially all of the taxpayer’s return is attributable to the time value of the net investment; and
      * The taxpayer bears no significant risks other than those usually borne by a lender.
      * Examples: straddles, transactions marketed or sold on the basis that they produce a capital gain, and the acquisition of property and a contemporaneous agreement to sell the same property in the future.
    - **Tax Treatment:**
      * **The gain on a “conversion transaction” will be treated as ordinary income.**
      * **The amount of gain treated as ordinary income cannot be > the interest the taxpayer would have earned if the rate were 120% of the applicable federal rate.**
  + **In the case of the Sale of a Going Business (§ 1060):**
    - **Partner’s interest in a going firm = capital asset.**
    - **BUT, when the entire business is sold, the PARTS are looked at individually to be classified as capital or ordinary 🡪 sale value apportioned.**
  + **In the case of Short Sales Against the Box (§ 1259)**
    - Definitions:
      * Short Sale = a contract for the sale of shares which the seller does not own or the certificates for which are not within his control so as to be available for delivery at the time when delivery must be made.
      * Short Sale against the Box = taxpayer borrows securities from a broker 🡪 sells securities 🡪 taxpayer closes the transaction by delivering identical securities to the lender.
      * Short Forward Contract = contract both obligates and entitles the investor to sell the security for a fixed price on a specified date in the future (this means the investor is no longer exposed to movements in the price of the security).
    - **Tax Treatment:**
      * **The holder is taxed on any gain where there is deemed to be a constructive sale of an appreciated financial position.**
        + Financial position = futures or forward contract, short sale, or an option with respect to stock, debt or a partnership interest.
        + Constructive Sale = occurs when the taxpayer enters into a short sale or an offsetting principal contract with respect to the same or substantially identical property, or enters into a futures or forward contract to deliver the same or substantially identical property, or where the taxpayer holds the appreciated short position in property and acquires a long position in the same property.
      * Sales of non-publicly traded property ARE NOT subject to this rule.
  + **In the case of Installment Sales** (§ 453):
    - **Installment Sale = where at least one payment is to be received in a year after the year of sale.**
    - Availability:
      * Available to:
        + Any non-dealer who sells real property or non-inventory personal property;
        + With a RECOGNIZABLE GAIN (not loss).
      * NOT available to:
        + Any installment obligations arising from the sale of stock or securities that are traded on an established securities market or arising from sales or other property of a kind regularly traded on an established market;
        + To sales under a revolving credit plan;
        + To dealers in personal or real property.
    - **Tax Treatment:**
      * **The seller may defer payment of tax by spreading the gain over a number of years, treating a portion of each payment as gain and a portion as recover of the taxpayer’s basis in the property.**
      * **Computation of Reported Gain:**
        + **Reportable gain = “Payments” received in the taxable year x (“gross profit” on sale/ “contract price”).**
        + “Gross Profit” = “Selling Price” – Adjusted Basis

Note: selling price includes full mortgage

* + - * + “Contract Price” = Total amount paid for the property
        + “Payments” ≠ assumption of “qualified indebtedness” on the property on the property. (Temp. Reg. 15A.453-1(b)(2)(iv)).
      * **When disposition of Installment Obligation occurs:**
        + **Generally triggers any remaining gain on the original sale.** (§ 453B). **Gain/Loss = amount realized on disposition – taxpayer’s basis in the installment obligation.**

Amount realized = sale/exchange value OR OTHERWISE, FMV

Basis = face value of obligation – amount that would be reported as income if the obligation were satisfied in full.

* + - * + This applies on the sale, exchange, transfer, gift, cancellation or unenforceability of the installment obligation, BUT DOES NOT APPLY to a transfer at death or between spouses.
        + If disposition by death:

No step-up in the basis.

Estate of beneficiary reports the gains as payments are received using the deceden’t profit ratio.

* + - * Sales between related parties (§ 453(e)):
        + Applies to a sale by a related party purchaser within 2 years of the installment sale by the initial related party seller.
        + If the taxpayer can demonstrate that neither disposition was motivated by tax avoidance, rule does not apply.
        + Initial seller must recognize gain on resale of property to the extent that amount realized > actual payments on installment sale. They recover subsequent payments tax free until they = amount realized from resale that triggered recognition of gain.
      * **The taxpayer may elect not to use the installment method.**
        + **Where the taxpayer elects out, income = FMV of the installment obligation.** FMV cannot be < FMV of property – other consideration received. (Temp. Reg. 15A.453-1(d)(2).
  + **For an Original Issue Discount (OID) (§ 1272):**
    - **= when the original “issue price” of a debt instrument is < the amount to be paid at maturity, when there is either no or very low interest payable.**
    - **Tax Treatment:**
      * **Rules are designed to treat the OID equivalent to one paying market rate of interest: Lender must report as interest income annually the amount of OID that economically accrues on the debt interest, and the Borrower treats an identical amount as an interest deduction.**
      * OID tax rules DO NOT APPLY to tax-exempt obligations, loans between natural organizations if total outstanding loans between them are $10k or less, the loan has not been made as part of the lender’s trade or business, and there is not a tax avoidance purpose.
  + **In cases of Market Discount (§ 1276):**
    - **= when the value of a debt obligation declines after it is used, typically because market rates of interest increase.**
      * Impact of changes of market rate on these debt obligations:
        + An INCREASE in the market interest rate (discount rate) 🡪 DECREASE in the value of the existing debt obligation.
        + A DECREASE in the market interest rate (discount rate) 🡪 INCREASE in the value of the existing debt obligation.
        + These are not “realized” gains or losses b/c the realization principle requires an event constituting a “realization”, not just an increase/decrease in asset value.
    - **Tax Treatment:**
      * **Code treats the market discount as ordinary interest income on a compound interest basis, but does not require cash basis holders of market discount obligations to report the interest until the bond is disposed of.**
      * **On retirement or sale:**
        + **Accrued market discount = ordinary (interest) income (NOT CAPITAL GAIN)**
  + **In cases of Interest-Free or Low-Interest Loans (§7872):**
    - Sect. 7872 prohibits the use of interest-free or low-interest loans between:
      * Employers and employees (treated as compensation);
      * Family members to shift income; and
      * Between shareholders and corporations to disguise income).
    - **Tax Treatment:**
      * **For each taxable year the loan is outstanding, the amount of interest that would have been payable if it had a normal interest rate is treated as if was transferred lender 🡪 borrower 🡪 lender as interest. THIS USUALLY NETS TO A ZERO TAX EFFECT.**
        + Treatment (????):

Borrower shows as income the amount received (b/c he has such a low interest rate);

Depending on how Borrower uses interest (i.e. business or house, etc), he may have = Interest Deduction.

* + - * **If between employer and employee:**
        + **Compensation to the employee and**
        + **Deduction to the Employer**
      * **If between corporation and shareholder:**
        + **Dividend distribution treatment to the shareholder.**
      * **If a gift loan** (ex. parent to child loan)**:**
        + **Donor = NO deduction for transfer of gift + taxed on interest income.**
        + But if total outstanding loans between the donor and the donee are less than $100k, interest to be taxed is limited to borrower’s net investment income.
  + **In cases of Term Loans (§ 7872):**
    - **= below-market loan where amount loaned > present value of all payments to be made under the loan. This difference = OID**
    - **Tax treatment:**
      * **On date of loan: Lender is treated as having transferred cash equal to amount loaned – issue price of obligation (present value of all required payments).**
        + Transfer Date:

Gift and Demand Loans – Values are deemed transferred by the lender to the borrower on the last day of the calendar year.

* + - * **Each accrual period: borrower is treated as paying interest at statutory rate 🡪 interest is income taxed to the lender on an accrual basis and is a deduction for the borrower.**
      * This does not apply to:
        + Gift loans as long as outstanding amount of loans do not exceed $10k and proceeds are not used for income-producing assets.
        + Loans in connection with the sale or exchange of property.
        + Loans as long as they are used to pay for higher education (in special University accumulation account).
  + **Treatment of Deferred Compensation:** 
    - **Two types of deferred compensation arrangements:**
      * **Qualified (§ 404(a)(5)**
        + Requirements to be classified as Qualified:

Plan cannot discriminate in favor of highly compensated employees. (This is satisfied if the % of employees covered under the plan who do not earn high wages is at least 70% of the % of highly compensated employees covered under the plan.)

* + - * + **Tax treatment:**

**Employers deduct deferred compensation as it is paid.**

**Employees are taxed only when they receive the compensation (at the deferred date).**

* + - * **Non-Qualified**
        + Requirements:

The deferred compensation generally cannot be distributed earlier than separation from service, disability, death, a fixed time or under a fixed schedule, an unforeseeable emergency, or change in ownership control of the employer.

The election to defer compensation must be made in a year before the services are to be performed.

* + - * + **Tax Treatment:**

**Deferred compensation is included in the employee’s income when distributed.**

* + - **If the compensation plan doesn’t meet the requirements of either a Qualified or Non-Qualified Plan, the income is treated under the taxpayer’s normal method of accounting.**