

## Basic Tax A Outline

### Overview

- A. Two methods of accounting
  - a. Cash method – an amount is included on the income side upon actual receipt and constructive receipt.
    - i. Constructive receipt – the payor (client) is ready willing and able to pay and is told to hold the money. Under the cash method you would have to include this as income on your taxes. For planning purposes do not bill the client.
  - b. Accrual method – (the 2<sup>nd</sup> method of accounting) an amount is included on the income side when it is fixed and determined.

### Gross Income

- A. §61 Income derived from whatever source
- B. Checks are income in the year they were received even if they bounce.
- C. Bartering services for payment IS income §1.61-1. FMV of the services.

### Above the Line Deductions

- A. §62 Adjusted Gross Income is Gross Income *minus* the following
  - a. Trade and Business deductions
    - i. §162(a)(1) rent,
    - ii. §162(a)(2) or (3) wages,
    - iii. §162(a)(1) office supplies,
    - iv. §167 or §168 equipment depreciation/§263 capital expenditure,
    - v. §179 bonus deduction deducting whole depreciation in one year
  - b. Certain trade and business deductions of employee

### Below the Line Deductions

- A. §63(d) Itemized deductions
  - a. §212 expenses incurred for the production of income (a mag subscription)
  - b. §170 Charitable contributions
  - c. §164 property tax deductions, estimated income tax
  - d. §163 interest

### Gross Income

- Above the Line Deductions

= §62 Adjusted Gross Income

ITEMIZE

Below the Line Ded.

- Personal Exemption

= §63 Taxable Income

OR

TAKE THE STANDARD DEDUCTION

Standard Deduction

- Personal Exemption

= §63 Taxable Income

### §67 the 2% Floor

The aggregate of miscellaneous itemized deductions will be applied only to that amount which exceeds 2% of AGI.

- This will reduce the amount of your BTL deductions.

- Kicks out any BTL deductions which are not listed in §67(b), unless the aggregate value of these deductions exceeds 2% of AGI.
- §67(b)
  - o §163 interest
  - o §164 taxes
  - o §170, §42(c) charitable contributions
  - o §213 medical, dental expenses
- If the misc itemized deduction is NOT listed, then it must exceed 2% of the AGI.
- IF the misc itemized deduction exceeds 2% of the AGI, the extent to which the misc itemized deduction exceeds AGI will be deductible.

**§68 overall limitation of itemized deductions**

§68(a)(1) when an individual's AGI exceeds 100,000 (the applicable amount) the amount of ITEMIZED deductions will be reduced by either 3% of the excess of AGI over the applicable amount OR by 80% of the amount of the itemized deductions otherwise allowable.

AGI <u>- 100,000</u> = X <u>X 3%</u> = One possible deduction	ITEMIZED DEDUCTIONS <u>X 80%</u> = alternative deduction
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Choose the one that least reduces your deductions.

**Personal Exemptions**

- A. §151(d) Exemption amount – means \$2,000.

**Taxable Income Computed with Itemized Deductions**

AGI  
 - BLT deductions  
- Personal exemptions  
 = Taxable Income

**Tax Liability**

1. Taxable Income here includes Capital Gain (already included in Gross Income: must be taken out and treated separately)
2. Ordinary Income = Taxable Income – Capital Gain
3. Tax on the Ordinary Income: Ord Income x % = amount.
4. Tax on Capital Gain: amount x 20% = amount
5. **Total Tax Liability = Tax on Ordinary Inc + Tax on Capital Gain.**

**Tax Credits**

**Taxpayer will always want to lobby for a tax credit rather than a tax deduction.**

Tax credits reduce the tax you pay dollar for dollar.

If you get 100 in child care that you can claim, you'd want to pay the 100 now and then claim the full credit on it. If you had simply taken a deduction for it at the end of the tax year it is going to be figured in to the total of all deductions and end up being multiplied by a %. (\$100 x 31% = 31 versus \$100 credit.)

## Gross Income Concepts and Limitations

- A. §61 Income derived from whatever source. Generally any accession to wealth is included in Gross Income.
- a. Gross Income can be realized in any form
  - b. Property paid, services rendered go by the FMV of the property or services rendered. If there is an exchange in property for services in an amount less than the FMV, the difference between the FMV and the amount paid is included in the taxpayer's Gross Income.
  - c. Interest earned from capital is included in Gross Income. Eisner v. McComber
  - d. Punitive damages are included in gross income. Glenshaw Glass
  - e. Employer/employee situations, the employee is likely being compensated in some form (sells \$500 worth of stocks to the employee for \$100, then the \$400 is income included in gross income.) §1.6-2
  - f. Income from an illegal business
  - g. Discharge of indebtedness. Mitch sold stock for 3,000 and gave it to a creditor for a 5,000 debt. Mitch has income.
  - h. Treasure trove is included in gross income the year it became undisputedly possessed. Cesarini
  - i. If someone else pays an obligation for you it is included in gross income. The discharge of an obligation is not likely to be considered a gift if it arises out of an employer/employee relationship. Old Colony Trust
    - i. §1.61(8)(c) and Old Colony, anytime you pay off something for another it has to be income for the person who should have rightfully paid.
  - j. Seminar or vacation? Court held that the seminar was a vacation and the employee had to be taxed for the FMV of the trip. McCann
    - i. Look at the facts of the situation – assume all the expenses were paid by the employer, did the employee still have to be there? If yes, then it's a business purpose.
  - k. Coming out ahead in a deal on a house or etc., is not included in gross income. Pellar
- B. Realization, Imputed Income, and Bargain Purchases
- a. §1001(b) the amount realized from the sale or other disposition of property shall be the sum of any money received plus the FMV of the property (other than money) received.
    - i. An exchange of property gives rise to a realization event so long as the exchanged properties are materially different. Cottage Savings
  - b. Imputed Income is not included in Gross Income. Ex., self help activities, i.e., performing services for oneself or one's family.
  - c. Bargain purchases are not included in Gross Income
    - i. Bargain purchases do not apply to employer/employee relationships
    - ii. §1.61-2(d)(2) if property is transferred by an employer to an employee as compensation for services for an amount less than the FMV, then regardless of whether the exchange is in the form of a sale or an exchange, the difference between the amount paid for the property and the amount of its FMV at the time of the transfer is compensation and is includable in Gross Income. Also §61

The motive of the donor determines whether the transaction results in a tax-free gift to the donee. If the donor had mixed motives, the primary motive applies.

## Effect of an Obligation to Repay

### Chapter 3

#### Loans

- A. Loans are not included in Gross Income
- B. There is no accession to wealth because you must repay the loan
  - a. If the Taxpayer fails to pay any of the loan back it may be includable in the taxpayer's income. Debt Discharge
  - b. §61(a)(2) and §108 Payment of one's liabilities by another may give rise to gross income.
  - c. If someone repays YOUR debt on a loan in order to be free of a debt which they owe YOU, then YOU have to report income as such (unless of course the repayment was a gift by them to you).

#### Claim of Right

- A. Finding a wallet
  - a. Included in Gross Income.
  - b. If you repay the amount you found then it is deductible.
  - c. Even if by local law you are not entitled to keep the money you must claim it on your tax return. North American Oil, you have to claim it when you get it even if there is a chance you have to give it back, you'll just get credit later on.
- B. Claim of Right Doctrine
  - a. Money received under a claim of right without restriction as to disposition, is income; the contingent repayment obligation does not allow the receipt to be treated as a loan.
- C. If you act as a conduit that is not includable in Gross Income.

#### Illegal Income

- A. Includable in Gross Income (except from the sale of illegal drugs)(?)
  - a. If there was an intent to repay all along, then the taxpayer may treat it as a loan.
- B. You cannot take a deduction for Illegal Business activity expenses!
- C. James, embezzlement involves an intent to return the money so you don't include in G.I.

#### Deposits

- A. An advance payment of income is still income. §1.61-8(b)
- B. If it is truly a security deposit, and not an advanced payment, it is not included in your Gross Income.
- C. If a security deposit is paid along with an understanding that it will be used as the last months rent or something, then it has to be claimed as income when received.

#### Problems

1. You report the income in the year you received the income. If you have to give it back later you will take the credit later. Year is from 1-1 to 12-31.

2. **Is it a loan or is it an advanced payment for services?** Linda and the 20g

Look at Form v. Substance

Loan

Year 1: No Income

Year 2: (1,000) Interest Deduction

20,000 Income

19,000 taxable income

Advancement

Year 1: 19,000 Advanced Payment

Year 2: 1,000 Income

(1,000) Interest Deduction §163

no income

This loan to Linda is most likely an advanced payment. You should argue both ways on your exam. If we go with this being a 20g loan, then Linda does not have income until year 2, and she gets to take the 1,000 interest deduction. If we say that it is an advanced payment, then Linda

has to report the 19,000 in year 1, then in year 2 she gets 1,000 income and under 163(a) she will also take the 1,000 interest deduction.

3. **If you take property and do not give it back you have to include the FMV of the property as income.** What is the intent. Ex., Joe taking tools from his employer to use in his own private car repair shop. If Joe has an intent to return the property then the issue becomes moot, and Joe does not have to claim the value of the tools as income. If you are the owner of the tools you should ask for the fair rental value of them, the Joe under §162(a) ordinary and necessary business expense can deduct the fair rental value of them. If Joe does not intend to return the property, then under §179 Joe maybe can take a depreciation deduction for the tools in his business. {Joe's Basis would be the FMV of the tools and under §179(b)(1) Joe can take the depreciation. Look at the chart}
4. **Who retains control of the money?** Indianapolis Power & Light Co., if there is an agreement to return the funds (no matter what the customer usually designates), then the payment is a true security deposit and not an advanced payment. Security deposits are not included in Gross Income because you have to give them back. **RULE:** If the TP retains control over what happens to the money when the TP receives the money under the terms of the agreement, then the money is treated as an advanced payment and included in Gross Income.

### Gains Derived from Dealings in Property

#### Chapter 4

#### Computation Formula

Unadjusted basis + Additions – Reductions = Adjusted Basis

Gain = Amount Realized – Adjusted Basis

Loss = Adjusted Basis – Amount Realized

§1001(b) Amount realized is any sum of money received from the sale or disposition of property, plus the FMV of any other property received

MINUS

§1012 Cost basis includes the cash you paid or any other property paid to obtain the asset.

AND MINUS

§1016 Adjustment to basis §1016(2) depreciation expense + §1011 E.g., expenditures on improvements that increase the value (of the house)

EQUALS

#### §1001(a) Loss or Gain Realized

THEN

§1001(C) Computation of Gain or Loss Recognized

Realized is not always taxed

Recognized is always taxed

\_\_\_\_\_ §1001(b) Amount Realized

( \_\_\_\_\_ ) §1012 Cost Basis

=/- \_\_\_\_\_ §1016 Adjustments to Basis, §1011, §1016(a)(2) depreciation expense. =

\_\_\_\_\_ §1001(a) Gain or Loss Realized

\_\_\_\_\_ §1001(c) Gain or Loss Recognized

### 3 RULES

1. The amount of recourse debt borrowed to purchase property is included in the basis of that property.
2. Debt on property that is assumed by the purchaser of the property is included in the seller's amount realized.
3. In a taxable exchange, the basis of the property received in the exchange is the fair market value of the property received as of the date of the exchange.

Barter Transactions

Services from a doctor in exchange for a painting (goods). §1.61-2  
Time is not deductible.

Philadelphia Park Rule: the cost basis of property received in a taxable exchange is the fair market value of the property received. (Do not use cost basis).

Crane v. Commissioner/Tufts

You include the unpaid debt in the amount realized. When you assume a mortgage, you include the mortgage amount in the amount realized.  
Services are included in the amount realized.

Rule:

On disposition, any unpaid debt is included in the amount realized.  
Non – recourse debt unpaid is also included in the amount realized.

Gift

§1015(a) Property acquired by gift has a transferred basis, and the donee takes the donor's basis in the property.

EXCEPTION: if the donor's adjusted basis in the property is greater than the fair market value of the property (the FMV is lower), and the donee sells or otherwise disposes of the property in a transaction which would produce a loss (the FMV is greater than what the donee is selling the property for) then the Donee takes the FMV of the property at the time of the gift.

Bargain Sale to Charitable Org.

The transferor is generally entitled to a deduction equal to the FMV of the property less any consideration received for the property. §170

§1011(b) requires the transferor in a bargain sale of property to a charitable org to apportion the basis of the property between the "sale" and "gift" portions of the transaction. Adjusted Basis will be this formula: **Entire Adjusted Basis x Amount Realized/Property's FMV.**

Property Acquired from a Spouse

§1041(b)(1) the adjusted basis of the property in the hands of the recipient is the same as the transferor's adjusted basis.

Problems

3. Trade of services – 1.61-2 the TP must report the receipt of the goods in the TP's G.I. \*make a tax note that the basis of the property is what you reported in your G.I. {probably the FMV}. When the TP sells the property, insert the amounts into the formula:

$$\begin{aligned}
 & \text{_____ } \S 1001(b) \text{ Amount Realized} \\
 & \text{(_____)} \S 1012 \text{ Cost Basis} \\
 & = / - \text{(_____)} \S 1016(a)(2) \text{ Adjustments to Basis like depreciation} \\
 & \text{_____ } \S 1011(a) \text{ Gain or Loss Realized}
 \end{aligned}$$

\_\_\_\_\_ §1011(c) Gain or Loss Recognized

For the party that got the services (Clare) the TP must include the value of the services in the TP's G.I. §61 and §1.61-2. You do not deduct from G.I. the time the TP put into making the property that the other party received, but you do deduct the cost of materials that the TP incurred in making the property exchanged.

4. Maureen exchanges a sailboat valued at 15,000 for a vacant lot owned by Patrick and also valued at 15,000. Maureen paid 10,000 for the sailboat 5 years ago and used it solely for personal purposes. A year after the exchange, Maureen sold the lot for 25,000. What tax consequences to Maureen on the sale of the lot? Taxable exchange of equal valued property.

i. Use the §1001 formula to figure the tax consequences.

1. \_\_\_\_\_ §1001(b) Amount Realized
2. ( \_\_\_\_\_ ) §1011(a) Adjusted Basis
3. ( \_\_\_\_\_ ) §1016 Adjustments to Basis
4. = \_\_\_\_\_ §1001(a) Gain/Loss Realized
5. \_\_\_\_\_ §1001(c) Gain/Loss Recognized

Assume the above facts except that the vacant lot had a FMV of 20,000 at the time of the exchange and that Maureen gave Patrick the sailboat plus 5,000 in cash for the lot. What tax consequences to Maureen on the subsequent sale of the lot for 25,000? Take the value of the property received (20,000) and subtract the cost of 5,000 in cash and the cost of 10,000 (the Basis in the sailboat) = 5,000 tax consequences

ii. Use the §1001 formula to figure the tax consequences.

1. \_\_\_\_\_ §1001(b) Amount Realized
2. ( \_\_\_\_\_ ) §1011(a) Adjusted Basis
3. \_\_\_\_\_ §1001(a) Gain/Loss Realized
4. \_\_\_\_\_ §1001(c) Gain/Loss Recognized

Assume that the vacant lot had a FMV of 20,000 and Maureen assumed a 5,000 mortgage which encumbered Patrick's lot. Assume also that Maureen subsequently paid 2,000 of the mortgage. She then sold the lot for 25,000. The purchaser paid Maureen 22,000 in cash and assumed the 3,000 mortgage balance on the lot. What tax consequences to Maureen?

\_\_\_\_\_ §1001(b) Amount Realized {the FMV – the mortgage assumption}

- ( \_\_\_\_\_ ) §1011(a) Adjusted Basis  
\_\_\_\_\_ §Gain/Loss Realized  
\_\_\_\_\_ §Gain/Loss Recognized

\_\_\_\_\_ §1001(b) Amount Realized {the 22,000 cash and the 3,000 mortgage, Crane}

- \_\_\_\_\_ § 1011(a) Adjusted Basis  
\_\_\_\_\_ § Gain Realized  
\_\_\_\_\_ § Gain Recognized

## **Gifts, Bequests, and Inheritances**

### Chapter 5

§102 Gifts are excluded from Gross Income.

§102(a) the value of property acquired by bequest, devise or inheritance is excludable from Gross Income. The exclusion from Gross Income does not apply if the legacy is not of a donative nature and instead is compensation for services, payment for property, or some other payment which would be included in income if received directly rather than by means of a will.

#### Duberstein

Detached, disinterested generosity, with no expectation of a return.

INTENT of the donor. Fact sensitive inquiry.

§102 excludes gifts and property acquired from a decedent through bequest, devise, or inheritance from including in gross income.

Employer-Employee relationship under §102(c), this trumps Duberstein.

#### Two questions:

5. Whether that which is received can be characterized as a gift, bequest, devise or inheritance?
6. Donative Intent is key.

#### Limitations on §102 exclusions

##### §102(b)

- (1) The income from property excluded as a gift is not excluded from Gross Income.
  1. If X gets IBM stock, the value of the stock is excluded from gross income, but not the dividends that IBM distributes to X.
- (2) Where the gift, bequest, devise, or inheritance is of income from property, the amount of the income from the property is included in gross income.
  1. Mom dies, leaving bonds in trust for her son. The son has a life estate, the income received by the trustees and paid over to A would be income.

#### Example,

Mom sets up a trust when she dies. 1 million – says all the income will be paid to her daughter. Then when she dies, all the income goes to the mom's grandchildren. Daughter gets 100,000. Is it excludable? No, under §102(b)(2) the 100,000 is not excludable because it is income generated from the trust.

#### General Rule:

Donee takes the Donor's basis where the FMV is greater than the adjusted basis of the property transferred. This is substituted basis or transferred basis.

#### Carry over basis rule:

§1015(a) the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.

#### §1015 Exception to the Carry over basis rule

Except that if the basis is greater than the FMV of the property at the time of the gift, then for the purpose of determining loss, the basis shall be the FMV.

### Part Gift – Part Sale

General Rule: B's basis in property received in a part gift – part sale transaction is either what she paid (§1012 Sale basis) or the basis in A's hands (§1015 Carryover basis) whichever is greater.

#### Exception:

If the FMV of the property at the time of the part-gift/part-sale is less than A's original basis, then for purposes of determining B's gain, use the general rule above to determine B's basis. For purposes of determining B's loss, B's basis cannot exceed the FMV of the property at the time of the transfer.

§1014(a)(1) says that the basis will be the fair market value at the date of the decedent's death. The best way to transfer highly appreciated property is to wait until death.

**Donee takes FMV at decedent's death: the set up or step down basis rule.**

§1014(e) Appreciated property acquired by decedent by gift within 1 year of death

- (a) within 1 year of death
- (b) The basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

Just assume the donor was not dead and ask what the basis would have been.

**§1014(e) if there is a death bed transfer and a re-transfer within one year to the donor or the donor's spouse, then they do not get the step up basis rule.** Bright line test, not intent is looked at.

### Problems

1. John was honored at a testimonial dinner held in recognition of his 20<sup>th</sup> year as head football coach. §102(c) employee gifts are not included in G.I., but here the facts indicate that John is no longer an employee of the university. Under Predestine, we have to analyze the intent of each transferor. Detached, disinterested generosity.
2. Caroline was named as personal representative in the will of her grandfather. "I direct that my Caroline be paid 25g for acting as personal representative of my estate." This is not excludable from G.I. under §102(a). The will says that it is for services. Caroline should argue that 10g is for services b/c of some state law, and that 15g is a gift.
3. Bernadette bought a lot of land for 5g. Three years later the lot increased in value to 15g. She refused an offer to sell it and deeded it to her son. Here there is not a realization event and Bernadette nor Robert recognize any income from this transfer. Under §1015(a) Rob will take Bernadette's basis in the land where the FMV is greater than the Adjusted Basis of the property. Here the FMV of the land 15g is greater than 5gs, so Rob will take the basis of 5gs in the land.
4. If Bernadette employs Rob, then you have an employee/employer relationship. §102(c) says that gifts between employer/employee are to be included in G.I. if the transfer is for the employee's benefit. Duberstein requires that the context of the transfer be examined.
5. If the value of the lot decreased then under §1015 Exception to the carry over basis rule, Rob would take the FMV of the lot. {Skipped.}
6. Part Gift/Part Sale: §1.1001-1(e) says that the seller-donor has a gain to the extent that the amount realized exceeds the adjusted basis of the property. Grandma transfers to Granddaughter property with a FMV of 50,000 and adjusted basis of 20,000, then the Granddaughter gives the Grandma 10,000 in cash.
  1. Gift Part: Take the FMV of the property that was "given" and subtract from the FMV the donor seller's adjusted basis in the property.  $FMV - AB = GIFT$

2. Sale Part: §1001(b) take the amount received from the donor (here Grandma and she only got cash) and subtract the Adjusted Basis in the property that the seller sold, this will give you the Gain or Loss Realized on the Sale part of the transaction. Amount Received – Adjusted Basis in the property sold = Gain or loss realized (not recognized).
3. Loss is not recognized under §1.1001-1(e) because the person making the gift controls how much they will take for it.
4. The basis that the Donor (here Granddaughter) will take under §1.1015-4 the sum of –
  - a. whichever is greater:
    - i. The amount paid by the transferee for the property, or
    - ii. The transferor's adjusted basis for the property at the time of the transfer and
  - d. The amount of increase, if any, in basis authorized by §1015(d) for gift tax paid.

The Granddaughter will take a basis in the property of 20,000.

Gift Part:

Sale Part:

1. What if Bernadette devised the lot to Robert in her will? Then Robert would take the FMV of the lot at the time of Bernadette's death. §1014(a)(1) . Rob will take a 15g basis and the gain from 5g to 15g of 10g will not be taxed. The best way to transfer highly appreciated property is to wait until death.
2. What if Rob was Bernadette's elderly Grandfather and that he did within 6 months after receiving the lot from Bernadette? His will devised the lot and their property to Bernadette's son Rusty. What basis will Rusty take in the lot?
  1. §1014(e) appreciated property acquired by decedent by gift within 1 year of death says that (a) within 1 year of decedent's death, (b) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.
  2. Just assume the donor was dead and ask yourself what the basis would have been.
  3. Rusty's basis is 15,000.

## Sale of a principle residence

Chapter 6

Jot this formula down on your exam

**§1001(b)** – Amount Realized is the sum of any money received, plus the FMV of any other property received

*MINUS*

**§1011(a)** – the basis shall be the cost of the property

*EQUALS*

**§1001(a)** – gain or loss recognized from the sale of property

**§1001(c)** – gain or loss recognized from the sale of the property

§121(a) gross income will not include gain from the sale or exchange of property if, during any time totaling 2 years or more during a 5 year period it was used as the taxpayer's principle residence.

§121(c) if taxpayers file a joint return the taxpayers may exclude up to 500,000 of the gain if the following are met:

- ❖ one of the spouses must satisfy the ownership requirements
- ❖ both spouses must satisfy the use requirement
- ❖ Neither spouse has used the exclusion within the past two years.

Under §121(c) if a sale or exchange occurs because of a change in place of employment, health or other certain unforeseen circumstances and a taxpayer fails to meet the ownership and use requirements, some or all of the gain still may be excluded.

**§121(c)(1)(B)(i) the shorter of**

- (I) The aggregate periods, during the 5 year period ending on the date of such sale or exchange, such period has been used by the taxpayer as the taxpayer's principle residence.
- (II) **the period of the most recent prior sale or exchange by the taxpayer to**

**2 years**

<u>Amount</u>	X	<u>6 months</u>
500,000		24 months

Problems

1. Brian and Jen husband and wife purchased a home in Denver in 1986 for 225,000. They held title as joint tenants with right of survivorship and that home was their principle residence until June 1989 when they moved and bought another home for 250,000. They sold the Denver home for 400,000 cash and a mortgage assumption of 200,000. Their Adjusted Basis in the home was 275,000.
  - a.  $400,000 + 200,000 = 600,000$  §1016(b) and Crane, received from the sale of the home.
  - b. Subtract the Adjusted Basis of 275,000 in the home they sold from the §1016(b) figure of 600,000 and there is a §1001(a) Gain Realized of 325,000.
  - c. Although there is a 250,000 limit excludable from Gross Income under §121, §121(a) allows a \$500,000 limit on the amount excludable from Gross Income on the sale of a principle residence where it is a joint return.
  - d. Both spouses do not have to own the property.
    - i. §121(b)(2)(A)(i) if either spouse meets the requirements of subsection (a) with respect to such property. All 325,000 can be excluded form G.I.
  - e. After living in ID for 1 year, Brian and Jen sold their home in ID and moved to VA, where Jen accepted a new job. Brian and Jen realized a gain of 60,000 on their ID home. The sale occurred exactly 6 months after the sale of their Denver home.
    - i. §121(c)(1)(A) allows for cases in unforeseen circumstances.
    - ii. §121(c)(1)(B)(i) you take the shorter of (I) the aggregate periods, during the 5 year period ending on the date of such sale or exchange, such property has been owned and used by the TP as the TP's principle residence; or, (II) the period of the most recent prior sale or exchange by the TP to

2 Years.

Amount (here 60,000)/500,000 (the total amount excludable on a joint return) X 6 months (the period of the most recent prior sale or exchange by the TP)/2 Year.

Here, it comes out to  $60,000/500,000 \times 6/24 = \frac{1}{4} \times 500,000 = 125,000$

The exclusion is 125,000 so the 60,000 is excludable in full from the Brian and Jen's Gross Income. §121(c)(1)(B).

3. Maggie practices law in NY and she rents an apt. She has owned a summer home in ME for a number of years. What if Maggie moves to ME and live there for 2 years, make it her principle residence for the purpose of §121 and then sell the house and exclude the gain from G.I.? This is too risky for Maggie to do. The Courts will attempt to define principle residence more narrowly and the IRS and the Courts will find themselves in coming years spending considerable time in evaluating whether a residence is principle or not.

## **Discharge of Indebtedness**

### Chapter 9

§108 and §61(a)(12)

If a loan is forgiven in whole or in part, it may be includable in Gross Income.

§108(d)(3) to the degree the taxpayer's liabilities exceeds their assets, the taxpayer will not have to include debt discharge in their Gross Income.

§108(d)(2) debt discharge in a Title 11 case will not have to be included in Gross Income.

Under §108((b) Reduction in Tax Attributes – the amount excluded from Gross Income will be applied to reduce the tax attributes of the taxpayer – Any Net Operating Loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

A debt cancellation which constitutes a gift or bequest is not included in gross income of the recipient.

### Problems

2. Grandma lends Grandchild 10g to go to school, then before death forgives the debt. §61(a)(12) the cancellation of indebtedness under some circumstances may represent a form of compensation or some other form of payment which should not be considered "income from the discharge of indebtedness" – this may be a gift or a devise – it may be excludable from G.I. under §102.
3. Borrower borrows 50g. He is solvent when he has to liquidate his business, and Lender agrees to accept a lump sum payment of 20g for the 49g loan balance. §61(a)(12) the Borrower has to include the debt discharge of 29g in his Gross Income.
  - a. Borrower owed back wages? – Then the wages are a liability, and that may have given rise to a deduction, §108(e)(2) exception, because if Borrower had paid the salary he would have deducted the salary under §162(a)(1) – ord. and necessary bus. expense. Income shall not be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction. Not includible in G.I.
  - b. Uncle (unenforceable loan) lent Borrower 50g and forgave the "loan"? §102 this could be excludable as a gift and there is no income. Not includable in G.I. of Borrower.
  - c. If Borrower's parents purchased the debt from Lender, then later forgave the debt of Borrower? §108(e)(4)(A) views the acquisition of outstanding indebtedness by parent from a non relative (the Lender) as if the debtor (Borrower) acquired the debt. This would be includable in Borrower's Gross Income. Under §102, 20g would be excludable as a

- gift if Kevin's parent's later forgave the 49g balance that Borrower owed on the debt. It is excludable as a gift b/c the 29g that was debt discharge and includable in gross income has already been dealt with.
4. Bill borrowed 75,000 from Judy and later when Bill is insolvent Judy accepted a tract of land from Bill in satisfaction of the debt. Bill bought the land from 25,000 and it has a FMV of 30,000 at the time Judy received it. Bill's other liabilities immediately prior to the transaction are the 75,000 debt to Judy, and 50,000 indebtedness to others, and he is guarantor on a loan of 25,000. Bill's assets are the land, and a piece of equipment with an adjusted basis of 70,000 and a FMV of 65,000. As a result of the satisfaction of the debt, the equipment is Bill's only asset. He still owes 50,000 to 3<sup>rd</sup> parties and the guarantor on the loan.
    - a. How much income must Bill report (if any) as a result of the settlement of the debt to Judy?
      - i. What is the Debt Discharge to Judy?
        1. **FMV** of the property (or money) given to satisfy the debt – the amount of **the debt = Debt Discharge**.
      - ii. Is there a gain on the property that was given to satisfy the debt?
        1. FMV of the property - §1012 Cost Basis in the property = Gain or Loss on the land. If there is a gain, the gain must be reported in
      - iii. Do not include guarantor debt if it more likely or not that the other party will pay. Merkel
      - iv. Bill has to report debt discharge in his Gross Income to the extent that he is insolvent.
        1. Look at the whole problem.
        2. **Add up all the liabilities**, including the debt that is being discharged in the property.
        3. **Add up all the assets**. Use the FMV of the assets and include the asset that is being used to satisfy the debt in the problem.
        4. Take **Liabilities and subtract out the assets = Insolvency**.
        5. **§108(a)(3)** the amount that the TP is insolvent is excludable from Gross Income.
        6. **§61(a)(12)** the amount the TP is solvent of the debt discharge is includable in Gross Income.
        7. Bill must include the 5,000 Gain from the property he used to satisfy the debt in his Gross Income. This has nothing to do with the 15,000 debt discharge that is includable in Bill's Gross Income. If we did not make Bill do this then everyone would pay their debt with property and not pay taxes.
    - b. What effect does the settlement have on Bill's basis in the equipment?
      - i. §1017 allows the TP to reduce their basis of any property held by the TP at the beginning of the taxable year following the taxable year in which the discharge occurs.
      - ii. Bill must reduce his bases in the equipment if the total bases of his property after discharge does not exceed his total liabilities after the discharge.
      - iii. After discharge Bill has 50,000 of liabilities and 65,000 FMV of the equipment. Bill's liabilities exceeds his assets by 15,000.
      - iv. § 1017(b)(2) Bill can reduce his basis in the equipment by 15,000, the extent his liabilities are greater than his assets.
    - c. What basis will Judy take in the land she got from Bill?
      - i. Judy will take a basis of 30,000 in the land, **the FMV**.
  5. Christina entered into a contract to purchase a condominium from Julie for 75,000. At a time when Christina still owed Julie 65,000 the FMV of the condo had fallen to 60,000.

To prevent Christina from defaulting on the loan, Julie agreed to accept 50,000. What are the tax consequences to Christina?

§108(e)(5) retro active reduction in purchase price. Purchaser/Debtor and a Seller/Creditor relationship and the creditor will take a lower price from the Debtor §108(e)(5) excludes the reduction from Gross Income, but the Debtor/Purchaser will reduce their basis in the property.

Outstanding Debt – Restructured Debt = Debt discharge that is excludable from G.I. just reduce the basis.

6. Remember if it is income, a payment for services or whatever, it is includable in G.I. no matter what the solvency of the TP. §61(a)(1); Rev. Rul. 84-176.

## **Compensation for Personal Injury and Sickness**

### Chapter 10

§104(a)(1) amounts received for personal injury or sickness under Workman's Compensation acts are excluded from gross income.

§104(a)(2) excludes from G.I. any damages received, whether by suit or agreement as a lump sum or periodic payment on account of *personal injury or sickness*.

- the damages must be tort type
- Personal injury under §104(a)(2) is "any invasion of the rights that an individual is granted by virtue of being a person in the sight of the law."
- Economic loss are also excludable from G.I., ex., can get back lost wages on a sex discrimination claim.

Raytheon: what are the damages replacing? Damages awarded on account of lost profits would be taxable.

Burke/Scheier: damages on account of personal injuries for §104(a)(2) purposes are those that bear a close nexus to the personal injury.

Origin of the Claim test: look to see that the origin of the claim was a personal physical injury and not one growing out of emotional distress. ROOT IN A PHYSICAL INJURY

Punitive damages are included in Gross Income even when they are attributable to a physical injury or physical illness.

Court's will look at settlement negotiations and whether the transaction was at an arm's length. If it is reasonable the Court will respect the allocation of personal injury damages and punitive damages, if not the Court will re-allocate.

ANNUITY CONTRACTS: the interest from the annuity will be included in Gross Income. §72. It is better just to take payments over time because then all of the payment amount will be excluded from Gross Income.

DAMAGE TO PROPERTY: is excludable from G.I. if the damage award is equal or less than your basis in the property. To the degree that the award is greater than your basis in the property it is includable in your G.I.

§104(a)(3) if the taxpayer is paying his own accident and health insurance with after-tax dollars, then payments from that will be tax free, not include in Gross Income.

Running back hype: purchases his own policy after tax, then payments are excluded from G.I.; also if the employer purchases the policy with the linebackers after tax money, the payments are excludable from G.I.

If you are self employed, then payments are excluded from G.I.

§105(a) if you get payments from an employer provided health plan, they are included in your G.I. Except under (b)(c)

(b) amounts expended for medical care §213

(c) payments for permanent loss or use of a member or function of the body.

§104(a) and §105(b) amounts that are attributable to previously deducted medical expenses are INCLUDED in G.I.

§213(a) you can get a deduction for medical expenses to the degree the payments exceed 7.25% of AGI.

§104(a)(1) you can exclude from you G.I. amounts received under Workman's Comp payments for P.I. or sickness

§104(a)(4) sharply restricted military payments for compensation for combat-related injuries and compensation from the V.A.

### Problems

1. Must be a tort type injury. Breach of K here – go through what would be included in G.I.

2. Payment for a car accident →

a. Payments for pain and suffering – excludable from G.I. §104(a)

b. Payment for future medical expenses – excludable from G.I. §104(a)(2)

c. Reimbursed medical expenses – §104(a)(3) payment is excluded MINUS whatever the taxpayer already took as a deduction §104(a)

d. Lost wages – exclude from G.I. Rev. Ruling 85-97; §104(a)(2)

e. Punitive Damages – includable in G.I. §104(a)(2)

f. Damages to property – amount goes against the basis – if payment is greater than basis, it is included in G.I.

\* Who paid the medical policy?

\* How is the payment allocated – it must be an arm's length transaction.

3. Sexual Harassment – the damages are going to be includable in G.I. if there was no touching. If there was touching and then was some sort of physical manifestation it may be easier to argue that the damages should be excluded from G.I.

4. Accident – loss of limb or bodily function - §104(a)(3) Self Financed – the payments that exceed the medical expenses remain tax free. §105 Employer Financed – TP will have to report some of the payments, BUT under §105(c)(1) – if the TP has lost the use of limb or bodily function the payments are excludable from G.I. Part Employer/Part Self Financed – the excess reimbursement is allocated in proportion to the relative payments made by each policy.

### **Depreciation**

#### Chapter 14

#### §167 (a)

1. used for trade or business (Simon/Liddle: violin bows – the instruments suffered wear and tear and the continued use over time)

2. held in the production of income

Land is not depreciable! TP's personal residence is not subject to depreciation; Home-Office deductions will generate smaller deductions and encourage IRS to look at your return.

§1.167(a) cannot depreciate inventory or property that is held primarily for sale to customers.

§263 there is NO depreciation deduction for amounts paid out for new buildings or for permanent improvements or betterments made to increase the value or any property or estate.

Example: Office building purchased for cost of 490g. 100g goes to the land. Basis in the real estate is 490g §1012 CB; less 100g for the land = 390,000 basis.

You cannot take a deduction for all of the basis in the office building in Year 1! You must depreciate! The Office Building is Real Property subject to the Straight Line depreciation method, with no salvage value, over a number of years. Take your basis divide it by number of years, with a 0 salvage value and you get your annual depreciation.

Income

(Depreciation) §167, §168

Net Income/Loss

Useful Life: measures the time with regard to calculating your depreciation

- Real Property – residential property recovery period is 27.5 years
- Real Property – non residential 39 years.
  - **Real Property uses the Straight Line method with 0 salvage value**; divide your basis by whatever years you have. §1.176(b)-1; 168(b)(4) salvage value is 0.
- Personal Property –
  - 5 year – most are; cars, trucks, copy equipment
  - 7 year – furniture, fixtures,

#### §179 Bonus Depreciation Deduction

1. Purchase
2. Tangible personal Property (not tested on §1245)
3. cannot take a §179 if you have a loss
4. Limitation – to the degree that the business places in service property greater than \$100,000 the §179 deduction is reduced each dollar over \$200,000.

#### Convention

Mid Month - the property is deemed to be placed in service in the middle of the month regardless of when it was.

#### ½ Year Convention

§168(d)(1) generally the applicable convention for 5 year property is the ½ year convention

Real Property: the straight line method will be used with the mid month convention.

#### Problems

1. Office stuff – must be subject to wear and tear. Art is not subject to wear and tear and is not deductible. If it is an arm's length transaction and used in their customary fashion it's depreciation is deductible.
2. Liz and a 25,000 computer system. Is the property used in trade or business? Meets §167.
  - a. **200% declining balance method** will be used under §168(b)(1)(A) -
  - b. §168(c) tells you the **recovery period** – 5 years office equipment
  - c. **Convention** – Usu. will be the half year convention. §158(d)(1).
  - d. Go to the **Rev Proc to see the % to be deducted** each year.

- If the TP did not make a §179 deduction (elect to expense certain depreciable assets) the TP must still adjust the basis of the asset to reflect the depreciation deduction, under §1016(a)(2) – adjustments to basis.
  - Do not adjust (reduce) your basis each year when using the table!
    - o When Liz sells the compute in say year 3, in the middle of the year, how much depreciation can she take?
      - **You figure out the full depreciation amount for that year, then you have to divide it by 1/2 if the TP sold it in mid year.** Any year but the 1<sup>st</sup> and the last the property is placed in service you have to reduce your property by ½ because of the ½ year convention.
  - If the TP makes a §179 deduction with respect to the office computer, what is the maximum they can deduct in Year 1? Assume the computer was purchased in Jan 19, 2000. Year 1 is 2000, and the TP's taxable income is 150,000 disregarding any depreciation deduction for the computer.
  - 5. Can the taxpayer use the §179 Election? Must be §179 property: 1. tangible personal property; 2. purchased for use in the active conduct of a trade or business; 3. has to be §1245(3) and 1 of the other enumerated property listed in (A) through (E).
  - 6. 2 Limitations: 1. the dollar limitation table in §179(b)(1); and 2. the deduction cannot exceed the taxpayer's gross income from and trade or business for the year.
  - 7. Look at the table in §179 – use the amount for the year listed, if it does not exceed the taxpayer's gross income from any trade or business, then the taxpayer can take the whole deduction.
  - 8. Subtract the deduction in §179 from the taxpayer's basis in the property. This is your new basis.
  - 9. Then you will §168 depreciate the property again with the subtracted amount. The property probably has switched to Straight Line Method.
  - 10. Take the number of years the property is {will be 5, or 7 year}, divide the basis by the number of years of the property, and you have your §168 deduction.
  - 11. Add that to your §179 deduction. This gives you your total deductions in depreciation.
  - You can take a §179 deduction if the property was a gift as long as you use it in your trade or business.
  - It does not matter how you acquire the property; gift, death, etc., as long as you use the property in your trade or business you could take a §168 deduction. {§179 property must be purchased}
  - Basis is always cost basis.
  - You cannot take a §179 deduction if you have a loss.
  - §179 Limitation: to the degree that the business places in service property greater than 200,000, the §179 deduction is reduced each dollar over 200,000.
3. Liz leased a small commercial building. She paid for the former tenant's rights in the lease, Liz paid rent each month. Liz bought an office building, the land was 100,000 and the office building was 100,000 for a total purchase price of 200,000.
- a. Leasehold deductions under §162(a)(3) Liz can take the rental payments she makes as deductions because Liz does not have title in the office building. Liz may also deduct the initial lease hold payment 3gs.
  - b. Liz cannot deduct the land. Land is not a depreciable asset.
  - c. How much depreciation may Liz claim on the apartment building in the year of purchase? Adjusted basis in the land is 100,000 {deduct for the land}

- i. §168(b)(3) – method is straight line
- ii. Recovery period for the office building is 27.5 because the property is residential rental property §168(c).
- iii. Convention – mid month - §168(d)(2)(B)

#### Apply the Formula

1. Adjusted Basis/Years Remaining = \$ amount each year deductible as depreciation each year
2. How many months left in the year? Months left/12 months in a year = (.xx) {your multiplier}
3. Take the figure in #2 and multiply it by the yearly depreciation amount.
4. This equals your first year's depreciation deduction.

### **Interest Deduction**

#### Chapter 22

§163 Interest – there shall be a deduction allowed on all interest paid or accrued within the taxable year.

#### §461 Pre Paid Interest

§461(g)(2) provides an exception to the rule that there must be a payment for interest to be deductible, for qualifying points based in connection with the purchase or improvement of an asset secured by the taxpayer's principal residence.

Points: additional fees a taxpayer pays when borrowing money from the bank or savings and loan to buy a home. Deduct the points in the year you pay the points. If loan over 30 years, then deduct the points {interest payments} at the end of the 30 year term.

§461(g)(1) Prepaid interest is deductible as it is allocable over the period of that loan. Allocate evenly. Cash method taxpayers can take a deduction when there is an actual payment.

§461(g)(2) Exception: A prepaid interest deduction if it is used to acquire a principal residence, and it is customary business practice then you can take the deduction at that time and not have to allocate. Write a separate check at closing for your points so you can take the Interest deduction at that time.

§163(h)(1) personal interest is not deductible

Exclusions: §163(h)(2) (A) – (F)

- (A) - can deduct interest paid or accrued on indebtedness properly allocable to a trade or business
- (B) – can deduct any investment interest within the meaning of §163(d)
- (D) – can deduct any qualified residence interest within the meaning of §163(h)(3).

Deduction allowed for mortgage interest on personal residences.

- 1 million dollar cap on acquisition indebtedness – acquisition debt is used to acquire or improve your principal residence. {cannot secure your 1 mil debt with a painting, must be secured by your principal residence}
- You can use your home equity indebtedness cap of 100,000 for any purpose. Home equity indebtedness is limited to the excess of FMV of the qualified residence over the amount of acquisition indebtedness with respect to such residence, and in no case can the home equity indebtedness be greater than 100,000.

#### Investment Interest

§163(d)(3)(A) investment interest is interest paid or accrued on indebtedness properly allocable to property held for investment – interest, dividends, royalties, annuities not attributable to income or business.

For interest to be deductible there has to be an actual cash outlay. There must be a payment.

#### Davison v. Commissioner

When a borrower borrows funds from a lender and immediately satisfies an interest obligation to the same lender, it is necessary to determine whether the borrowed funds were, in substance the same funds used to satisfy the interest obligation. A cash basis borrower is not entitled to an interest deduction where the funds used to satisfy the interest obligation were borrowed for that purpose from the same lender to whom the interest was owed.

#### Problems

1. Interest on a bank loan used to pay operating expenses in Taxpayer's business. Deductible under §162 as ordinary and necessary business expense and under §163(h)(A).
  - a. Credit card interest is not deductible at all.
  - b. Interest on loans used to pay son's college tuition several years ago. §221 Education loan interest deduction – there is a table page 220 IRC.
  - c. Prepayment of interest the taxpayer was required to make under a contract (business) – deductible under §163 because the payment of the interest was a prerequisite to getting a loan. Under §461(g)(2) – only the interest that is allocable to that year is deductible {when you make a prepayment of interest}.
  - d. Investment Interest - §163(d)(1) you cannot deduct investment interest which is greater than your net investment income. Add up the income from your investments, and income from any other dividends, and deduct any expenses. You then carryover what ever interest is greater than your investment income to the next year.
  - e. What if the taxpayer had a net capital gain too? §163(d)(4)(B) if the taxpayer made the election to include his net capital gain, it will build up the taxpayer's investment income. You add the net capital gain to the investment income. If the sum of the net capital gain and the investment income is greater than the amount of investment interest, the full investment interest is deductible.
2. Pat bought a house. Points and the interest on buying a home are both deductible as long as §461(g)(2) is met (for the points). For the interest payment look to §163(h)(2) – limitation of 1 million cap on acquisition indebtedness and 100,000 cap on home equity indebtedness and is secured by the principle residence.
  - a. Assume the home is now worth more money. And taxpayer borrows an additional amount of money. You can split up the amount additionally borrowed und §163(h)(3) home equity indebtedness and §163(h)(B) acquisition indebtedness.
  - b. Allocation of acquisition indebtedness and home equity indebtedness.
  - c. Make sure that there is not just an exchange of paper and there really is a payment of interest when the bank makes another loan to the same customer.
  - d. If the taxpayer owes still on his mortgage and then moves and buys another house. (Like a townhouse). If the taxpayer retains the original residence as a second home, the taxpayer can deduct the interest on the townhouse mortgage as well as the interest on the mortgage on the original residence. §163(h)(4)(a)

## Charitable Deductions

### Chapter 26

#### §170

To be deductible the charitable transfer must:

1. be made to or for the use of a qualified recipient;
2. constitute a transfer of money or property made with no expectation of a return benefit;
3. actually be paid to the recipient; and
4. not exceed certain percentage limitations

§170(c) lists organizations who qualify

1. it must be organized and operated exclusively for religious, charitable or other specified purposes;
2. §170(c)(2)(C) its net benefits cannot inure to the benefit of any private shareholder of individual
3. §170(c)(2)(D) its lobbying and political activities must be limited

Look at the intent of the transferor

Detached disinterest generosity without expectation of return

Actual Payment is required

#### Limitation of Charitable Deductions

1. 50% of contribution base/AGI
2. §170(B)(1)(F) contribution base means AGI
3. Cannot deduct the value of services one contributes to a charity §1.170A-1(g).
4. TP may deduct the expenses incurred in providing the services. Davis; however, TP cannot deduct the expense incurred of another TP.

Contribution of Appreciated Property will be the FMV of the property §1.170A-1(c)(1).

#### Charitable Contributions of Real Property

1. Radio ads – bring us your car
2. The appreciation on the vehicle in most cases will not be taxed and the person making the charitable contribution will be able to take **the FMV of the property as a deduction** on their tax return.
3. §170(e)(1)(A) – tangible personal property, donated to charity, where it will be used in the charity's function – **then the FMV of the property will be the charitable contribution.**
4. §170(e)(1)(B) – tangible personal property, donated to charity, where it will not be used in their function – then **it is the BASIS (not the FMV)** – this is less favorable Ex., photos at church, the church will probably not use them in their services, so the charitable contribution is the BASIS and not the FMV.

#### Bargain Sale to a Charity

1. **§1011(b)** – the bargain sale to a charity is similar to a part gift part sale
2. **AR/FMV \* AB**. When property is sold to (or exchanged with) a qualified donee for an amount which is less than the FMV of the property. The adjusted basis of the property is apportioned between the gift portion and the sale portion of the transaction accordingly in the formula.
3. **The contribution limitation is 50% of AGI**, so if the AGI is 100,000 then the max charitable contribution will be 50,000. (if the charitable contribution was 75,000 the 25,000 would be carried over).
4. **Selling Price – Basis = Amount Realized.**

## 5. Amount Realized – Adjusted Basis = Gain Realized.

### Problems

1. Church and a whole bunch of amenities. Is the expectation of 5% to the church a disguised membership fee? Fact Driven. Tithe is not unusual, just look if it is a church or is it something else.
2. Davis – must be to an individual
  - a. Who has control over the money. If the money was to go to a student and the student had control over it then there would be no deduction allowed.
  - b. Not deduction b/c it goes right back to her. Close call – transferring it to the school with direction to supervise students on the trip. Scholl would be unable to make the final decision as to how to spend the money.
  - c. Would be deductible because it is given to school board generally even though the problem indicates that it is to help defray the costs of the airline ticket.
3. Contribution base – Assume Peggy has a contribution base of 250,000. What tax consequences to Peggy if she gives 150,000 to the local college? 125,000 is deductible now and 25,000 is carried over to be deductible spread over the next 5 years, §170(d)(1)(A).
4. William makes the following donations to charity during the year. Assuming an adequate contribution base what deductions if any may William claim:
  - a. Williams owns a condominium he donates the use of the condo for one week during July. FMV of the rental is 2,500. Not deductible §170(f)(3)(A) because he didn't give away any amount of property.
  - b. William donates 30 hours of his time to a private college. William also incurred 500 in unreimbursed travel expenses in providing these services to the college, 300 are attributable to William and 200 are to his friend. Reg 1.170A-1(g) time is not deductible. The 300 expenses are deductible as it goes to William §170 and 1.170A-1(g) but not his colleagues unless the colleague may be an agent of William.
  - c. William owns a painting he has a life interest in the painting and transfers the remainder interest to the local art museum. The remainder interest is valued currently at 50,000. §170(a)(3)
  - d. Assume the sale of the painting would have generated long term capital gain. What tax consequences to William if, in lieu of the transfer in (c), he gives the painting to his church? The charitable contribution is unrelated to the church would be the basis. If related to the church it would be the FMV of the painting.
  - e. William sells 100,000 worth of stock to his church for 50,000. William's adjusted basis in the stock is 40,000. AR/FMV \* AB. FMV of 100,000 – Selling price (the Amount Realized) 50,000 = 50,000 Donation.

## Capital Gains

### Chapter 31

Three requirements to generate long term capital gains (that is all you need to convert into net capital gain).

3. Capital asset
4. Sale or Exchange
5. Property must be held for longer than a year

Capital Asset –

§1221(a)(1) – inventory type property is not a capital asset but an ordinary asset

§1221(a)(2) – property used in trade or business

Capital asset: property held by a taxpayer, whether or not it is connected with her trade or business, other than certain categories of property enumerated in §1221 such as inventory and depreciable property used in a trade or business.

#### Problem 1

1. Margaret is an artist whose paintings command significant prices. Terry, her husband, is a sole proprietor of a retail hardware store. Determine which of the following are capital assets:
  - a. The own owned by Margaret and Terry and used exclusively for personal purposes. This is capital asset and upon sale or exchange will generate capital gains if held longer than a year. §1221
  - b. The inventory of Terry's hardware store. This is a capital asset under §1221.
  - c. The delivery truck Terry uses exclusively for business purposes.
  - d. IBM stock owned by Margaret.
  - e. Margaret's paintings. In M's hands they are not capital assets. If M gives one of her painting to her daughter, would the painting be considered a capital asset in the daughter's hands? This would be a capital asset of the daughter.
  - f. The A/R of the hardware store. Not a capital asset under §1221(a)(4)
  - g. A computer which Terry and M use exclusively to manage their stock investments and to account for their household expenses. This is a capital asset §1221.
  - h. The commercial building and land owned by Terry and used in his hardware business. The commercial building is not a capital asset, b/c §1221 (2) subject to depreciation, but the land is not subject to depreciation and is a capital asset.

## Assignment of Income

### Chapter 34

§1015 a transfer from a donor to a donee in a gift context, the donor takes the donee's basis.

**Lucas – the party who earns the money is the party who is taxed on it.**

**Helvering – the party who owns the property is the party who will be taxed on the income generated from that underlying property.** {Landlord leases the land, then the tenant leases the land again, the one in the middle will be taxed on what the 3<sup>rd</sup> leasee pays, not the original land owner.}

Critical question:

**Did the TP get to designate where the income is to go?**

#### Author Case

Has the world famous author created a book that everyone knows will make millions and then assigned the right of ownership to her child? In this case the Author still has the ability to transfer the income to someone else.

#### Kiddie tax

#### Problems

1. Mom is a dentist, and daughter is a starving actress.
  - a. Mom and Daughter enter into a K where mom signs over checks (income) to daughter. Lucas → the person who earns the income is taxed on the income. IF the child has a clear pathway to a lot of earnings maybe it could be said that all the Mom is doing is supporting the Daughter and she will receive greater rewards.
  - b. Patients of Mom cannot directly pay Daughter! Look to who is earning the money.
  - c. Cannot tell the ABC stock company to pay dividends to Daughter. Mom still owns the underlying property, the stocks. Mom will be taxed under Helvering.
  - d. What if the Mom sold the right to the stock dividends to Daughter for a number of years and the Mom may forgive all or part of the principal and interest from time to time as a gift? Here Mom is selling the dividends and will not pay the tax. Mom is looking into the future also and planning for her retirement when the Daughter pays her back at whatever rate. If the Mom has no prearranged plan to forgive the debt then Mom will not be taxed on the dividends.
  - e. What if Mom gave to Daughter the right to the dividends for the next four years and at the same time Daughter will give the stock to the Dad.
  - f. Mom owns an office building that is almost already all depreciated. Mom will convey the building to Daughter as a gift, and then will lease back the part that Mom uses for her dental practice. As long as a fair rental value is being given for the office space that the Mom uses for her dental practice then this is a bona fide transaction and Daughter will get the income and be taxed. Since the building is already almost depreciated, the Mom is okay with conveying it to Daughter b/c the depreciation deduction is all gone. §1015 says that Daughter will take the Mom's basis in the office building.

- g. What if the Mom was going to sell some stock that is worth a lot of money and she tries to give it to Amy and then the income will not be to the Mom? This will not work, because the fruit is too ripe.

## Tax Consequences of Divorce

### Chapter 37

§71 Gross Income includes amounts received as alimony or separate maintenance payments.

- The ex-spouse has to include alimony in their Gross Income.

§251 the Payor spouse will get a deduction and the deduction will be an Above the Line deduction.

§71(b) rules that must be met in order for payments to be alimony:

1. §71(b)(1) payments must be in cash
2. §71(b)(1)(A) the payment is received by on behalf of a spouse – payor spouse can pay payee spouse's rent, car payment, etc., and this is still alimony.
3. §71(b)(1)(B) the cash payment must not be non-deductible by the payor spouse (The payment must not be designated as not being alimony.)
4. §71(b)(2)(B) the spouses must not be members of the same household at the time the payment is made.
5. §71(b)(1)(D) the payor spouse must not have any obligation to make payments after the payee spouse's death.

All rules must be met for there to be an alimony payment.

§71(c) child support is non-deductible

§152(e) the custodial parent receives the dependency exemption. This can be waived by agreement though.

§212(3) Atty's fees incurred incident to a divorce are deductible to the extent they are attributable to obtaining alimony or are related to tax advice in the divorce proceedings.

Divorced taxpayers have 2 filing status options:

1. single
2. head of household – you must have a dependent to support

Transfers of property between spouses, ex spouses, and soon to be ex spouses:

Davis –

**§1041 RULE: no gain or loss shall be recognized on the transfer of property between spouses during the marriage and/or incident to a divorce.** H & W are really an economic unit so if you have property or cash between spouses this should not generate any gift tax.

§1041 trumps §1015 and if there is a property transfer during the marriage, H will take W's basis.

Under §1041 you can shift the loss to the transferee (you cannot in §1015).

§1041 trumps §1015

§121(d)(3)(A) the transferee spouse is able to tack on the transferor's time

§121(d)(3)(B) when a taxpayer continues to have an ownership interest in a residence but does not live in the residence, because of pursuant to a divorce decree, the taxpayer's spouse or former spouse is granted the use of the residence, the taxpayer will be treated as using the residence while the residence is used by the taxpayer's spouse or former spouse.

### Problems

1. You have to have a meeting of the minds in order to have a valid alimony payment agreement.
2. If Frank and Maureen agree that F will pay M 2,000 a month by check this is alimony.
  - a. Transfer of a parcel of land is not alimony because it is not in cash!
  - b. If F pays M's landlord her monthly rent this is alimony – payments to third persons on behalf of the ex spouse. BUT payments of utilities, and other stuff can be like a gift and not alimony (because they are not in the agreement.)
3. Primary custodian: the parent who is the primary care giver will be able to file head of household.