BASIC INCOME TAXATION

CHAPTER 1 – INTRO TO FEDERAL INCOME TAXATION

Expectations…
Website: class websites under fac/staff
Username: basic
Password: code

I. PROBLEM

II. VOCABULARY

- GROSS INCOME
- ADJUSTED GROSS INCOME
- ABOVER THE LINE DEDUCTIONS
- BELOW THE LINE DEDUCTIONS
- STANDARD DEDUCTION
- PERSONAL EXEMPTION
- TAXABLE INCOME
- CREDIT
- RATE SCHEDULE
- JOINT RETURN
- TAX BRACKET
- MARGINAL RATE
- TIMING
- W/HOLDING TAX
- TAX BASE
- INPUTED INCOME

III. OBJECTIVES

IV. OVERVIEW

Why are tax codes good?

- To raise revenue
- Social policy
- Distribution of wealth
  - Measuring Fairness:
    - (a) <u>vertical equity</u>: we ought to tax people according to their ability to pay….raises the question of how we should treat differently situated people? PROGRESSIVE RATE SYSTEM
    - (b) <u>horizontal equity</u>: to treat similarly situated taxpayers similarly

MARGINAL RATE: rate that applies to the last dollar that the taxpayer earned
EFFECTIVE TAX RATE: takes into account the lower rate taxed on early dollars

$$\frac{\text{Tax Liability}}{\text{Taxable Income}}$$

How would you develop a tax code to make the system work well?

- Uniformity

A. A BRIEF HISTORY OF FEDERAL INCOME TAX

B. THE TAX PRACTICE

C. RESOLUTION OF TAX ISSUES THROUGH THE JUDICIAL PROCESS

1. TRIAL COURTS
   Courts which have original jurisdiction in federal tax cases:
   (a) The Tax Court
   - Court in which a taxpayer brings action for redetermination of a deficiency w/o first paying the asserted deficiency.
   - Has 19 members, established in 1924, named so in 1969 under Art 1, sec 8, cl 9 of constitution and part of judicial branch.
   - Cases tried w/o jury and by one judge who submits opinion to chief judge for consideration. Chief judge either allows decision to stand, or refers to full court for review.

   (b) Federal District Courts
   - Have jurisdiction in any tax case against the US seeking a tax refund, regardless of amt involved.
   - Action can only be brought in district where taxpayer resides, or w/ corporations, the district of principle place of business.
   - May be tried before juries….and taxpayer must first pay the amt in dispute prior to bringing a refund action.

   (c) US Claims Court
   - Created in 1982 and has jurisdiction over all tax suits against US regardless of amount…however, no jury trial.
   - Residence is irrelevant…no jurisdiction to hear deficiency cases, taxpayer must first pay, then bring refund action.

2. APPEALS
   - Appeals from Tax Court as heard as matter of right by US Fed Ct of Apps.
   - Jurisdiction is in circuit where taxpayer resides
   - Decisions are reviewable by SC.

3. SELECTION OF FORUM
   - Typically based on whether taxpayer wants jury trial, or wants to pay deficiency beforehand.

V. ANALYSIS OF THE COMPUTATION OF TAX LIABILITY OF MR. & MRS. TAXPERSON

PROBLEM 1…
Gross income – Deductions = taxable income

A. BASIC QUESTIONS ADDRESSED BY AN INCOME TAX SYSTEM

Cash-method acct: include taxable item when you actually receive the cash
Accural-method: include the item when you do the work

B. EVALUATING MR. & MRS. TAXPAYER'S TAX LIABILITY

1. GROSS INCOME
   (1) $145,000
   (2) $1000
   (3) no
   (4) above the line – business expenses - $6000/yr
   (5) ..
   (6) ..
   (7) §212 – may be deducted as expense paid to help taxpayer produce income, manage his portfolio. (below the line)
   (8) not deductible -
   (9) ..
   (10) mortgage interest - $2000, below the line deduction
   (11) $5000 - top capitol gain is 28% - then you are only taxed at 28% instead of 39%
   (12) §170 - charitable deduction…below the line…all $1800
   (13) sales tax not deductible – personal taxes typically not deductible – state income taxes…§164(a)(30) deductible…$2600 b/c taxpayer is a cash-method taxpayer.

2. ADJUSTED GROSS INCOME

3. DEDUCTIONS

Above the line: deductions considered in determining AGI - §62
Below the line: deductions considered after AGI is determined (more limitations—do not get them at all if you take standard deduction) -
deductions not listed in §62

- Interest on mortgage
- Newsletter
- State income tax

Lecture – August 23, 2000

4. CALCULATING ADJUSTED GROSS INCOME

$151, 000 (total gross income)

ATL deductions:
(1) rental expenses
(2) office supplies
(3) wages
(4) depreciation
TOTAL: $25,000

BTL deductions:
(1) interest
(2) newsletter
(3) state income tax
(4) real property taxes
(5) charitable contributions
TOTAL: $10,400

AGI = $151,000 - $25,000 = $126,000

So should the taxpayer itemize or take standard deduction??
ITEMIZE b/c standard is only $5000, and Itemize is $8620 in BTL exemptions.

Personal Exemptions….allowed for taxpayer, spouse, and any dependents. There are four Personal Exemptions allowed in this case. amount unadjusted for inflation in text is $2000 for each of 4.
$8000 deduction

$126,000 (AGI)
- 8,620 (itemize)
- 8,000 (PE)
= $109,380 (taxable deductions)

TAX LIABILITY
$109,380 -- $5000 capitol gain taxed @20% = $1000
-- $104,380 @ §1(a) rates
tax = $20,165 + 31% of excess over $89,150….$15,230 = $24,886

TOTAL TAX LIABILITY = $24,886 + $1000 = $25,886

5. TAXABLE INCOME
Computing Tax Liability:

Gross Income (§61)
--- ATL deductions
AGI (§62) – either itemize or take standard deduction

Itemizing…AGI subtract BTL deductions and Personal Exemptions = taxable income
Standard…AGI subtract Standard deduction and Personal Exemptions = taxable income

6. TAX CREDITS

Credits…don't reduce taxable income…they reduce tax liability $1 for ever $1 of credit.

Tax liability = $24,000

Tax credits = $ 5,000
Taxable income = $19,000

What's better, a deduction or credit??

CREDIT…b/c deductions will only reduce taxable income by the % amount of your tax bracket, but credit you get regardless of your tax bracket.

(1) deductions are worth different amts to diff taxpayers

- $1000 deduction is only worth $150 to a 15% tax bracket payer
- Deductions are worth less to low income individuals, more to higher tax bracket payers.

BASIC INCOME TAXATION

CHAPTER 2 – GROSS INCOME: CONCEPTS AND LIMITATIONS

What constitutes gross income, and what does not?

Treas. Reg.… §1.61-2

1-means this is an income tax regulation

.61 means that it is interpreting code §61

I. PROBLEMS

1. What must be reported…
   (a) wages of $5/hr.…YES, §1.61-2(a), §61(a)
   (b) $500 tips…YES, §1.61-2(a), §61
   (c) $1000 cash bonus.…YES, §1.61-2(a), §61
   (d) found wallet w/ money it in.…YES, §1.61-14 – treasure trove counts in year of undisputed possession…taxpayer gets title in year the money was found, not the possessing of the money.
   (e) $50 rebate…NO, she's purchasing item from company and she gets a bargain. Bargains are not considered as income, unless there is some kind of employer-employee relationship.
   (f) Frequent Flyer ticket…NO, same logic as above

2. What's Larry's gross income, when Martha lives in his house for a year? §1.61-8(c)
   (a) mortgage payments $3600 - YES
   (b) property taxes $1200 - YES
   (c) monthly utility bill $600 – NO…b/c Larry could cancel these services
   (d) monthly cleaning $480 – NO…b/c Larry could cancel

   If someone pays a liability that is yours, then you have an accession to wealth, that you're responsible for.

3. Martha is carpenter, she builds cabinets for Larry, in exchange for not having to pay mortgage payments, but she spends $100 in materials.
   (a) Larry's income??
   - Barter transaction…trading free housing for new kitchen cabinets
   - This income is considered <u>rental income</u>…but it's coming in the form of services, not cash. (revenue ruling 79-24)
   - Larry's income would be equal to the fair market value of kitchen cabinets…which is approximately the same as the monthly mortgage payments.
   -

   (b) Martha's income??
   - She lived in house for free, so her economic well being is better off in amt of rent she did not have to pay. Her gross income is the value of amt received…or $600.
   - Martha's income is considered <u>services income</u>.
   - Martha should get a deduction of $100 for supplies purchased to make cabinets.
   - What about the 25 hrs she spent on making the cabinets? No deduction…b/c she was compensated for her time.
   - M's taxable gross income is then $500.

4. Does the president of a company have income as a result a paid business trip by the company?

- He gave speeches at the seminar as motivational for employees.
- He was doing things to benefit the company
- **IF YOU'RE PROVIDING WORK FOR THE BENEFIT/CONVENIENCE OF YOUR EMPLOYER THEN IT IS NOT INCLUDED IN YOUR GROSS INCOME**.

5. Sam hires Rick to sell his house, and he will get 6% commission, or $6000, based on $100k selling price.
   (a) Whether Rick has gross income if he foregoes his commission and sells the house to Ellen for $94k?
   - NO. Ellen gets the benefit of Rick's commission.
   - Rick is providing services, and Sam is providing money…but the money goes to Ellen as discount for house…so is anyone more economically better off b/c of this??
   - Well Rick has income equaling $6000…b/c it was his compensation that he later forwarded to benefit his friend, Ellen. (like two separate transactions.…first to Rick for services, then to Ellen for gift).

6. P, T's employer, wants $100k for her home. T offers to pay $80k. Any GI?
   - Assuming the house is really $100k at fair mkt value…and b/c of employer-employee relationship…Ted is getting a house worth $100k for $80k.
   - Then Ted is actually better off by $20k…and must pay taxes on this.
   - How could Ted get away from being taxed?? Called a **BARGAIN SALE**…and the rule applies when no employer-employee relationship is involved.
     - Exception…er-ee relationship, and a bargain results, then amt of bargain may be found to constitute income to person getting income. (Pellar case)

7. Barter Transaction…parties are trading benefits in consideration for each other. Cat care and looking after house, in exchange for free living space.

- Amt of income for both parties is the fair mkt value of benefit.
- Fair mkt value of cat care…costs saved by housesitting

8. Mitch purchases stock in XYZ corp in yr 1 for $1000, at end of yr 1 stock is worth $1500.

(a) YEAR 1: no gain included in GI, not realized
(b) YEAR 2: no income
(c) YEAR 3: no income. $2000 is a loan, he still owns stock, no realized gain
(d) YEAR 4: repayment has no impact…destruction makes no difference—still has ownership interests. he never disposed of stocks, no tax consequences
(e) YEAR 5: no actions by Mitch to dispossess himself, the change in form of the corp was not his doing…there is no gain/loss
(f) YEAR 6: Income=$3000 (paid $1000 for it, sold it for $4000). The stock was used to discharge an obligation—the previously incurred debt.

- **A discharge of an obligation gives rise to income…the same as if he sold stock and paid creditor in cash.**

Gifts: only considered so if given out of disinterested generosity

II. VOCABULARY

- ACCESSION TO WEALTH
- APPRECIATION
- BARGAIN PURCHASE
- BARTER
- EXCLUSION
  Those items not included in taxable gross income
- FAIR MARKET VALUE
  Price a willing buyer would pay a willing seller, w/ neither under a compulsion to buy or sell, and both having reasonable knowledge of relevant facts
- GROSS INCOME
  §61 – all income from whatever source derived
- IMPUTED INCOME
  Non-taxed income which is divided into two categories…
  (1) from services
  (2) from property
- REALIZATION
  The time at which any income, appreciation gains are taxed.

III. OBJECTIVES

IV. OVERVIEW

What is income?? (Haig-Simons)
Sum of:
(a) taxpayer's personal expenditures plus (or minus)
(b) the increase (or decrease) in taxpayer's wealth

A. THE SEARH FOR A DEFINITION OF INCOME

§61 – GROSS INCOME defined…
"all income from whatever source derived, including (but not limited to) following items…"

- (1)(a) includes "compensation for services," including "fringe benefits"
- Reg §1.61(a)…includes income realized in any form, whether in money, property or services."

Eisner v. Macomber:
Defined gross income as the "gain derived from capital, from labor, or from both combined."

- But this is incomplete b/c other cases further narrowed this concept of income.

B. INCOME REALIZED IN ANY FORM

C. REALIZATION, IMPUTED INCOME AND BARGIN PURCHASES

COMMISSIONER v. GLENSHAW GLASS CO.

F: G failed to report payment of punitive damages received as income for tax purposes. Tax Court and Ct of Apps upheld the taxpayer, commissioner appeals.
I: Whether these damages should be considered as taxable income under §61(a)?
H: "gains or profits and income derived from any source whatever" just b/c the payments were from wrongdoers as punishment for unlawful conduct does not detract from their character as taxable income. Actual and punitive damages are taxable.
Ruling: **reversed. Punitive damages are taxable income.**

1. Defined gross income as "accessions to wealth"
2. Taxpayer received damages….so do these count as income for tax purposes?
   Eisner definition is not applicable…
3. Court in this case…refined def of income to be "accession to wealth, clearly realized, and over which the taxpayer's have complete dominion."
   What about a gift? Well you're still better economically off….but they are not considered income…b/c Congress provides an exception to gifts under Glenshaw Glass.

BASIC INCOME TAXATION

CHAPTER 3 – EFFECT OF AN OBLIGATION TO REPAY

I. PROBLEMS

(1) Steve receives royalty payments for his book of $25,000 in Y1, but in Y2 the company said there was a mistake and payments should have been $20k. what's steve's income?

TWO CHOICES…

- Report all $25k for Y1 tax return, and get a $5k deduction in Y2
- Or just report only $20k in Y1

Time value of money…$1 today is worth more than $1 next year….you can get interest on it for a whole year. Measured by interest rates charged on borrowed money.

(2) Whether the loan Linda received on July 1 constitutes gross income for Y1?

(3) Embezzled money must be included in income for year embezzled. However, if money is borrowed, no income is reported

(4) Advance payments v. true security deposit….

- True security deposit does not belong to recipient until applied to the last month's rent…so it is NOT included as income when collected.
- Advance payments must be included as income in year received.
- In this problem, K must return security deposit if tenant complies w/ all terms. According to contract, tenant has right to get it back. Under IPL (IN power & light case) standard, it is NOT income when received…but a true security deposit. Once it is applied to rent it is taxed.

STANDARD after IPL….**CONTROL FACTOR**…

- Which party has control over whether the money will be returned or not?

II. VOCABULARY

- CLAIM OF RIGHT (finding money, etc.)
  A taxpayer who properly reports income under the claim of right doctrine is entitled to a deduction if subsequently required to refund the money.

III. OBJECTIVES

IV. OVERVIEW

A. LOANS

LOANS DO **NOT** CONSTITUTE GROSS INCOME – do not represent an "accession to wealth" or increase in taxpayer's net worth b/c the loans are accompanied by an equal and offsetting liability.

- Repayment is not a deductible expense
- Lender has no income when loan is repaid
- Lender has no deduction when loan is made

HOWEVER, a failure to repay may generate tax consequences…payment of one's liabilities by another may give rise to gross income.

B. CLAIM OF RIGHT

C. ILLEGAL INCOME

- Gains from illegal business may be taxed.
- Embezzled funds are included in gross income
- Extorted funds constitute income
- Repayment of illegal income entitles taxpayer to a deduction

D. DEPOSTIS

§1.61-8(b)…rent paid in advance constitutes gross income in the year it is received regardless of the period covered or the taxpayer's method of accounting.

What about security deposits??

Deposits must be included in income for the tax year received…however, if returned to lessee, they constitute a deduction for taxpayer.

NORTH AMERICAL OIL CONSOL v. BURNET

F: profits were earned on property owned by NA Oil in 1916, but payments were not made to the company until 1917.

I: Whether a sum of money received by NA Oil in 1917 was taxable as income that year?

H: Profits made in 1916 were not taxable b/c it was for money that the company may never receive. The income is not considered taxable until the payments are actually made, in this case, in 1917.

Ruling: **if taxpayer receives earnings under claim of right and w/o restriction as to its disposition, he has received income that he is required to return even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.**

1. When were the earning first includable in the oil companies earnings? The court held you don't have to include in income money you've earned but might not have any right to ever receive
2. When taxpayer finally received those earnings, then they are to be reported – this is the claim of right doctrine.
3.

JAMES v. UNITED STATES

F: a union official and another embezzled in excess of $700k over 3 yrs from their employer and ins co and then failed to report the money as gross income. They were later convicted for tax evasion.

I: Whether the embezzled funds are to be included in gross income of embezzler for year embezzled?

H: YES. This case overrules Wilcox, which held that embezzled income is not taxable. This court held that under §1.61-14(a) that illegal gains constitute gross income…and that it was the intention of Congress to tax all gains except those specifically exempted, of which embezzled gains is not.

COMMISSIONER v. INDIANAPOLIS POWER & LIGHT CO.

F: IPL requires certain customers to make deposits w/ it to assure payment of future bills for electric service. Those customers having to make deposits were based on their suspect credit…IPL relied on credit test, but there was no fixed formula. Later IPL amended their process and based it on a fixed formula…and the money could be returned provided the customer made timely payment for a consecutive number of months. C contends that these deposits were advance payments and taxable, ILP argues that the deposits are similar to loans.

I: Whether the deposits by IPL's customers constitute gross income?

H: only when a taxpayer enjoys "complete dominion" over a given sum, has the taxpayer assumed the income and therefore is taxed accordingly. The key is whether or not the taxpayer has some guarantee that he will be allowed to keep the money…IPL had no such guarantee w/ the deposits.

Ruling: court holds that IPL did NOT have that such dominion over the customer deposits to qualify it as taxable income at time they were made.

BASIC INCOME TAXATION

CHAPTER 4 – GAINS DERIVED FROM DEALINGS IN PROPERTY

I. PROBLEMS

(1) Dennis purchased land 10 yrs ago for $100k. He sold land this year for $175k. How much income should D report?

$75k…amount realized ($175k) minus adjusted basis ($100k) = gain/loss

§61(a)(3) – any gain is included in income
§1001 – gain is the amount realized less the adjusted basis
§1011 – the basis is determined under…§1012 – basis means cost
§1013 – provides for downward adjustment of basis

(2) Maggie bought house for $100k. Used $15k of own and borrowed $85k from S&L.

- In Year 1…her basis is $100k the cost of home.
- Adjustments under §1016…
- In Year 5, M refinanced…she still owed $75k and borrowed additional $50k. Mortgage now $125k. $40k used to build new room, $10k to take vacation.
- Year 7 she sold house and purchaser paid $80k in cash and assumed the $120k mortgage balance.
  - (a) Maggie's tax conquences?
    $200k (amt realized) - $140 (adjusted basis = original basis + improvements) = $60k (income)
  - (b) Basis purchaser will take in home?
    $200k (cost)

(3) Clare owes Dr. W $5k for medical services. To satisfy, C gives one of her paintings w/ fmv of $5k. Year 5, Dr. W sells painting for $10k. BARTER TRANSACTIONS

(a) Dr. W's tax consequences of receipt and sale of painting?
RECEIPT… no tax consequences b/c it was in satisfaction of debt owed
SALE… $5k income (diff in amt realized and adjusted basis)
Adjusted Basis under §1012…cost basis is $5k

- Phildelphia park says that the basis received in barter exchange is the fmv of property received at time of transaction.
- TAX-COST BASIS…

(b) C's tax consequences assuming she invested $100 in materials used to create painting and 25 hrs of time?
$4900… amt realized less adjusted basis (cost of materials)

(4) Year 5, M exchanges $15k sailboat for $15k value vacant lot w/ P. M paid $10k for boat in Year 1 and used it for personal purposes. Year 6, M sold lot for $25k

- Amount realized boat – Adjusted Basis boat = M's gain
  ($15,000) - ($10,000) = $5000
- Tax consequences on sale of lot?
  Amt realized ($25k) – adjusted basis ($15) = $10k
  (selling price) - (fvm of amt received) = gain

(a) Vacant lot had fmv $20k at time of trade, and M gave P sailboat plus $5k cash for lot. What tax consequences on sale of lot for $25k?
$25k - $20k = $5k

- M's gain on disposition of sailboat?
  Amt realized ($20k) – adjusted basis ($15k) = $5000
  (fvm of lot) - (cash and cost of boat) = gain

(b) Instead of give P cash, M assumed $5k mortgage. Later paid $2k on mortgage, then sold lot for $25k. Purchaser paid M $22k and assumed $3k mortgage. Tax consequences to Maureen?
($22k + $3k) – ($15k + 5k) = $5k

- AR boat – AB boat = gain
  AR boat is fmv of lot encumbered by mortgage
  ($20 – 5k = 15k)
  AB boat is original cost or $10
  Gain = $5000
- AR lot – AB lot = gain
  AR lot is $25k…sells lot for $22k + $3k mortgage
  AB lot is $20k…the fvm of what she received in exchange. It was $15k in lot, but her mortgage is also included in cost, $5.
  Gain = $5000

II. VOCABULARY

- AMOUNT REALIZED
  §1001(b)…this equals the money received plus fair market value of any other property received.
- BASIS
  § 1012…equals cost, except where otherwise provided
- ADJUSTED BASIS
  Unrecovered cost…i.e. amount paid for stock that is not recovered after stock is sold.
- COST BASIS
- TAX COST BASIS
  i.e., basis
- GAIN
  (Amount realized) – (adjusted basis) = gain
- RECOVERY OF CAPITAL
  The amount of capital/investment a taxpayer is entitled to recover tax-free…protects the taxpayer from being taxed a second time.

- NONRECOURSE DEBT
  Where there is NO personal liability associated w/ borrowing
- RECOURSE DEBT

III. OBJECTIVES

Three techniques of COST RECOVERY:
(1) Deduction…could get business cost deduction to cover cost of materials used
(2) Capitalizatoin & Depreciation…you deduct or recover the cost over a period of time
(3) Disposal…reduces gross income by subtracting out basis (cost) from amount realized when you sell the item

IV. OVERVIEW

§61(a)(3)…"gains derived from dealings in property"
- Interpreted in §1.61-6(a)…"gain is the excess of amount realized over the unrecovered cost or other basis for the property sold or exchanged."

A. TAX COST BASIS

If I want to buy a $40k car and have to borrow $30 to do so…what is my basis?
- Whole cost includes both the cash paid and loans incurred to buy the item.

RULE: Amount of recourse debt borrowed to purchase property is included in the basis of that property.

RULE: Debt on property that is assumed by purchaser of property is included in seller's amount realized.

RULE: In a taxable exchange, the basis of property received in exchange is the fmv of property received as of date of exchange. (Philadelphia Park Rule)

B. IMPACT OF LIABILITIES

1. IMPACT ON BASIS

2. IMPACT ON AMOUNT REALIZED

C. BASIS OF PROPERTY ACQUIRED IN TAXABLE EXCHANGE

PHILADELPHIA PARK AMUSE CO. v. UNITED STATES
F:

BASIC INCOME TAXATION

CHAPTER 5 – GIFTS, BEQUESTS AND INHERITANCE

I. PROBLEMS

(1) John was given $10k in honor of 20 yrs as football coach. The check was from funds given by assistants, former players, alumni, and local businesses, not the Univ.
Is the $10k excludable as a gift under §102(a)?

- Under §102(a), gifts, bequests, inheritance are not included in GI. However, under §102(c) this does not include gifts from employers to benefit the employee, this must be included in GI.
- Under §74(b), GI does include amounts received as prizes and awards, unless awards made in recognition of achievement and recipient was selected w/o his action, he is not required to render future services as condition, and prize is then transferred by payor to organization designated by recipient.

ANSWER: GIFT…the award to John was in recognition of 20 yrs as coach…not to retain him or a prize that he was designating to another organization. Since the University did not give him the money §102(c)(1), but instead it came from assistants, former players, alumni, and local businesses…the money can be seen as a gift and excludable from GI under §102(a).

EMPLOYER situation…must ask:
1. Is the employer actually involved, did they give out the gift?
2. Is it a gift at all?

ISSUES…
(a) Assuming gift, is it from J's employer? If yes, then includable in GI.
- What's J's argument to keep this gift excluded?
  Employer was just a conduit, did not specifically give him the money…did not provide money for the honor.

(b) Assuming no gift from J's employer, is it really a gift at all or just compensation for services?
- Must look at intent of donor…under *Duberstein* case.
- GIFT is something given w/o any expectation of return benefit, given out of detached or disinterest generosity. If transferor meets this factual standard based on donor intent, then it does count as GIFT.
- Intent…did donor take a tax deduction?
  If yes, then they did not really intend this to be a gift.
  --Donative intent would be absent and money received would have to count as income.

(2) Carolyn named rep in g/pa's will…assets were stock of $250k, that generated dividends of $20k/year. Will devised stock to C's aunt, but for C to be paid $25k for being the rep of estate. Under state statutes, rep's commissions are not to exceed 4% of gross estate…$10k in this case. however, C still awarded herself the $25k.
Is this $25k excludable under §102(a)?
- Carolyn will argue gift b/c she wants to exclude…
- State will argue that the money was compensation for her services and therefore includable in GI...b/c it exceeds the 4% allowed under state law.

ANSWER: GIFT…under *Duberstein*, must look at the donor's intent, it's obvious that G/pa intended $25k gift and no compensation .
1. Must look at donor's intention to determine whether Carolyn was being compensated for acting as personal rep, or whether it merely gift from g/pa.

BASIS RULES		
§ 1012	Applies when purchased	Basis = cost
Philadelphia Park case	Applies when you acquire the property in a taxable exchange	Basis = fair market value of property received at time of exchange
§ 1015 (gifts)	Applies when you receive an inter-vivos gifts	Basis = carry-over basis received from donor
§ 1014 (bequests)	Applies when you receive property from decedent at death	Basis = fair market value at time of decedent's death
§ 1.1015-4 (part-sale/gift)	Applies when transferor sells property for considerably less than the fair market value	Basis = the larger of cost or carry-over basis

BASIS RULES…
1. **§1012 –applies when purchased, and basis equals cost**
2. **Philadelphia Park—applies when you acquire property in a taxable exchange, and basis equals the fair mkt value of property received at time of exchange**
3. **§1015 (gifts) –applies when you get a gift, and basis equals the carry-over basis received from donor**
4. **§1014 (bequests) –applies when you receive property at donor's death**
5. **§1.1015-4 (part-gift/part-sale) –applies when transferor sells property for considerably less then the fmv**

(3) B purchased lot for $5k in Y1. In Y3, lot was worth $15k. B was offered this much for lot, but refused. In Y4, when worth approx the same amount, B deeded lot to son, R, as graduation gift.
(a) Does B or D recognize income on transfer?
- B = NO INCOME, no gain or loss b/c making a gift does NOT count as a realization event and not included in GI.

- R = Since B intended the lot to be a graduation gift, no income to R.

(b) What is R's basis in lot?
- $5000……§1015(a) the basis in property is same as in hands of donor, unless greater than fmv, then basis will equal fmv for determining losses.
- The appreciation to $15k will ultimately taxed to the donee when realization occurs, i.e., sale, transfer, etc.

(4) What if B is a realtor and son, R, is an employed sales agent?

(c) Does B or D recognize income on transfer?
- §102(c)…limitation on employee gifts…any amount transferred to employee for his benefit is included in GI
- But under TR §1.102-1(f)(2)…transfers to employees will not be considered GI if the employee, R, can show that the transfer was not made in recognition of the employee's employment.
- In this case, B was still giving to her SON, R, as a graduation gift, and has no relation, as far as we can tell, to his employment as sales agent.

(5) Same facts as #3, but lot decreased in value to $4000 at time Rob received it. Year later Rob sold for $3500.

(a) Rob's tax consequences?
- R's basis upon receipt = $4000 under §1015 (fmv at time received b/c determining loss)
- Amount Realized – Adjusted Basis = Gain
- $3500 - $4000 = $500 LOSS
- NO INCOME GAIN

1. His basis is $4000 b/c we are determining loss and that's the fmv.
2. What if Rob sold it for $5500?

He would have a gain, and the basis = $5000, b/c you are no longer determining loss. $5000 is B's basis when she bought the lot that carried over to Rob.

(b) What if he sold it for $4200?
- Amount Realized – Adjusted Basis = Gain
- Rob still recognizes NO GAIN OR NO LOSS b/c he resells the property for a price b/w the amount used for basis of loss ($4000) and basis of gain ($5000).

1. NO real solution, b/c under tax law there is no gain or loss recognized b/c if you re-sell property for amt b/w two amounts (loss basis, gain basis) you recognize no income or loss.

(6) Same facts as #3, but instead of giving R the lot, B sold it to him for $7500

(a) B's tax consequences?
- This transfer is considered PART-GIFT AND PART-SALE b/c the lot increased in value from $5000 to $15,000 during time B held it.
- Under §1.1001-1(e), when part-sale and part-gift, transferor has gain to extent that the amount realized exceeds his adjusted basis.
- $7500 is amt received for selling to Rob, $5000 is original cost (basis) to B
- Amount Realized – Adjusted Basis = Gain
- $7500 - $5000 = $2500 GAIN

1. Determine gain in part-gift/part-sale as same as in normal sale transaction.

2. What if lot was transferred for only $4000?

AR ($4000) – AB ($5000) = $1000 loss….this is wrong b/c under §1.1001(e), the transferor has a gain to the extent that AR exceeds AB, but NO LOSS is sustained if AR is less than AB (no recognition of loss voluntarily sustained).

(b) Rob's tax consequences?
- Fmv = $15k…
- Under §1.1015-4(a), where part-sale/part-gift, the unadjusted basis in transferee is sum of the **greater** of amount paid by transferee ($7500), or transferor's adjusted basis at time of transfer ($5000)
- In this case, the greater is amount paid…$7500
- Rob's basis = $7500

1. Rob has to take the basis that is the GREATER…Donor's basis, or buyer's basis … under Treas Reg §1.1015-4
2. The gift basis = carry-over basis, the sale basis = cost. Part-sale/part-gift rules say that you take the basis that is greater of two.

(7) Same as #3, but B devised lot to R in will. At time of B's death, lot's value was $15k.

(a) Rob's basis in lot?
- Under §1014(a), the basis of property acquired from decedent is the fmv of property at time of decedent's death.
- Rob's basis = $15,000

(8) Same as #3, except R was B's elderly g/pa and died w/in 6 mos after receiving lot from B. R's will devised lot and other property to B's son, Rusty.

(a) What basis will Rusty take in lot?
- Rob's basis = $5k if B gives it to Rob as a gift b/c that is the carryover basis under §1015 (original cost of lot to B).
- If to Rob as gift, then when R dies, devising to Rusty, Rusty's basis is $15k, or the fmv at time of decedent's death

under §1014, and under §1014(e)Rusty will have a stepped-up basis of $10k

- If B devises it to Rob in her will, then Rob's basis =$15k, or fmv at time of decedent's death under §1014.
- If to Rob under will devises to Rusty, then Rusty's basis is also $15k, but no-stepped up basis.

II. VOCABULARY
- GIFT
- BEQUEST
- DEVISE
- INHERITANCE
- PART-GIFT, PART-SALE
- EXCLUSION
- STEPPED-UP BASIS
- CARRYOVER BASIS
- BASIS FOR PURPOSES OF COMPUTING LOSS

III. OBJECTIVES

IV. OVERVIEW

A. WHAT IS EXCLUDED BY §102?

1. THE NATURE OF THE GIFT

Under *Duberstein*, SC held that the critical consideration is the MOTIVE OF THE DONOR…the transferor's intent.

§102(c)…denies exclusion for amounts transferred by employer to, or for the benefit of, an employee.

§274(b)…denies deductions to businesses for any gifts made to individuals in excess of $25

2. THE NATURE OF THE BEQUEST OR INHERITANCE

3. STATUTORY LIMITATIONS ON THE EXCLUSION - §102(b)

§102(b) two limitation on the exclusion

(1) Income from property received is not excludable from GI (i.e., the stock received as gift is excludable, but not dividends received as a result of the stock gift)

(2) Denies exclusion to gifts, whether made during life or at death, of income from property. (i.e., a life estate to A w/ remainder to A's kids…??)

B. BASIS OF PROPERTY RECEIVED BY GIFT, BEQUEST OR INHERITANCE

1. GIFTS OF APPRECIATED PROPERTY

§1015…substituted basis

- If property is acquired by gift, the BASIS shall be the same to recipient as it would be in hands of donor, or last person who did not receive property as a gift. If basis is greater than fmv of property at time of gift, then to determine loss, the basis equals fmv.

APPRECIATION INHERENT IN GIFTS MAY ULTIMATELY BE TAXED TO THE DONEE

2. GIFTS OF PROPERTY – BASIS IN EXCESS OF FAIR MARKET VALUE

Although gains are shifted from donor to donee, loss are NOT. When a loss is present, the basis then equals fmv. §1015(a)

3. BASIS OF PROPERTY RECEIVEDB Y BEQUEST OR INHERITANCE

STEPPED-UP BASIS…

- §1014…provides a tax relief for the gain inherent in property at time of a person's death. The devisee or heir receiving the "stepped-up basis" can sell the property for its value as of the decedent's death and not realize any gain.
- Only the appreciation occurring after decedent's death is subject to tax.

§1014(b)(6)…applies this to a surviving spouse's ½ share of community property "if at least ½ of whole of community interest in such property was includable in determining value of decedent's gross estate."

C. PART-GIFT, PART-SALE

§1.1001-1(e)…the seller-donor has gain to the extent that the amount realized exceeds the adjusted basis of the property. Also, NO loss is recognized in such transaction.

§1.1015-4…favors taxpayer by providing that the donee's basis will be the GREATER of the amount the donee paid for property or adjusted basis of donor.

COMMISSIONER v. DUBERSTEIN

F: D and M did minor business together. In consideration of all his help, M wanted to give B something in return. M gave B his cadillac, but then later wrote it off as a business expense. However, B did not include in GI thinking it was a gift. A deficiency was asserted against him.

I: Whether the cadillac was a gift?

H: NO.

Must look at all the facts and circumstances to decide donor intent.

- **A gift is based on the detached and disinterested generosity w/ no expectation of a return benefit.**

BASIC INCOME TAXATION

CHAPTER 6 – SALE OF A PRINCIPAL RESIDENCE

I. PROBLEMS

(1) Brian and Jen purchased home in Denver in 1986 for $225k…joint tenancy w/ ROS. This was their principal residence until June 1999 when moved to ID, and purchased home there for $250k. In Jan 2000, B&J finally sold Denver home for $400k cash, and $200k assumed mortgage. B&J adjusted basis in Denver was $275k.

(a) B&J's tax consequences on sale of Denver home if file jointly?

- Amt Real – Adj Basis = Gain
- $600k - $275 = $325
- Under §121(b)(2)(A), the amt of gain excluded from GI w/ respect to any sale or exchange shall not exceed $500.
- The $375 GAIN is excluded from GI b/c B&J both meet the ownership, use, and eligibility requirements under §121(a).

(b) Would (a) change if title to Denver was held by J alone?

- YES. If B&J do not file a joint tax return, then only $250k gain on sale or exchange of property is excluded from GI. Therefore, $125k is still taxable gross income.
- If still filing jointly, then NO change.

(c) Assume J purchased Denver home in 1986, and met B in July 1998. B&J live together in Denver until ID. One month before sale, B&J married and title transferred to both names as Tenants in Common. Does answer to (a) change?

- Brian does not meet the "use" requirements under §121(b)(2)(A)(ii), therefore, §121(b)(2)(B) applies.
- Jen's exclusion = $250k, but Brian has no exclusion under §121(c)(2)(A)(i)…total exclusion = $250.

(2) Assume facts of #1(a) and after living in ID for 1 year, B&J sold ID home and moved to VA, where J got new job (§121(c)(2)(B)). B&J realize a gain of $60k on ID home. Sale occurred exactly 6 mos after sale of Denver home.

Tax consequences on sale of ID home?

- Under §121(c)(1)&(2)…
- 6 mos/2 yrs….= 6mos/24mos = ¼
- ¼ x $500k = $125k excludable from GI on sale.
- $500k is recognized b/c of joint filing

actually, 9/24 = 3/8 x $250 = $93,750
9 mos living there….not after sale of denver home

(3) Maggie practices law in NY and rents apt in Greenwich Village. She owned summer home in ME for while and now decides that upkeep is prohibitive. The home appreciated substantially and Maggie is concerned about the gain she will have to report upon selling property. Friend advised her that she could avoid this gain if she moved to ME and lived there for 2 yrs. She could maintain practice by living in NY 5 days/month and communicating thru technology during rest of time. How should we advise her?

II. VOCABULARY

- PRINCIPAL RESIDENCE

III. OBJECTIVES

IV. OVERVIEW

A. §1034 AND §121 BEFORE THE TAXPAYER RELIEF ACT OF 1997
B. §121 AFTER TAXPAYER RELIEF ACT 1997
1. OWNERSHIP AND USE REQUIREMENTS
2. AMOUNT EXCLUDABLE
3. PRINCIPAL RESIDENCE
4. CONCLUSION

§121…

(a) General rule…exclusion from GI a gain from sale/exchange of property if that during last 5 yrs, if for more than 2 yrs the sale was of taxpayers principal residence.

- Principal residence defined in case law…
- Elements that must be satisfied…
  - (i) ownership…aggregated 2 yrs over last 5 yrs
  - (ii) use…used it as principal residence
  - (iii) eligibility…

(b) Limitations…

- (2)(A) $250k limit increases to $500k…for spouses filing joint return
- (3) you can only use this benefit exception once every two years
-

(c) may be able to get partial exclusion under this section…if not under (a)

BASIC INCOME TAXATION

CHAPTER 9 – DISCHARGE OF INDEBTEDNESS

I. PROBLEMS

(1) Grandma lent Jessica $10,000 for college. Right before death, G/ma forgave the $10k debt that Jessica owed, the forgiveness was in appreciation of the care which Jessica provided her during the last years of her life. Tax consequences to Jessica of debt forgiveness.

If discharge of indebtedness…it's considered GI under §61(a)(12)
If gift, then excluded from GI under §102
If compensation, then included in GI under §6(a)(1)

- Jessica's arguments…the forgiveness was a bequest excluded from GI under §102. Argument could succeed based on family relationship and **donative intent at time debt was cancelled** (detached and disinterested generosity w/o any expectation of future services or return of past services)
- Gov't arguments…that the forgiveness is compensation for services rendered, then §108(a) does not apply and the cancellation must be included in income.

ANSWER:
Jessica must include in GI…does not fit any §108 exclusion.
Unless gift, then excluded under §102

(2) Kevin borrowed $50k from Lender to finance purchase of shoe store inventory. After operating less than one year, K had to liquidate b/c of poor downtown economy. As such, L decided to accept $20k lump sum payment in satisfaction of $49k loan balance.

(a) What result to Kevin? Assume he is solvent.

- Under §108(a), Kevin fails to meet any of the requirements for exclusion b/c he is not filing for chapter 11, is not insolvent, not farm indebtedness, not real property business indebtedness.

ANSWER:
Under §61(a)(12), Kevin must include $29,000 in GI…the amount not repaid of the original loan proceeds.

(b) Does above answer change is K instead owed $49k in back wages, and employees accepted $20k in satisfaction of back wages?

- Under §108(e)(2), forgiveness of a debt does not generate income if the payment of the debt would be deductible.
- In the case of employer/employee relationship, paying employees entitles employer to a deduction. Since K already lost the deduction by not paying, there is no need to tax the discharge…

ANSWER:
The $29,000 is NOT included in Gross Income, as it falls under the §108(e)(2) exception.

(c) What results if K's uncle lent K the money when K was under age and debt was unenforceable?

- The Uncle's lending of money could be considered a gift under §102 provided there was no expectation of a return benefit.
- Under *Zarin*, SC held that if a loan is unenforceable, there is NO real loan. Therefore, there is no income b/c there is nothing to discharge.

ANSWER:
Either way—NO income

(d) Would answer change if K's parents purchased debt from L for $20k? What happens if later the parents forgave the $49k balance K owed?

- Under §108(e)(4)(A)…the acquisition of outstanding indebtedness from a parent (certain relatives) from a non-relative shall be treated as if the debtor is acquiring the debt.
- When the parents purchase the debt, their acquisition of debt is treated as an acquisition by Kevin.

ANSWER:
Kevin must recognize the $29,000 income

- When K's parents forgive the remaining balance, it can be treated as a gift under §102 provided it is done out of detached and disinterested generosity.

ANSWER:
Kevin must recognize the $29,000 at time parents acquire the debt, but never the other $20,000 gift.

(3) Bill borrowed $75k from Judy and later, when B was insolvent, J accepted a tract of unimproved land in satisfaction of debt. B purchased Land for $25k and fmv was $30k when J got it. B's liabilities included $75k debt owed to J, and $50k indebtedness

to other parties. Bill's other assets included equipment w/ AB of $70k and fmv of $65k. B is also guarantor of son's $25k loan.

(a) How much income must B report as result of settlement w/ J?

- $75k (debt) - $30k (fmv) = $45k discharge of indebtedness
- Bill gave up $30k value in land to pay off a $75k debt, therefore there is a $45k discharge of indebtedness.
- Under §108(a), when taxpayer is insolvent this discharge can be excluded, but only to the amount of insolvency (§108(a)(3))

ASSETS at time of discharge…

$65,000 (fmv equip) + $30,000 (fmv land) = $95,000

LIABILITIES at time of discharge…

$75,000 (J debt) + $50,000 (other debt) = $125,000

AMOUNT OF INSOLVENCY…

$125k - $95k = $30k

ANSWER:

Of the $45k discharge of indebtedness, $30k may be excluded from income. Bill must report income of $15,000 under §61(a)(12)

(b) What effect does settlement have on B's basis in equip?

- Under §108(b)(2)(E), and §1017…an amount excluded under §108 is to be applied to reduce basis of property held by taxpayer in next taxable year.
- Under §1017(b)(2)…reduction of basis shall not exceed (A) over (B).
  - (A) Aggregate of the bases of property held by taxpayer immediately after the discharge
  - (B) Aggregate of the liabilities of taxpayer immediately after discharge
- (A) = $70k (adjusted basis of equip)
- (B) = $50k (other debt still owed)

ANSWER:

Bill's reduction in basis is $20,000. This reduces the $30k already excluded from income, so there is a $10k permanent exclusion under §1017.

- The larger your basis is, the smaller your gain when you sell property.

(c) What basis will J take in land received from B?

- J will have a $30,000 basis in B's land b/c this transaction is characterized as a taxable exchange.
- Under *Philadelphia Park*, basis equals fmv at time of exchange.

(4) Skip

(5) Chistina entered contract to purchase condo from Julie for $75k. When C still owed J $65k, the fvm fell to $60k b/c of real estate mkt. To prevent C from defaulting on contract, J ageed to reduce balance owing to $50k. What are C's tax consequences?

- $15k discharge of indebtedness, which also equals the decrease in condo's value ($75k to $60k).
- Under §108(e)(5), if the debt of a purchaser of property is reduced by seller, and if it is not reduced b/c of chap 11 or insolvency, then such a reduction is treated as purchase price adjustment.
- This means that the situation is treated as if the two parties originally agreed on a lower purchase price.

ANSWER:

Christina has no income to report. However, the basis in condo is lowered.

Therefore, as long as all requirements of §108(e)(5) are met, C will have to recognize a greater gain later, but nothing right now.

§108(e)(5)…purchase-money debt reduction

IF…

1. **debtor owes money to seller,**
2. **debtor is not insolvent or in bankruptcy, and**
3. **discharge of debt would otherwise be treated as income**

…THEN, THERE IS NO INCOME TO RECOGNIZE NOW, but will have to recognize a greater gain later.

(6) Lloyd is professional actor and received $10k for toothpaste commercial. But even after payment, L remained insolvent.

(a) What are L's tax consequences of receiving the $10k?

- Compensation for services is distinguished from discharge of indebtedness.
- B/c L is receiving $10k in return for services, there is no discharge of debt and the $10k must be included in GI for taxing purposes.

ANSWER:

L must report $10k in GI

(b) Does answer change if L owed $10k to produce of commercial and debt is canceled in lieu of paying $10k to L?
- NO…L is still being compensated for services rendered.

ANSWER:
L still must include the $10k in GI

II. VOCABULARY
- INSOLVENCY
- INCOME FROM THE DISCHARGE OF INDEBTEDNESS
- QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

III. OBJECTIVES

As a general rule, discharges of indebtedness are included in GI under §61(a)(12).
But §108(a) provides exceptions where the person is insolvent or in chapter 11 bankruptcy
- §108(a) generally deals w/ taxpayers that are insolvent or in bankruptcy when debt is cancelled. The cancellation of indebtedness is excluded from GI to extent of insolvency. However, this is TEMPORARY exclusion b/c in order to apply (a), (b) must also be applied.
- §108(b) in exchange for excluding the discharge from income, the taxpayer must reduce a tax attribute. Tax attributes are things that taxpayers like.
  Ex: net operating loss, basis
- §108(a)…I am insolvent and someone cancels a debt. I can exclude this to the extent of insolvency but cost of doing this is that I must reduce a tax attribute because of (b); for example basis. The exclusion is TEMPORARY – exclusion now is at the cost of a higher reduction later.

If the §108(a) exclusion applies, but the cancellation is really a compensation for services rendered, then §108(a) does not apply and the cancellation must be included in income.

IV. OVERVIEW

A. SPECIFIC RULES GOVERNING EXCLUSION
1. DISCHARGE OF INDEBTEDNESS WHEN TAXPAYER IS INSOLVENT
- No income results if a taxpayer were insolvent before and after the discharge or cancellation of a debt.
- However, a debtor will realize income to extent that discharge of indebtedness makes debtor solvent

§108…The discharge of indebtedness will not generate gross income if the discharge occurs in bankruptcy case, or when taxpayer is insolvent.
- Except provided in this section…there is NO insolvency exception from GI including the discharge of indebtedness.
- Instead of providing permanent exclusion for income, may just defer reporting of income and reduce other tax benefits, i.e., depreciation deductions.

2. DISCHARGE OF QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS
- §108(a)(1)(D)…exclusion for income from discharge of "qualified real property business indebtedness"…taxpayer qualifies once he make an election for this exclusion.
- The amount excluded may not exceed the outstanding principal amount of debt less the value of business real property before securing debt.
  - DEBT – VALUE = EXCLUDABLE AMOUNT
- This excludable amount cannot exceed the aggregate AB of taxpayer's depreciable real property held immediately before discharge.

3. PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTORS
- §108(e)(5)…when debt of taxpayer has been cancelled, no income results, but rather a retroactive reduction in purchase price.
- Accordingly, basis of taxpayer in property is correspondingly reduced.

4. ACQUISITION OF INDEBTEDNESS BY PERSON RELATED TO DONOR
- §108(e)(4)…if person related to debtor acquires the indebtedness, the acquisition shall be treated as an acquisition by debtor.

5. DISCHARGE OF DEDUCTIBLE DEBT
- §108(e)(2)…forgiveness of a debt does not generate income if payment of debt would have been deductible.

B. DISCHARGE OF INDEBTEDNESS AS GIFT, COMPENSATION, ETC.
- Taxpayers will most likely be UNSUCCESSFUL in arguing the discharge of indebtedness in commercial context as an excludable gift.
- However, in certain, more personal contexts, the discharge of debt can be an excludable gift.

UNITED STATES v. KIRBY LUMBER, CO.
F:

§108

General rule…discharge counts as income unless it's a gift, or you fall under insolvency rules.

§108(a), if taxpayer is insolvent, then discharge doesn't count as income to extent of insolvency.

§108(b), says that there is a cost to be imposed on taxpayer for getting this benefit.

- Requires taxpayer to reduce one of their other tax attributes
- Combination of (a) and (b) is really a deferral of income, not a permanent exclusion.
-

§108(c),

COMPENSATION FOR SERVICES…

HYPO: exclusion applies. Individual is insolvent, debt is cancelled.
But the debt is really compensation for services…then this always counts as income despite the fact that taxpayer may fit under §108(a).

BASIC INCOME TAXATION

CHAPTER 10 – COMPENSATION FOR PERSONAL INJURY AND SICKNESS

I. PROBLEMS

(1) Larry paid $100k to Bert in connection w/ business contract. After B breached contract, L sued B and recovered $175k, including $100k for funds advanced and $75k in lost profits. In lieu of the cash, L agreed to accept from B commercial land w/ appraised value of $175k. B's adjusted basis = $125k.

(a) Tax consequences to Larry?

- §104 does NOT apply to exclude damages received b/c the damages did not stem from personal physical injury or personal sickness. §104(a)(2)
- The 100$ received for damages is be excluded from GI b/c it replaces Larry's initial investment.
- However, Larry would have to recognize $75k in GI b/c lost profits are included b/c the profits they replace would have been included in GI.

(b) Tax consequences to Bert?

- AR – AB = gain
- $175 - $125 = $50,000 gain on disposition of land

(2) Tom injured last year in accident w/ drunk driver. Tom and other driver settled for $250k. (see allocation in book) Tom paid $3k from own pocket for med expenses and was allowed $1k deduction under §213. Remaining $7k med expenses was paid by T's health ins.

(a) Tax consequences to Tom as result of settlement?

- Pain and suffering: under §104(a)(2), full amount deductible for personal physical injury. The out of court settlement makes no difference. **He can exclude the $20k each year. $100,000 total excluded.**
- Reimbursed medical expenses: §104(a)(2) applies – all excluded except what is deducted as medical exp. under §213 ($1000). **$9000 excluded, $1000 included**
  - Deducted $1000 in previous year…this must be included in GI.
  - Raytheon doesn't apply when damages are received on account of personal physical injury. §104(a)(2) excludes these damages.
    - But, how much is excludable does not apply to amounts attributable to deductions allowed under §213.
- Future medical expenses: under §104(a)(2) may be excluded as personal physical injury, but no deductions may be taken later. **$15,000 excluded.**
- Lost Wages: Under §104(a)(2), excluded from GI so long as received due to personal physical injury. **$40,000 excluded from GI**
- Punitive Damages: under §104(a)(2) following 1996 amendment, this amount must be included in GI. **$75,000 included in GI**
- Damages to car: property damage is not personal physical injury or sickness. Therefore, any amount over the AB will be included in GI. Destruction of car w/ reimbursement is treated as realization event.
  - AR – AB = gain
  - **$10,000 gain**
- $7000 reimbursed from ins co: (only amount that own ins co provided) either excluded under §104(a)(3) or partially excluded under §105.
  - If employer financed, §105 applies. General rule is that amounts received are included unless it is for medical expenses. §1.105-2, exclusion under §105(b) is limited to amount of actual medical expenses.
  - **If employee financed**, §104(e)(3) applies. **$7000 is excluded from GI**, unless already deducted under §213…but not b/c it was out of pocket.
- Total tax consequences:
  - $1000 reimbursed medical expenses
  - $75,000 punitive damages
  - $10,000 gain on car
  - **TOTAL = $86k included in GI**

(b) Would answer change if T negotiated a settlement w/ ins co and T was paid $150k cash immediately w/ $100k paid over the next 5 yrs in cash installments? T wanted to allocate all damages to pain and suffering.

- All excludable if he can pull it offs

(3) Martha was fired after complaining about sexual harassment on the job. She suffered severe emotional distress as result of loss of job, this caused pre-existing ulcer condition to reemerge and resulted in hospitalization. M suffers from depression and see psychologist. Firm offers M $250k in settlement. What are the tax consequences to M in accepting the settlement? What if the sexual harassment was from actual touching and kissing?

- This is **non-excludable income under §104** b/c the origin of her suffering claim does not stem from physical injury.
- However, if the kissing and embracing was at issue, then maybe b/c it could constitute personal physical injury under §104??? But damages would still be divided up b/w touching/assault, harassment, emotional distress.

(4) Susan injured in skiing accident and lost sight in one eye. She incurred $30k medical expenses. She had accident health policy that she purchased that paid her $15k for med exp, $10k for lost wages, and $25k for loss of sight. Another accident and health policy provided by employer paid $20k for med, $12k for lost wages, and $20k for loss of sight. What tax results?
- Under §104(a)(3), everything from self-financed insurance policy is excludable (except to extent of previous medical deductions…none here).
- Under §105, employer financed…general rule is that all is included unless (b) medical expenses, or (c) permanent disfigurement or loss of limb (eye included)
  - LOSS OF EYE: excluded under §105(c)…not income
  - LOST WAGES: included §105(a) [Reg 1.105-3]
  - MEDICAL EXPENSES:
    - TOTAL EXPENSES = $30,000
    - SELF FINANCED = $15,000
    - EMPLOYER FINANCED = $20,000
    - $5000 EXCESS
- To determine how much of the $5000 excess is included in GI, you must first determine how much relates to employer financed and how much to self-financed.
  - TOTAL EMPLOYER FINANCE ÷ TOTAL MEDICAL EXPENSES
    - $20,000 ÷ $35,000 = 4/7 or **57%**
    - **57% of the $5000 excess must be included in GI or $2850…therefore, under §105(b), $17,150 is excluded**.
  - TOTAL SELF FINANCED ÷ TOTAL MEDICAL EXPENSES
    - $15,000 ÷ $35,000 = 3/7 or 43% are excluded from GI

II. VOCABULARY
- DAMAGES
- PERSONAL PHYSICAL INJURY
- PUNITIVE DAMAGES

III. OBJECTIVES

IV. OVERVIEW

A. DAMAGES

1. BUSINESS OR PROPERTY DAMAGES

What is still good law since amendments?
- **Raytheon Products** is still good law. It discusses business like damages…in order to determine whether the damages themselves are taxable you look at what the damages are replacing, so if you're suing for lost profits, you're damages are taxable under GI.
- Compensation for loss of good will in excess of its cost is gross income.

2. DAMAGES RECEIVED ON ACCOUNT OF PERSONAL PHYSICAL INJURIES OR SICKNESS
- 104(a)(2) excludes from imcome any damages received, whether by suit or agreement, as a lump sum or periodic payment, on account of personal physical injuries or sickness.
- This is distinguished from damages received for injury to one's business or property.

3. SC LIMITATIONS ON PRE-1996 VERSION OF §104(a)(2)
1992 – 1995…
- 1992 court ruled that sexual harassment damages are to be included in GI
- 1995 court ruled that in an age discrimination case the damages received are also included in GI.
- B/c of this uncertainty…amendment!!

4. THE 1996 AMENDMENTS TO §104
- Narrowed exclusion…
  - §104(a)(2) now also excluded damages of physical personal injury. (i.e., …)
  - Damages awarded to your civil rights are not excludable as income

5. PUNITIVE DAMAGES
- <u>Punitive Damages</u>: Never excluded anymore under new §104(a)(2)…
- <u>Emotional Distress</u>…under code it does NOT count as physical income or sickness. They ARE included in GI.
  - But if individual paid for med exp related to Emotional Distress, these damages are not included in GI.
- <u>Pain and Suffering</u>…are excluded from GI, they constitute physical personal injury or sickness.

6. ALLOCATIONS OF AWARDS
7. PERIODIC PAYMENTS

B. ACCIDENT AND HEALTH INSURANCE
- Under 104(a)(3), payments received through accident or health insurance policies are EXCLUDED from GI, provided that they are NOT employer financed, or financed through employee contributions not includable in taxpayer's income.

- Under §105 generally includes payments made by employer-financed accident and health plans in the employee's GI.

C. PREVIOUSLY DEDUCTED MEDICAL EXPENSES
D. WORKERS' COMPENSATION
   - §104(a) excludes from income
E. CERTAIN DISABILITY PENSIONS

§104

(a) Except in the case of deductions for amounts attributable to med expenses under §213, gross income does NOT include…
   (1) Amounts received under worker's comp
   (2) Amount of any damages received on account of personal physical injuries or sickness
   (3) Amount received though accident or health insurance for personal injury or sickness
      - Employer financed ins, then use §105
      - Any amounts received from own insurance is covered under §104(a)(3)
   (4) Amounts received as pension, annuity, or similar allowance for personal injuries resulting from armed forces.

BASIC INCOME TAXATION

CHAPTER 11 – FRINGE BENEFITS

I. PROBLEMS

(1) William is University President and in addition to salary he gets a university-provided home near campus. University purchased home specifically for president. In advising William re: tax consequences to him of the rent-free use of home, what kind of info would you want from him and why?

- Under §119(a), lodging is excluded only if three requirements are met:
  (1) Convenience of employer
  (2) On the business premises
  (3) Employee is required to accept lodging as condition of employment
- William sorta meets these requirements but §119(d) is better statute

Exclusion for qualified housing if on premises….but this is a few blocks away.

- Under §119(d), in case of educational employee, GI does NOT include value of qualified campus lodging furnished to employee during the year if…
  (1) on/in proximity of campus to educational institution
  (2) furnished to employee (spouse, dependents) on behalf of institution for use as residence
  (3) §119(a) must not apply
- In this case, William is w/in 5 blocks and this counts as proximity, the house is furnished as a residence, and §119(a) does not apply…

ANSWER:
No tax consequences for rent-free use of home….excluded from GI under §119(d)

(2) skip

(3) Walter is assoc w/ XYZ firm, which as unwritten policy that young associates should spend some time each week-day evening working at office. As result, Walter usually does not go home until 9pm on M-TH. The firm gives associates working late $15 to break and eat supper at nearby restaurant.

(a) Must W include the supper money in income?

- YES…two problems…meal is not furnished for convenience of employer and not on business premises. Also, W is not given food, but cash.
- However, if W was to use the money in his business' cafeteria, then the $15 would be excluded.

- §119(a) to apply, provided must be a meal, not cash, and provided on business premises.
- Since he is provided cash for outside restaurant, §119(a) is inapplicable.
- Under §1.119-1(e)…(p.918)…applies only to meals furnished in kind…the meal itself is furnished, not the cash. Actual food must be provided in order for §119 to apply.
  - Under §1.132-6(b) the meals (4 days/week) is not provided "infrequently" this is pretty consistent.
  - Further under, §1.132-6(d)(2)(A), for occasional meal money basis, three criteria required:
    (1) occasional
    (2) enables employee to extend hours
    (3) enables employee to work overtime of working during meal time (like lunch)

ANSWER:
Walter fails to meet the occasional prong b/c he is getting meals 4 days/week, §61(a)(1) applies and W has to include the meal money in GI every time he receives it.

(b) What if he skips dinner and keeps $15 for other expense?

- Same analysis…income must be included in GI…also under §61(a)

(c) What if firm had employee's cafeteria on premises providing free supper for late workers?

- Under §119(a), meals will be excluded from GI provided that the meals are provided for the convenience of employer and provided on premises.
- Both conditions are met…income will be excluded from GI.

(4) HotAir Inc operates hotels and airline. Corporate policy allows employees and relatives to receive 50% off at hotels, 50% on reserved airline seats, and free flights on standby basis. What tax consequences for the following circumstances:

(a) Linda Lawyer takes vacation by buying a $400 rt reserved seat ticket for $200 and receives 50% off her $600 hotel bill?

AIRFARE….

- PART (1)…
- Under §132(b)…service must be offered to customers in the line of business…AND employer incurs no substantial additional cost in providing such service.
  - HERE, L is GC for all of HotAir's lines of business, therefore, she meets the "in-line" requirement.
  - Apparently company is incurring substantial additional cost, in form of forgone revenue, and therefore the §132(b) exclusion is not applicable.
- If L had flown on standby basis, the seat would have been unfilled and L would not have caused airline to lose revenue….therefore, no additional cost exclusion does NOT apply.
  - Under §1.132-2(a)(5), the no-additional-cost exclusion would not apply, b/c L is flying on a reserved seat, which HotAir incurs a substantial

additional cost by giving to L at a discounted rate, when a normal paying customer could use it.

- PART (2)…
- Qualified employee discount means any employee discount w/ respet to qualified property/services to the extent such discount does not exceed, gross profit percentage (Porperty), or 20% of price offered to paying customers (services).
    - BUT, under §132(a)(2) for <u>qualified employee discount</u> to apply, according to §1.132-4(a)(1)(iv), the services must be provided in the line of business in which the employee works. HERE, L is GC for all of HotAir's lines of business, therefore, she meets the "in-line" requirement.
    - Then, under §132(c)(1), a qualified employee discount w/ respect to services is excluded from GI only up to 20%. If an employee's discount exceeds 20%, the excess discount is includible in employee's income, (§1.132-3(e)), unless another exception apply.
    - 20% x $price charged to normal customers = excluded GI
    - 20% x $400 = **<u>$80</u>** (the additional $120 must be included in employee's GI)

HOTEL…

- W/ regard to hotels, unlike airlines, reserving a room is not considered a substantial additional cost…unless the hotel is going to be filled to capacity, i.e., it's busy season. Otherwise company is not foregoing any revenue.
    - Under §132, must look at requirement that there be <u>no substantial additional cost</u>. Hotels are based on whether or not there was any vacancy regardless of reservation.
        - If predictable that hotel would be empty, no foregone revenue.
        - If hotel is likely to be booked w/ paying customers, then foregone substantial additional cost and exclusion may not be used.
    - Not enough facts to determine if the hotel would be fully booked or not…so,
    - Under §132(c)(1), a qualified employee discount w/ respect to services is excluded from GI only up to 20%. §1.132-4(a)(1)(iii) tells us that she meets the line of business req's for both hotel and airfare.
    - 20% x $600 = **<u>$120</u>** (the additional $180 must be included in GI)

(b) While staying at the hotel, Linda buys bracelet at hotel shop for discounted price of $300. The bracelet would sell for $500. A month later she sells it to sister for $400.

BUYING DISCOUNTED BRACELET…

- §132(j) places a non-discriminatory requirement on §132(a)(1)&(2). If only highly compensated employees may get benefit, the discount may not be excluded from as qualified employee discount or no-additional-cost item.
- Assuming no discrimination, then L can use qualified employee discount in §132(a)(2)…
- As such, the discount on property under §132(c)(1)(A) cannot exceed the "gross profit percentage."
- §132(c)(2) defines gross profit as (i) the excess of aggregate sales price of property sold by employer to customers over the aggregate cost of such property to employer, is of (ii) aggregate sale price of such property.
    - Assume that agg sales = $100,000, agg costs = $90,000
    - $100,000 - $90,000 = <u>$10,000</u> / $100,000 = 10%
    - 10% of $500 (price sold to public) = $50 (qualified employee discount)
    - Therefore, **<u>$50 of discount to L can be excluded from GI as qualified employee discount</u>**.
    - $200 (discount to L) - $50 (gross profit) = **<u>$150 included in GI</u>**

1. **This is not a no-additional cost service, b/c it is a good, not a service.**
2. Qualified emp discount available b/c she meets line of business req, so must look at gross property percentage.
3. Limit is gross profit times the price offered to customers. Divided by agg sales = gross profit %age.
4. see calculation above.

SALE TO SISTER…

- AR – AB = Gain
- $400 – ($300 + 150 + 50) = **<u>$100 LOSS</u>**
- $300 = amount paid
- $150 = portion of discount included in GI when purchase bracelet and excluded under §132(a)(2)…congress intended to prevent taxpayer from being taxed on the discount when property is sold, so it's included in basis.
- $50 = portion of qualified employee discount excluded from GI

1. In year when she purchases bracelet, must include $150 in income.
2. She paid $300 for bracelet, got discount of $200. $300 included in basis under §1012—your basis is your cost.
3. $150 that counted as income when she bought bracelet…since she was already taxed on this when she bought it, this amt is included in basis.

4. $50 that was excluded as qualified employee discount must be included in basis so she wont get taxed on that either.
5. Since she generates a loss, she wont be able to take it b/c generally business losses are not deductible to employees in personal income tax accounting.

(c) Alice is hotair flight attendant and husband Hal receives 50% discount on his $500 reserved ticket and his $200 hotel bill

AIRFARE…

- Under §132(h)(2), spouses and dependents are treated as employees for purposes of §132(a)(1)&(2). Therefore, in order to qualify for the exclusions, the person receiving the benefit must be an employee of the employer giving benefit (except de minimis fringe)
- §132(a)(1), can't use no-additional-cost exclusion b/c he reserved the seat, the airline has foregone revenue.
- §132(c)(2), qualified employee discount…
  - 20% x $500 = **$100 excluded from GI**
- The other $400 must be included in ALICE's GI under §1.61-21(4)(i).
  - Taxable fringe benefit is include in income of person performing the services in connection w/ which the fringe benefit is furnished…taxable even though the person did not actually receive the benefit.

1. A is in line of business…but one problem b/c Hal is husband and not employee. The exclusion is not available in this case…under §132(h)(2)(a), spouses can count as employee.
2. Therefore qualified employee discount is available and $100 excluded from GI. The other $150 is included as ALICE's income, since A is the employee.

HOTEL…

- The hotel discount does not apply in this case b/c Alice fails to meet the "line of business" condition for the exclusion under no-additional-cost or qualified employee discount.
- Therefore, the full **$100 discount received is included in ALICE's GI**

(d) Bob, Alice's brother, flies free on standby basis…a reserved seat was $300. he also gets free food and drinks on flight.

- The code does not give exclusion to anyone other than spouses and dependents (sometimes parents). Therefore, brothers are not permitted to use the §132(a)(1)&(2) exclusion.
- The **$150 discount on flight must be included in GI**.

1. Can the brother be considered an employee…well, must look to §132(h) where brothers are NOT included. The no additional cost exclusion therefore cannot be used.
2. Can qualified employee discount be used? No b/c the benefit is not being provided to the employee…it's to the brother who does not count as an employee.

(e) Reciprocal agreements…

1. The problem w/ getting a no additional cost exclusion is the employee/employer relationship. The employer must be providing the benefit to employee….but Alice is getting the benefit from Global and not Hot Air. But this fails the no additional cost benefit b/c a third party is providing the benefit.
2. Under §132(i)…rescues the benefit…it permits companies to enter into written agreements w/ each other, and if there is no additional cost incurred by either employer…the employee is treated as receiving the benefit from her own employer rather than from the 3rd party.
3. Since alice meets all the req's under §132(i) and §132(b), she will get to exclude the value of the flight from her income.

(f) Paula, HotAir's president goes to WA on business flying 1st class and staying in the luxury suite of a company hotel, and getting a company car…all for no charge.

- §132(d) working condition fringe…where employer provides item to employee, but if employee had paid for that item on her own she could deduct it as a business expense. This applies to air and hotel.
  - The full value of hotel and airfare are each excluded.
- CAR…had she paid for it she could have deducted the portion allocated to business use. That portion is treated as a working condition fringe and is excludable. The rest should be included in GI.

1. Under §132(d) working condition fringe…this benefit applies to anything that occurs in the course of business, not personal use of the benefits.

(5) XYZ law firm provides free parking for members of firm in private parking garage. Firm pays garage $150/month for each parking space. Attorney's using bus get $25/month to cover costs of bus pass. What tax consequences to member of firm who accepts free parking space or bus pass?

- §132(f) qualified transportation fringe…
  - (1) definition…
    - on or near the business premises (or location of pickup for mass transit), here across the street
    - not for residential purposes – okay.

- (2)(b) limitations…
  - no more than $175/month
- The $150 paid by firm each month for parking is fully excludable w/in the $175 limit.
- §132(f)(1)(B) any transit pass…
- (f)(5)(A) defines pass, token, farecard, voucher for mass transit facilities
- (f)(2(A) limit is $100/month. The $25/month costs of bus pass is w/ the $100 limit and is fully excluded from GI.
- Under §132(f)(3), cash reimbursements are okay as well, so long as there is no system allowing the employer to issue the vouchers.

1. Up to $175/month…qualified can be excluded from GI. So in this case, entire amount is excluded.
2. Bus pass…up to $100/month is excluded from GI.

(6) University pres travels a lot on university bill. However, all the frequent flyer miles accumulated are added to his account. As a result, he gets numerous free RT flights for US travel. William and spouse take advantage of the flights, any income to William?
- §1.132-5 working condition fringe…the ff mile tickets are excluded from GI b/c they are received during the course of business.

1. Free flights might be considered a rebate…but here, the employer was paying for all the flights that led to the free trip.

II. OVERVIEW

General rule is that fringe benefits are included in GI…§61(a)
Exceptions…

- **§119**, deals w/ employer provided lodging/meals. Certain requirements must be met for exception to apply.
- **§132**, covers variety of topics
  - **No additional cost service**…where company provides service that normally provided by employer to public for sale in ordinary course of business. Since employer is providing it for free to employee, no additional cost is imposed.
    - If this applies, then use it b/c there is no limit on amt excluded.
  - **Qualified employee discount**…excluded from GI, but there is a limit.
    - To extent that discount exceeds limit, the excess must be included in GI
  - **Working condition fringe**…bar dues (if employer pays this for me)…definition is an item that would have been deductible as business expense if I had paid it.
  - **De minimis fringe**…lost cost, low frequency item. I.e., pencil from employer. Of such insignificant value that it's too much admin burden to account for it.
  - **Qualified transportation fringes**…covers some parking, mass transit passes, maybe able to exclude these.
  - **On premises gyms, athletic facilities**….

A. MEALS AND LODGING
- Excluded from GI is value of any meals or lodging furnished to him, spouse, dependents by employer for convenience of employer if (1) meals are furnished on business premises, and (2) employees are required to accept such lodging on business premises of employer as condition of employment.

B. FRINGE BENEFITS AND §132
1. NO-ADDITIONAL-COST SERVICE
   - Under §132(b), the service must be offered for sale to customers in ordinary course of business
   - Under §132(b)(1), the service must be offered in the ordinary course of the line of business of employer in which employee is performing services, and
   - Under §132(b)(2), the employer must not incur any substantial additional cost in providing such service to employee.
   - §132(j)(1) prohibits discrimination in favor of highly compensated employees…including officers and owners.
   - §132(i) provides for reciprocal agreements b/w employers in same line of business, thus enabling employers to provide tax-free benefits to one another's employees.
     - These agreements must be in writing and employers must not incur substantial additional costs in provides such services.
2. QUALIFIED EMPLOYEE DISCOUNT
3. WORKING CONDITION FRINGE
4. DE MINIMIS FRINGE BENEFITS
5. QUALIFIED TRANSPORTATION FRINGE
6. ON-PREMISES GYMS AND OTHER ATHLETIC FACILITIES

C. VALUATION

BASIC INCOME TAXATION

CHAPTER 12 – BUSINESS & PROFIT SEEKING EXPENSES

I. PROBLEMS

1. Karen is sole shareholder of Soda Fountain Pharmacy, a company that owns 5 pharmacies in suburbs of large city. During current year, SFP incurs following expenses. May the company deduct any of the expenses?

(a) $150,000 salary and bonus to Laurie, K's daughter, who works as pharmacist at one of the stores. The amount includes a $100,000 year-end bonus. Other pharmacists only received $2500 year-end bonuses.

- §162(a)(1) allows for a business deduction of a reasonable allowance for salaries or other compensation for personal services actually rendered. Also, under §1.162-9…bonuses will constitute allowable deductions from GI when made in good faith and when such payments do not exceed a reasonable compensation for services rendered.
- Since the other pharmacists only received $2500 compared to L's $100,000, the amount of the bonus can be seen as excessive and **not deductible**.

1. Does SFP get deduction for the cost? In general, salaries are deductible, if reasonable.
2. If the extra money is considered reasonable…then the extra bonus would be deductible.
3. If the company could deduct $52,500 of what laurie gets, that leaves $97,500 that company could not deduct as business expense.
4. This addition non-deductible expense could be treated as a GIFT…if treated this way, then the mother had to get the money from company somehow…DIVIDENDS…then shareholder will have dividend income and company will be tax on paying out the dividends

(b) $60,000 in rent paid for plush office in exclusive business district of city. Space is owned by K's son Robert, real estate broker.

- Elements under §162
  a. Ordinary
  b. Necessary
  c. Expense
  d. Paid or incurred during the taxable year
  e. In carrying on
  f. A trade or business
- The rental expense can be seen as ordinary and necessary under §162(a)(3) and **deductible** as a business expense.

1. The rental expense is ordinary b/c its typical of a business to incur this in operating
2. Is the expense necessary? Well, the space is luxurious, but case law gives incredible amt of deference to business owner about what is necessary.
3. Therefore, a deduction can be taken for the expense.
4. If this is excessive, the excess can be seen as dividend to mother and then gift by mother to son.
5. Dividends are NOT deductible.

(c) $12,000 to K's son John as payment for his staying away from SFP. John is typically disruptive to the company.

- To be deductible under §162, the payment must meet the above 6 requirements.
- A large payment is hard to justify as necessary to keep away a nuisance. Taxpayers usually get great deference in determining NECESSARY, but this might be a little much.
- Even if necessary, K must show it is ordinary…
- **ORDINARY STANDARD: ARE THESE PAYMENTS THAT A TAXPAYER IS LIKELY TO INCUR IN MAINTAINING A BUSINESS?**
- §1.162-7(a)…not necessary or ordinary. If not for services, then not deductible.

a. This payment is unusual…under case law, ordinary standard does not factor on unusual, it is not enough to deny deductibility.

2. Sally graduated from law school and is finishing a one-year judicial clerkship. She now seeks an associate position w/ a firm. Sam, her husband is finishing a 2-yr MBA program, and is now seeking management trainee position in large corp. Sally and Sam travel to NY at own expense to hunt for jobs. Expenses incurred include $400 each for airfare, hotel of $500, resume and writing sample preparation costs of $50. After three days, they return home. Sally receives and accepts job as associate, but Sam is still looking. Are expenses deductible?

- Certain expenses are deductible under §162 as "business seeking expenses." For expenses to be deductible, they must meet the 6 criteria under §162.
  - Ordinary
  - Necessary
  - Expense
  - Paid or incurred during the taxable year
  - In carrying on
  - A trade or business
- Here the problem element is "in carrying on." STANDARD: if seeking a similar position (and you are already in that trade or business), then the spending is in carrying on the trade or business and therefore deductible.

- Sally: the jobs are comprised of the same services and skills—in same trade/profession. Therefore, she is seeking a similar job and her expenses are deductible.
- Sam: since he is a student most of the year, he can only hope that his new job requires the same responsibilities of previous jobs. His chances of meeting the "carrying on" requirement are less likely then Sally's.
- The success of a job search is irrelevant in determining whether the search qualifies for a deduction.

a. If considered under §162 carrying on a trade or business, then deductible.

3. Phil, bored w/ lucrative tax practice, decides to enter the fast-food business. He buys Burts Burgers franchise for his area for $100,000. Phil decides to rent commercial space, rather than buy and spends $1000 in advertising. After finally renting, he spends two months remodeling. Prior to opening he paid $5000 in rent, $3000 for employee training sessions at HQ of Burts, and $2000 in wages to employees being trained. Can Phil deduct the advertising, rental, employee training and wage expenses he incurred prior to opening the business?
    - §195(c) defines start-up expenditures..
        - (A) incurred in connection w/ investigating or starting up a new trade or business; and
        - (B) it would be deductible if incurred in operation of existing business
    - FRANCHISE…this is a capitalized expense, and NOT currently deductible b/c it is an asset that lasts beyond the current year.
    - ADVERTISING…would be deductible if incurred in connection w/ operating a current business §195(b)(1)
    - RENT…would be deductible (see above)
    - TRAINING…would be deductible
    - SALARIES…would be deductible
    - All qualify as start up costs, except franchise, which fails (B)
    - Consequences of being a start up under §195:
        - (a) no current deduction
        - (b) can be amortized over a period of at least 5 years, but not until business actually starts up.

a. Not under §162, b/c no carrying on…see §195
b. What counts as start up cost? Amt has to be paid or incurred w/ investigating a current trade/business, and the expense has to be immediately deductible in connection w/ current business.
c. If item lasts beyond the current year, then it can't be currently deductible, it must be capitalized.
d. First, see if expenses are currently deductible…(not here b/c Phil is not currently carrying on a trade/business)
e. Second,
f. §195(c)(1)(A) or (B)…start up expenditure.
    i. Franchise fee must be capitalized to asset called franchise.
    ii. Other expenditures are deductible as start-up expenditures…
        - Other option is to Amortize…at least 5-years.

4. Vic has portfolio of stocks and bonds worth about $300,000. This year he pays:
    $200 for subscription to WSJ – **YES…§212…§1.162-6, and §1.212-1(o) – would not be deductible if for personal use.**
    $25 for a copy of "A guide to tax-free bonds" - **if for a course or training, then NO under §1.212-1(f)**
    $500 for newsletter and investment advice from financial planner – **YES, under §1.212-1(g) only if paid for production or collection of income for managing investments, and they are ordinary/necessary under all circumstances. Here, both conditions met.**
    $50 for a one-year rental of safe deposit box to hold stock certificates and bonds – **NO under §1.212-1(f)**
    $400 to accountant to prepare tax return. – **YES under §1.212-1(L)**
    $250 to you, his lawyer, to tell him whether these expenses are deductible… - **YES under §1.212-1(L)--§212(3)**
    What do you say?
        - Under §162, Vic's situation fails the trade and business requirement. (but this deduction is preferable b/c it's an above the line deduction)
        - See §212 for certain below the line deductions.

a. Can't use §162 b/c it's not a carrying on a trade/business…it's an attempt to collect and make some money.
b. Under §212(3)…can be deductible as expenses for production of income.

II. CLASS NOTES

EXPENDITURES		**PERSONAL EXPENSES**	
Business	**Profit-Seeking**		
Deductible—can get cost-recovery benefits		Not deductible, cannot get cost-recovery	
§162 – current (i.e. paying rent for business space) --immediate deduction	*§212 – current*		
Non-current… (i.e., buying furniture) --will not get immediate deduction…you must capitalize the cost and put the cost in basis of asset and take depreciate deductions over the life of the asset.			
Requirements for the deduction of costs associated w/ business… 1. the cost must be an "expense"; 2. the expense must be "ordinary"; 3. it must be "necessary"; 4. it must be "paid or incurred during the taxable year"; …and it must be paid or incurred in… 5. "carrying on a 6. "trade or business."			

III. BOOK NOTES

§162 – business deduction
§212 – profit-seeking deduction

- Both sections reflect the principle that "net income" rather than gross income should be subject to tax, and that expenses necessary to earning of taxable income ought to be allowed as deductions.

- Under §262(a), personal expenses will not be deductible in determining the net income subject to tax.
- Also, capital expenditures of the business or profit-seeking type may not be deducted in full at time of expenditure.
  - Instead they must be deducted in increments over some period, i.e., upon disposition of the asset.

ELEMENTS UNDER §162(a)…

Requirements for the deduction of costs associated w/ business…

7. **the cost must be an "expense";**
8. **the expense must be "ordinary";**
9. **it must be "necessary";**
10. **it must be "paid or incurred during the taxable year";**

…and it must be paid or incurred in…

11. **"carrying on a**
12. **"trade or business."**

ORDINARY…

a. requires that a cost be customary or expected in the life of a business
b. are distinguished from capital expenditures, such as reputation, goodwill or learning
c. has the connotation of normal, usual or customary
d. it is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.

NECESSARY…

- appropriate and helpful
- typically a factual determination

"REASONABLE SALARIES" DEDUCTION…

- under §162(a), only reasonable salaries may be deducted…
- the nature and quality of services should be considered
- and the effect of those services on return of investor's investment
- court's factors…
  - position held by employer
  - hours worked and duties performed
  - general importance of employee to success of company
  - comparison of past duties and salary w/ current responsibility and compensation
  - comparison of employee's salary w/ those paid for similar services
  - size of company and general economic conditions
  - existence of potentially exploitable relationship b/w taxpaying company and employees
  - existence of bonus system that distributes most of all company's pre-tax earnings
- Under §162(m), the deduction of certain employee compensation in excess of $1mill is prohibited

LOBBYING EXPENSES…

- §162(e) disallows any deduction for amounts paid or incurred in connection w/ (1) influencing legislation, or (2) any direct communications w/ a covered

executive branch official in an attempt to influence official actions or positions of the official. §162(e)(1)(A)
- However, this disallowance rule for influencing legislation does not apply to "legislation of any local council or similar governing body." §162(e)(2)
    - I.e., boards of county commissioners, city councils and tribal councils.

TRADE OR BUSINESS…
- Factual determination
- To be engaged in a trade or business, the taxpayer must be involved in the activity w/ continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit.
- Sporadic activity, hobby or amusement diversion does not qualify.

CARRYING ON….
- Results in a distinction b/c pre-opening (start up costs) and operating costs of a business.
- Development of new business includes two stages….
    (1) investigatory stage
        - Expenses of investigating and looking for a NEW business and trips preparatory to entering a business are NOT deductible as an ordinary and necessary business expense incurred in carrying on a trade or business.
    (2) after taxpayer has decided to acquire or establish a specific business and commences preparations for its operation
        - however, a taxpayer is required to treat the pre-operating expenses as capital expenditures until such time as the business has begun to function as a going concern and performed those activities for which it was organized.
- This requirement also prevents the taxpayer from deducting expenses which are actually personal expenses…
- The requirement forces the taxpayer to establish that expenses are actually associated w/ the operation of a trade or business making it more likely that the expenses are genuinely business-related, as opposed to merely personal expenses.

APPLICATION TO EMPLOYEES…
- Scope of employees current trade or business is relevant…there is a comparison b/w the position which taxpayer occupied before and after the change of employment.
- Typically a one-year standard for how long a person can be unemployed w/o losing her trade or business status.

§195 – START-UP EXPENDITURES
- Permits taxpayer to elect to amortize (i.e., to pro-rate at an even level) business start-up expenditures over a period of not less than 60 months.
- Eligible expenses consist of **investigatory costs** incurred in reviewing a prospective business prior to reaching a final decision to acquire or enter that business.
- Also include **startup costs** which are incurred subsequent to a decision to establish a particular business and prior to time when business begins.
- Under §195(b), amortization period must begin **w/ the month in which the active trade or business begins.**

§212 DEDUCTIONS…
- Sometimes referred to as the non-trade-or-business analog to §162
- Allows a deduction for the "ordinary and necessary" expenses of producing or collecting income, maintaining property held for the production of income, or determining, collecting or refunding any tax.
- See §1.212-1 for examples
- No deduction is allowed for expenditures allocable to tax-exempt income.

BASIC INCOME TAXATION

CHAPTER 13 – CAPITAL EXPENDITURES

I. PROBLEMS

SEE §263(A)

1. Rich Lord made following expenditures w/ respect to an apt bldg he owns. Discuss whether each expenditure is currently deductible as expense or constitutes capital expenditure:

(a) $500 for painting of one of the apartments. What if he paid $15,000 to have entire bldg painted?
- **One apartment** – Repair…**deductible**
- **Entire bldg** – Repair…**deductible**

(b) $1000 for patching roof of bldg. What if he paid $5000 to have new roof?
- **Patch** – Repair…**deductible**
- **Entire roof** – major improvement and more than keeping in operating condition. Will improve bldg for number of years…**capitalize**

(c) $!500 for some rewiring and plumbing work? Would answer change if R paid to have the rewiring and plumbing done as part of overall renovation of bldg?
- **Some** rewiring and plumbing – Repair…**deductible**
- **Overall renovation** – permanent improvement…**capitalize**
  (major improvements at once runs the risk of falling into the capital expenditure category)

Wherli case…expenditures that are alone viewed as repairs will be seen as capital expenditures of done in whole as part of major renovation.

(d) $5000 for aggressive advertising campaign for new tenants?
- **Advertising** is currently **deductible** even if it creates a value beyond one year. This is an exception to the one-year rule.
- **ONE-YEAR RULE**: if you incur an expense and the benefit lasts beyond the current year, you must capitalize and take deductions over the life of the improvement.

(e) $1000 for new washer and dryer for laundry room…assume he replaces every 2 yrs?
- Purchase of asset which will most likely last more than one year….**capitalize**

(f) $5000 for cleaning materials…b/c of low prices, R purchased a two-year supply.
- A small amount would be deductible, but he spend money to create a benefit which will last longer than one year.
- This must be deducted over two years to match expense and benefit… **capitalize the full amount and deduct ½ this year, and ½ next year**.
- Pre-paid asset: buying extra for whatever reason (you know how long it will last) then you must…capitalize
- Under §1.162-3, he can only deduct what he actually uses in current year.

(g) $1500 for wages paid to carpenter who spend three weeks building a large carport for apt bldg. R failed to have the new carport painted at time it was constructed, but paid $400 the following year to have it done.
- Wages are normally currently deductible under §162(a), BUT these wages are really the cost of an asset being created and must be capitalized w/ the cost of the asset.
- **THE COST OF CONSTRUCTION OF AN ASSET IS TO BE INCLUDED IN THE CAPITALIZATION OF THE COST OF THE ASSET**.
- If he had purchased a pre-fabricated carport, then he would have to capitalize the full cost of it, which would also include the cost of its construction.
- When he had it painted last year, it was just a delayed part of the construction. It was still construction of an asset…**capitalize**.
  - If he had painted it and it needed repainting in two years, then repair and deductible.

(h) $2500 for consultant's advice on economic feasibility of purchasing adjacent land and expanding the apartment complex to take advantage of anticipated increase in population of area?
- If used to create a **new asset**…**capitalize** (long term benefit)
- If maintenance cost of an existing asset…currently deductible
- This seems like the creation of new asset so the cost should be capitalized.

(i) $2000 in legal fees to block effort by city to condemn some of R's land adjacent to bldg in order to widen nearby hwy?

- Under §1.263(a)-2(c), the cost of defending or perfecting title to property is considered an example of a capital expenditure.
- Therefore, the legal fees incurred to protect property must be **capitalized** to protect title.

(j) Lease payments on fire sprinkler system from Automatic Sprinkler Corp. The system was specially designed for R's apartment bldg. The 3 year lease required R to make lease payments of $3500/year. The lease agreement provided that at end of 3-year lease term, R had option to purchase system for $100.

- Rent payments in connection w/ a trade or business or ordinarily deductible.
- However, this is a purchase disguised as a lease…gives rise to a **capitalized** expenditure.

II. VOCABULARY

- CAPITAL EXPENDITURE
- IMPROVEMENT
- REPAIR
- CAPITALIZE
- ACQUISITION COST

III. CLASS NOTES

If the asset will last beyond the current, then you capitalize.
Difference b/c capitalizing and taking a current deduction…
Capitalizing means you get a deduction over time.
Source of law for this is case law.

IV. BOOK NOTES

Do business deductions receive a current deduction or capitalized w/ cost recovery over years?

Regulations diminish:

- Repair: maintaining current value (prevent from decrease); keeping in current efficient operating condition ⇨ current deduction
- improvement: substantial improvement; acquiring asset (fixtures); increases value; tent to last more than one year ⇨ capitalize

How do I capitalize?

- Increasing the basis of property to reflect the change in value as a result of the improvement. NOTE…this is b/c you immediately deduct the cost, but only when a gain is realized.

BASIC INCOME TAXATION

CHAPTER 14 – DEPRECIATION

I. PROBLEMS

(1) Liz is considering purchasing a carpet for $5,000. Carpet is at least 150 yrs old. Friend advises that she can deduct carpet's cost if she uses it in office for few yrs rather than at home. She thinks it a good idea but asks your advice re: carpet's deductibility. What do you say?

- L cannot deduct in current year b/c carpet is asset that will last beyond the current year. She must capitalize.
- To determine whether she is entitled to depreciation, she must satisfy elements under §167.
  - Trade or business? Yes, used in business office, even though she does get personal enjoyment from it
  - Subject to wear and tear? Yes, it is on floor (would be diff if hung on wall for decoration)
    - In *Liddle*, the courts held that works of art are not depreciable b/c there is no determinable life. In that case, court held that violin (antique) was depreciable b/c violinist used it as tool in business such that the tool became subject to wear and tear…depreciation. If same violin held in collection…no depreciation.
  - Not Inventory? Yes.
  - Subject to valuation? Yes (must be appreciable by an appraiser)
- **L make take deduction**

1. Won't get deduction under §162…but can look to depreciation
2. Look at elements under §167…are they satisfied…YES.
3. If carpet is art…is it subject to wear, tear, etc? NO…art is not subject to wear and tear.
4. what about §179…she must meet all the requirements there…but §167 is better.

(2) Liz consults you re: deductibility of sophisticated office computer that she got Jan 19 by paying $25,000. §168 classifies this as 5-year property. Liz uses computer solely in conjunction w/ tax law practice, and was the only depreciable property she put in service that year.

(a) Disregarding §179, how much depreciation may Liz claim w/ respect to computer in:

- Under §168, 3 things to determine for computing depreciation: applicable depreciation method, applicable recovery period, applicable convention
  - §168(b)(1) - Applicable depreciation – default method is *double declining switching to straight line method **(200%DDB to SL)***…use unless some other method applies (either sub (2) or(3)).
  - §168(b)(2) – ***(150%DB to SL)*** 15 or 20 yr property…no. farming business…no. or can elect for this slower depreciation under sub (5)…doesn't usually happen. As long as NO election…sub(2) does NOT apply.
  - §168(b)(3) – ***(SL)*** - non-residential real, residential rental, RR grading, election under sub (5) to use slowest (straight-line). A computer is none of these, so unless there is an election, sub (3) does NOT apply.
    - Sub (2) and (3) are ruled out so the default ***double (200%) declining switching to straight line* method of sub (1) is applicable.**
  - §168(c) – recovery period – applicable period §168(e)(3)(B), five year property for computer based equip.
    - **the recovery period is 5 years**
  - §168(d)(1) – default convention is half-year convention (treat as placed in service at half-point of year). To use default, other conventions must be ruled out…
  - §168(d)(2) – mid-month…certain real property (not computer)
  - §168(d)(3) – mid-quarter…not last three months b/c L bought computer in January.
    - **Sub (1) re: half-year convention applies**.

1. Year of Purchase (year 1)?
   - $25k x 20% = **$5000 depreciation reduction can be claimed**
2. Year 2?
   - $25k x 32% = **$8000 depreciation reduction can be claimed**
3. What is computer's adjusted basis at beg of Year 3? §1016(a)(2)
   - $25k - $13k = **$12,000**

1. Process of computing depreciation…three things you need to know under §168(a): applicable depreciation method, applicable recovery period, applicable convention
2. After determining these three things, you look in book, p. 301, table 1 to determine depreciation % figures.

(b) Assuming Liz did not make a §179 election w/ respect to computer, how much depreciation can she claim in Year 3 if she sells computer on Aug 15 of that year?

- Under §168(d)(4)(A) – half-year convention applies based on Aug 15 disposition
- Looking at chart on p. 301, depreciation rate is 19.2%
- $25k x (19.2% ÷ 2 = 9.6%) = **$2,400 depreciation can be claimed**

1. Normally she would claim the $4800 19.2% of original basis if she had computer for whole year, but since she sold it in Aug, she can only claim half-convention.
2. Her basis, after disposition of property, equals $12,000 - $2400 = $9600

(c) How would answer change in (a) if Liz purchased computer in December of Year 1?

- Under §168(d)(3), if computer is only purchase made in that year, **mid-quarter convention applies**.

1. Depreciation rate for first year is smaller b/c getting depreciation only for 1/8 of year.
2. Basis at beg of Y3 is $14,200

(d) Assume Liz elected to use §179 w/ respect to computer. Assume Year 1 is 2000 and the computer was purchased on Jan 19, 2000 and Liz's taxable income from law practice is $150,000.

1. What is maximum she could deduct w/ respect to computer in Year 1 under §168 and §179?
   - **§168**…$5000 x 40% x ½ year convention = $1000
   - **§179**…$20,000 b/c under §179(b)(1) the taxable year begins in 2000.
   - Maximum deduction in Y1 = **$21,000**
   - The taxable income does not apply b/c only $150,000, see §179(b)(2).

1. In order for §179(a) to be available…must look at requirements and show that computer is property under §179. Must be tangible property, must be property to which §168 applies (depreciable as described in §167), must be acquired by purchase (for years in active conduct in trade/business, not personal), and must be §1245 property as well.
   §1245 property…personal property, or others listed.
   Computer does count as §1245 property b/c it's personal.
   Therefore, property is §179 property.
2. How much of deduction is available….must look at limits.
   a. How much can be treated as current expense??
      - $20,000 is the limitation
   b. Taxable income does not apply b/c she only got $150k for the year…in order for that limit to change our answer L must make $200k +, issue of insolvency. To the extent that property exceeds $200,000 then amount you are allowed to expense is decreased by amount over $200k the property is worth. (up to $0)
2. Depreciation under §168…DDL to SL…
   - If using SL method, you get 20% each year. Double it for DDB method, 40%, then you apply half-year convention (times by ½)
   - Or table 1 in book.
3. The $20,000 deduction in §179(b)(1) is for the aggregate purchases that year, total dollar amount limitation…not applied to each asset purchased that year separately.
4. Mid-quarter convention only comes into play when 40% or more of the assets are purchased or put into service during the last quarter of the year.

(3) On March 30, 2000 Liz leased small commercial bldg conveniently near county courthouse. She will use bldg for law practice. L paid $3000 for former tenant's rights in lease that had remaining term of 2 yrs. Under terms of lease, L was also required to pay lessor rental of $1500/month. On March 30, L also purchased apt bldg for $200,000 by paying $15,000 down on property with balance paid in installments over next 20 yrs. $100,000 of $200,000 cost is allocable to land and other $100,000 to bldg.

(a) What deductions may L claim w/ respect to leasehold?

- §162…rent

(b) May L claim §179 deduction w/ respect to purchase of apt bldg?

- NO…only tangible personal property can be deducted, see §1245(a)(3)

(c) How much depreciation may L claim on apt bldg in year of purchase?

- Depreciation rates for residential real property subject to 27.5 year recovery period. See table 6, p.
- Year 1…$100,000 x 2.879% = **$2,879**

1. Must use SL method…under §168(c) the recovery period is 27.5 years, and applicable convention is mid-month (§168(d)(2)(B)
2. If property is being placed in March, that means L has 9.5 months of depreciation.
3. Therefore, the amount of depreciation L can claim is $100,000 ÷ 27.5 = $3636/yr x 9.5 ÷12 = $2879
4. by using the table…table 6…it uses the 27.5 recovery and mid-month recovery…depreciation rate is 2.879% x 100,000 (original basis) = $2879 of depreciation.

(d) How much can L claim in following year? (Assume that all gross rental income L receives from bldg is rental income from units)

- Year 2…$100,000 x 2.564% = **$2,564**

II. VOCABULARY

III. CLASS NOTES

Depreciation…capitalizing cost of item and gradually take deductions over useful life of item.
Simple method…divide total cost by life of item and take equal deductions every year.
Spreading out the costs over time.
Why depreciation rather than immediate tax deduction?
Taxpayer wants to defer taxes as long as possible b/c of time value of money.

§167 – provision that authorizes depreciation deduction
§168 – shows how to compute amount of deduction

Cost of item = $10,000
Useful life if 10 yrs.

REQUIREMENTS TO DEPRECIATE

1. In order to be depreciable the property either has to be trade or business property or property used for the production of income
   I.e., Personal property is not entitled to depreciations deductions
2. The property must be subject to wear, tear, decay, decline or obsolescence,
   I.e. it must decline in value…Land is not depreciable b/c it is not subject to wear, tear, etc.
3. Item cannot be inventory
4. Property must not be susceptible to valuation

Recover paid…**useful life concept**

- Cannot take depreciation deductions for more than your total basis in property, otherwise you'd be reducing your total GI by more than actual cost
- Every time you take a deduction, you must reduce your basis.

§179 – Special Election…allows taxpayer to deduct something that would normally be depreciable as expense if you make the election (this is capped).

- HYPO: you buy a $30K piece of equipment. If the taxpayer makes the election, under § 179 $25K is immediately deducted and the remaining $5K is capitalized and depreciated

When the mid-quarter applies…§168(d)(3)…
If personal property exceeds 40% by value is placed in service in last quarter of year, the mid-quarter will apply to personal depreciable property, not real depreciable property.
If mid-quarter applies, it only applies to property that half-year convention would have applied to.

IV. BOOK NOTES

THREE DIFFERENT TYPES OF COST RECOVERY…

1. **DEDUCT CURRENTLY IN FIRST YEAR** – deduct as expense
   (i.e., spend money on six months of cleaning supplies)

2. **COST RECOVERY AT END OF USE** – if you buy asset (personal) and hold on to it for a few years. When you sell it you subtract AB from AR to reduce amount of income from the disposition.

3. **DEPRECIATION** – capitalize the cost of item and gradually take deductions over time (§168); matching cost to expected economic life…amortization
   RATIONALE: (of capitalization and depreciation): if you are buying an asset that will last beyond current year, to correctly reflect income, you should match cost of item w/ years item will be used to produce income.
   GOAL: to foster the clear reflection of income in each of the years of use of asset

<u>REQUIREMENTS TO DEPRECIATE</u>:

1. trade or business property held for production of income
2. property is subject to wear and tear, decline, decay, exhaustion, waste, economic deterioration, obsolescence
3. item cannot be inventory
4. item has to be susceptible to valuation
5. property must have a determinable life (this req read out of rule after *Liddle* and *Simon* cases)

When depreciation deduction is taken, an ***adjustment*** must be made in ***basis***.
<u>HYPO</u>: if cost is $100,000, once a depreciation deduction is taken of $10,000, basis must be reduced to $90,000. Otherwise there would be double cost recovery: at time of deduction and at time of sale/disposition. To prevent this, any depreciation deduction must be met by a reduction in basis.

BASIC INCOME TAXATION

CHAPTER 21 – DUAL USE PROPERTY

I. PROBLEMS

(2) Kevin is self-employed contractor and builds commercial bldgs. K's only office is in his home office where he conducts all admin work. K seldom meets clients in home office, but meets usually at construction site or their office. During current year, K spent about 80% of time at two diff construction sites and balance in home office.

(a) May K deduct his home office expenses?

- §280A does apply b/c K uses his dwelling as residence and for business purposes.
  - If K has his business in home, but not used as residence, then he's entitled to deduction under §162
- EXCEPTIONS that apply…§280A sub(c)(1) certain business use
  - Exclusive use…assume office is only used for business purposes (and not for storage)
  - Regular basis…all of his admin work is done there, yes
  - Either…Principle Place Business, separate structure, or meet clients there.
    - Under PPB, must ask…were the activities performed at home office essential? Was substantial amount of time spent there? Was there no other location available?
    - As applied to Kevin, most activities at site were more important than those at office, 80% of time spent at sites
  - Therefore, not his principle place of business or where he meets clients.
- **NO HOME OFFICE DEDUCTION under Soliman test…but since K's facts also apply to the flush language of §280(c)(1)(C), there will be a home office deduction.**

(b) May K deduct his transport costs b/w home office and construction sites or clients' offices?

- If K had been entitled to deduction under §280A(c)(1) b/c home office was principle place of business, then he could deduct his transport costs as business travel.
- **B/c there was no deduction under §280A(c)(1), no travel deduction either…it is merely commuting which is a personal expense.**

(c) Would answers change if K were employee instead of self-employed?

- Yes, K would also have to show that he was using home office for employer's convenience to get deduction.

(3) Cathy, accountant for XYZ Corp, works 40hrs/wk for $25,000/yr salary. To supplement income, C maintains part-time accounting practice in home. She uses one of the rooms as office and meets clients there. The room represents approx 10% living space in her home. It's furnished and C has separate phone line for the business. During current year, C had GI of $2500 from private acctg practice. She had the following expenses:

- Supplies $100
- Advertising $600
- Office phone service $800

With respect to home, the following expenses:

- ✓ Real estate taxes - $1500
- ✓ Interest mortgage - $4000
- ✓ Fire/casualty insurance - $500
- ✓ Maintenance of yard - $300
- ✓ Total utility charges - $1000

Adjusted basis of home is $100,000 and if depreciable the deduction of entire home for current year is $5000.

(b) Assuming home office is C's principal place of business for private acctg practice, how much of these expenses associated w/ home can be deducted?

- §280A general rule applies b/c she uses home office also as a residence
- look at exceptions…
  - sub(b) – may deduct real estate taxes and mortgage interest
  - sub(c)(1) – home office deduction?? Assume it is her PPB…(if C used it for XYZ corp then she would have to show employer's convenience)

Why are the deductions limited?? B/c home mortgage might be so large, and this could off set all income from trade or business…creating a net loss. Congress in limiting the total amt for home office deduction…wanted taxpayers to be able to offset more from home office…and regular income.

- C is entitled to deduction under sub(c)(1), but how much??
- Home office is also used as home, and only 10% of house allocable to business.
- Sub(c)(5) limitation…the amount you may deduct is limited to amount of GI from business.
  - Reg §1.280A-2(i)(2)(iii) gives a special definition of GI for these purposes. GI reduced by expenditures (i.e., supplies, compensation of employees) normally deductible w/ no relation to fact that the house is a business location.
  - Reg §1.280A-2(i)(5) sets order for deductions…
    i. trade or business expense that would exist regardless of business location

ii. allocable portions of "house type" deductions (things deductible in respect to house whether or not involved w/ business)
iii. allocable portions of expenses that are trade or business expenses b/c of locations in home – no basis adjustment (i.e. property tax)
iv. allocable portions of expenses that are trade/business b/c of locations in home – no basis adjustment (i.e., house)

- **Since GI = $2,500…deductions can not exceed this amount**
- Supplies (100), advertising (600), phone (800) are deductible regardless of location. Total = $1500
  - **$2500 – $1500 = $1000**
- Real estate tax (1500) and mortgage interest (4000) are allowed regardless of trade/business and are allowed to extent allocable to business (10%) = $550
  - **$1000 - $550 = $450**
- Utility charges (1000) and insurance promotions (500) are trade/business b/c business is located in home – allowable for allocable portion (10%) = $150
  - **$450 - $150 = $300**

1. Home office deduction can be a below the line or above the line deduction….depending on if you use the office as an employee for convenience of employer (BTL), or for your own business(ATL).
2. §121(d)(6) denies you exception for gain attributable to deduction…

(c) What tax consequences would any current depreciation deductions have in event C subsequently sold home at gain?

- **Depreciation (5000)** is business/trade expense b/c of location – **allowed for allocable portion (10%) = $500**
  - $300 - $500 = -$200
  - **The most that can be deducted is $300** b/c otherwise she would exceed the $2500 GI limit
  - The other $200 can be carried over to the next year (§280A(c)(5)) as long as it does not put her over the limit next year

(4) C owns lakeside cabin. During current year, she spent 20 days at cabin and rented cabin at $150/day for 100 days. C incurred following expenses during year w/ respect to cabin:

✓	Real estate taxes	$1000
✓	Maintenance Exp	$ 500
✓	Realtor's Fee	$1500
✓	Utilities	$ 500
✓	Fire Insurance	$ 500

Annual depreciation of cabin (under §168) would be $1000 for current year. How much if any of above expenses may C deduct in current year?

- Does it fall under §280A at all?? Only if the cabin was used as a residence.
  - Under definition of "residence," C must use cabin the greater of 14 days or 10% of days rented.
  - She rented it 100 days. 10% = 10 days. 14 is greater so she must have stayed in cabin at least 14 days. C stayed there 20 days so she falls under the general rule of §280A – NO DEDUCTION
- However, look to rental use exception - §280A(c)(3)…
  - Limited to gross income less certain expenses
  - GI = gross rental receipts less expenditures to obtain tenants for unit
- Formula for order of deductions Reg §1.280A-3(d)(2) and (d)(3)
  - **GROSS RECEIPTS = $15,000 maximum deduction**

1. Expenditures to obtain tenants for unit (i.e., realtor's fee, advertising)
   - Not clear from facts, management fee might not be applicable
   - **$15,000 – 0 = $15,000**
2. Allocable portions of "house-type" deductions – entitled to whether or not she rents out the property (i.e., real estate taxes)
   - Allocable portions = days rented ÷ 365 days
   - $1,000 x (100 x 365) = $274
   - **$15,000 - $274 = $14,726**
3. Allocable portions of expenses that are trade/business expenses b/c of location in home (no basis adjustment)
   - Allocable portions = days of business use (rented) ÷ total days
   - Maintenance expenses (500) + realtor's fee (1500) + utilities (500) + fire insurance (500) = $3000 x (100 ÷ 120) = $2500
   - **$14,726 - $2500 = $12,226**
4. Allocable portions of expenses that are trade/business expenses b/c of location in the home (basis adjustment)
   - Allocable portions = days of business use ÷ total days
   - Depreciation (1000) = $1000 x (100 ÷ 120) = $833
   - **$12,226 - $833 = $11,393**

- Since $11,393 does not meet the $15,000 maximum deduction limit…C has $3607 to apply to next year.

II. CLASS NOTES

If you spend money for business purposes, you can get money for cost-recovery purposes.
How do you treat expenses for part-business and part-personal purposes?
§280A deals w/ these problems.

- General rule…if the section applies (if unit that you are using for business purposes is used as residence, then no deduction w/ respect to dwelling unit.)
  If used as residence, then no deduction under this section.
- EXCEPTIONS…
  - Sub (b) exception for expenditures that would be deductible w/o regard to whether the expenditures are related to trade/business
    - Home mortgage interest
    - Property taxes
  - Sub(c)(1) exceptions for some trade/businesses of personal residences
    - Home office use
      - Expenditure has to be allocable to portion of dwelling purpose
      - Must be used exclusively
      - Must be used on regular basis
      - Either,
        - use portion as principle place of business, or
        - place of business to meet clients in normal course or trade of business, or
        - in case of separate structure, use must be in connection w/ trade/business
    - Storage use – i.e., storing business inventory
    - Rental use – i.e., like a vacation home when you're not there
    - Day case use
    - NOTE: if home use is as an employee – it must be for employer's convenience.

- §280A(c)(1)(C) language was added by congress to define the "principle place of business" requirement. This addition broadened the definition, allowing more leniency in following requirements.
- *Soliman* is still important…b/c the flush language does not always apply. *Soliman* is used when the language does not apply.
  - Under this case, you look at two factors to assess PPB…(1) relative importance of business activities, (i.e., bldg, billing clients, etc.— determine most important), (2) time spent at each business location.

BASIC INCOME TAXATION

CHAPTER 22 – INTEREST DEDUCTION

I. PROBLEMS

(5) To what extent may Monte deduct following interest payments made during taxable year?

(a) $5000 interest on bank loan used to pay operating expenses in Monte's cattle business?

- Under §163(h)(2)(A) – **DEDUCTIBLE** – incurred in connection w/ trade or business—not personal.

(b) $350 interest on M's mastercard acct to which he charges personal items?

- §163(h)(1) – **NOT DEDUCTIBLE** – personal interest
- credit card debt is pure consumption…no income produced by incurring that debt…doesn't make sense for deduction

(c) $2000 interest on bank loan used to pay son's college tuition

- deductible subject to limits of §221
- as long as the son was a dependent of M at time indebtedness was incurred then this loan could constitute a qualified education loan.
- Req's…
  i. §221(e)(1)…used to pay for tuition, room/board, and paid toward these fees for taxpayer, spouse, or dependent.
  ii. Under §221(b)(2) the deduction will be reduced based on if taxpayer's salary is too high
- Also, if 1999, can only deduct $15000
- If 2000, can deduct $2000

(d) $500 prepayment of interest he was required to make pursuant to terms of cattle purchase contract

- **DEDUCTIBLE** as trade/business expense like #1a, but under **§461(g)(1)**, only currently deductible to extent allocable to current tax year. (capitalize and amortize)

(e) $1000 interest he paid on loan through brokerage house for purchase of stock.

(during year M received $300 interest income and $400 dividends from other stock, also paid $50 to investors weekly magazine)

- §163(d)(3)(A) applies to the $1000 investment interest…the interest paid to finance purchase of investment. This is excluded from income under §163(h)(2)(B).
- Not personal…Deduction limited to net investment income…defined in §163(d)(4)(A)
  - Investment income – investment expenses
  - ($300 + $400) – ($50) = $650 net investment income
- **$650 can be deducted under §163**
- Under §163(d)(2), the remaining $350 can be carried over and treated as investment interest paid in subsequent year

(f) Does answer change if M also had net capital gain for year of $500, all attributable to sale of other stock held for investment?

- **Answer does NOT change** due to capital gain. Capital gain is not part of investment income for purposes of limitations on deductions.
- (Although taxpayer could elect treatment of capital gain as investment income and take investment deduction, he would not get preferential 28% tax rate for capital gains)

(6) Patrick bought home for $300k by paying $30k down from own funds and borrowing $270k from bank. Loan is secured by mortgage on home. P paid bank $5000 in points and $27k in interest in year he purchased home. Can he deduct points and interest?

- The interest is NOT personal (§163(h(2)(D) qualified residence interest) if it meets the definition of qualified residence interest under §163(h)(3):
  - (A) QRI is any interest paid or accrued during taxable year on *acquisition indebtedness* or *home equity indebtedness* w/ respect to any qualified residence of taxpayer.
  - (B): (i) defines *acquisition indebtedness* as any indebtedness which is (1) incurred in acquiring, constructing, or substantially improving any QR of taxpayer, and (2) is secured by such residence. (ii) limits the aggregate amount treated as acquisition indebtedness not exceeding $1 million.
- P incurred the debt in acquiring the residence and debt is secured by house and he is w/in limit. P meets definition of acquisition indebtedness and therefore the interest paid is QRI and entitled to deduction.

- THE POINTS…
  - Service charges are NOT deductible…if points are in addition to service charge, then probably interest.
  - Assuming points are interest, are they QRI? Incurred in acquisition of residence, secured by residence and w/in $1mill limit…
    - ***Prepaid***: §461(g)(1) general rule…any prepayment must be capitalized.
      - If cash basis taxpayer, and prepay interest, no deduction in current year…only currently deduct the portion allocable to current year.
        - EXCEPTION…general rule does not apply to points in respect of any indebtedness incurred in connection w/ purchase or improvement of, and secured by, principal residence to extent that it is the regular business practice in area and amount of such payment does not exceed amount generally charged in such area.
      - If all requirements are met, P may deduct.

(a) Assume P's home is now worth $350k and amount owing is $250k. P borrows additional $50k, giving bank second mortgage on home. Half of loan is used for improvements to home and other half for personal travel and vacation. Annual interest payment is $4000, is that interest deductible?

- Under §163(h)(3)(B)(i)(I), the $25,000 used for improvements is additional acquisition indebtedness (this § includes any substantially improving of QR)
  - Definition of qualified residence interest under §163(h)(3):
    - (A) QRI is any interest paid or accrued during taxable year on *acquisition indebtedness* or *home equity indebtedness* w/ respect to any qualified residence of taxpayer.
    - (B): (i) defines *acquisition indebtedness* as any indebtedness which is (1) incurred in acquiring, constructing, or substantially improving any QR of taxpayer, and (2) is secured by such residence. (ii) limits the aggregate amount treated as acquisition indebtedness not exceeding $1 million.
- Why do you want to get stuff qualified as AI? B/c the limits are higher for this than HEI.
  - Limit for HEI is $100,000…
- The $25,000 is considered AI b/c it's being used to improve home.
  - The **$2000 points** in tax attributable to half of loan regarding improvements to home is **deductible** as QRI.
  - The personal expenses half may qualify as ***home equity indebtedness*** (HEI) if it meets definition under §163(h)(3)(C)…
    i. Any indebtedness (other than acquisition indebtedness) secured by QR to extent the aggregate of such indebtedness does not exceed the fmv of such QR reduced by amount of acquisition indebtedness w/ respect to such residence.
    ii. Limit: aggregate amount treated as HEI for any period shall not exceed $100,000
  - As applied to this case, the ½ loan cannot be considered acquisition indebtedness b/c it was not incurred in acquiring, improving or constructing QR.
  - $350k - $275k = $75,000 (aggregate does not exceed $100k)
  - **$2000** interest paid on other half is considered **HOME EQUITY INTEREST** and is **deductible** as QRI.
- The other $25,000 is not AI b/c it is used for other purposes…financing a vacation.
- Could be considered HEI…and it is b/c it meets the requirements.
- Look at limitations…cannot exceed $100,000 and limit determined by takes diff b/w fmv and AI.
- Any amount above these limits cannot be treated as AI.

(b) Assume (a) facts, except value of home is $550k and new loan is $200k, of which $50k is home improvements and $150k is personal. Annual interest payment is $16,000, is this deductible?

- The $50k used for home improvements can be treated as QRI.

- $4000 in interest attributable to this portion meets §163(h)(3)(B) acquisition indebtedness…substantially improving; secured by residence; w/in $1mill limit.
- The interest is currently deductible…total acquisition indebtedness is $300,000.

- The other $150k has $12,000 in interest attributable.
- Under §163(d)(3)(C)(i) the loan meets the definition of HEI…not acquisition indebtedness; secured by residence; first limit $550k (fmv) - $300k (a.i.) = $250,000.
    i. Under first limit the most that can be treated as HEI is $250,000
        This portion of loan is w/in that limit.
    ii. Under second limit, the home equity loan cannot exceed $100,000. Therefore, $100,000 of the $150k can be treated as HEI and interest on that portion an be deducted ($8000).
        Any interest related to the $50k excess ($4000) cannot be deducted.
- Total: **$4000 (a.i.) + $8000 (HEI) can be deducted as QRI = $12,000** of $16,000 annual interest payment is deductible.

(c) Assume (a) facts…except P no new loan, instead P owes bank $10k of unpaid interest on first mortgage. P refinances home and will be treated as if he borrowed $260k. $250k will be w/held in payment of $250k owed on first mortgage. The other $10k will be w/held in payment of $10k unpaid interest owing. P will not receive any cash as result of refinancing. May P deduct the $10k in interest that was deemed to be paid as result of bank's withholding of $10k refinancing proceeds? Does any of the debt constitute "acquisition indebtedness" under §163(h)(3)?

- §163(h)(3)(B) addresses refinancing
- P owed $250k mortgage balance all of which was a.i. so the new indebtedness is also a.i.
    i. But he borrowed an additional amount, $5000 of which was used to pay interest, did he pay it?

Battlestein: every time the interest payment came due, the taxpayer sent check to bank supposedly to pay interest, but bank simultaneously sent same amt back as additional loan payments. For tax purposes, taxpayer did not pay interest, no deduction.

- P borrowed $5000 but bank retained it to pay interest due. It could be treated as payment(he got less out of loan proceeds), or deduction, or non-payment (he wont pay interst until he pays the additional $5000 in loans—more like extension, no deduction).
    - Caselaw…P did not make payment…
- *Battlestein*…look to purpose of second loan..if it is to finance interest payment, it is not payment on interest but an extension. If purpose of second loan is unrelated to first, then there is payment. If you cannot know the purpose of second loan, *Burgess* standard applies…ask whether loan proceeds passed into taxpayer control. If yes, it counts as payment—then deduction.
    - P really got an extension…he never had control of money, so he never made payment….NO DEDUCTION.

1. If the $260k, or the $250k of it secured by residence and used as refinancing of old debt, then the new debt also counts as AI.
2. How could you argue that the 10,000 was paid and he should get deduction?
3. well, he refused to take the 10,000, so it could be considered a repayment.
4. Argument against no payment?
5. well, it's not paid b/c he still owes the money…he didn't pay it, he's not out $10k, he's just received an extension to pay.
6. IRS's position…if second loan is from same lender, then IRS position is that initial payment will not be treated as being paid. NOT PAID, NO DEDUCTION.
7. If second loan is from different lender, then initial interest payment would be considered paid, and you would get deduction. PAID, DEDUCTIBLE.
8. Must ask if second loan is coming from new lender or same lender…
9. Courts are more generous than IRS in this case…Davidson said that when borrowing from same lender, then you don't have to forego the deduction…you may get it in some cases, i.e., those cases where the new loan is to pay off part of old loan.
10. What was purpose of second loan? If to pay off interest due, then not treated and borrower making payment, but that borrower is getting extension to pay at future time, no deduction until paid in future.
11. If the money borrowed is same money that is being used to satisfy current debt, then must ask purpose of second loan. If used to pay off current loan…treat as extension.
12. In this case, the second loan is from same lender…following IRS, no deduction
13. Under Davidson, you might get deduction…but NOT the case b/c it was same lender and purpose was to pay off the loan…so again, NO deduction.

(d) Assume now that when P owes $250k on mortgage he moves to NYC, buys townhouse for $900k, borrowing $820k. Interest on townhouse mortgage is $64k/year. P retains original residence as second home, may he deduct $64k and $27k annual interest on original home??

- Debt: 250,000 820,000 = $1,070,000
- Interest: 27,000 64,000
    - $27k in interest on 1st home = acquisition indebtedness
    - but now that he lives in NYC, must see if that house is still QR under §163(h)(4)(A).
        - The principal residence and one other residence of taxpayer if there is use as residence w/in meaning of §280A(d)(1)—the greater of 14 days or 10%of days used.
    - Both can be treated as QR b/c they meet definition…it is QRI and deductible (assuming it meets a.i., but that was previously determined)
    - $64k interest = QR. Debt incurred to acquire a QR assume secured by residence—therefore, meets definition for a.i., but there is $1mill limit.
        - $1mill limit on aggregate can be <u>treated</u> as a.i. for any period.
        - The excess $70k cannot be treated as HEI b/c the first requirement under HEI is that amt cannot be treated a.i.
        - $70k meets definition for a.i., but cannot be treated as such b/c of the limit.
- ($70,000 ÷ 820,000) x 64,000 = $5463 amount of interest not deductible

1. As long as P continues to use first home as residence…for at least 14 days a year, he can treat it as QR.
2. If he can treat as QR, then $250k debt continues to be AI.
3. W/ respect to debt on townhome….the $27k interest relating to $250k debt continues to be deductible.
4. The $820k debt was incurred in obtaining residence…w/in $1mill limitation and qualifies as AI, but there is a problem. B/c the limit applies to all outstanding indebtedness at one time.
5. What do we do? We can treat up to $750,000 as AI…the interest on second loan that relates to that portion of debt is deductible.
6. The excess, $70k, over debt….if it cannot be treated as AI b/c it's over the limit…what is it? HEI b/c you are still w/in the $100k limit for HEI. Remaining interest on second loan is deductible b/c it relates to QR.
7. EXCESS has to come out of last loan incurred.

II. CLASS NOTES

<u>INTEREST DEDUCTIONS</u>…in general §163 authorizes the deductions.

- General rule §163(a) deduction is allowed for interest expense provided incurred during current year.
- §163(h)…no deduction for personal interest
    - §163(h)(2) deductions excluded…and deductible…
        - interest incurred in conjunction w/ operating trade/business
        - investment interests – interest expense incurred as result of having borrowed money to purchase investments.
            - Can't use this deductions to offset more than your investment income.
            - Prepaid interest…not allowed to take deduction until interest actually accrues.
            - EXCEPTION…§461(g)(2) applies to points that incurred in constructing homes.
            - Interest on school loans…certain req's must be met…if income is too high under §221 the benefit of deduction is reduced. Deduction is only available during first five years of repayment.
                - There are limits…
        - Qualified residence interest (QRI)…HEI or AI…if house counts as residence then the interest will be deducted in those respects.

§163 – general rule…deduct all
§163(h)…limitation…denies all personal interest.

- Certain things are defined as not being personal interest and are entitled to deduction:
    - Trade or business
    - Investment interest (borrow money to purchase investment, interest on that loan is NOT personal)
    - Qualified residence interest (home mortgage)

§461(g)(1) puts cash basis taxpayers on accrual method.

- Prepaid interest is only allowed to deduct the amount allocable to current tax year (even though you paid it all that year).
    - Exception: interest is points paid in connection w/ acquiring home.

BASIC INCOME TAXATION

CHAPTER 26 – CHARITABLE DEDUCTIONS

I. PROBLEMS

(7) M is active in church, attends every Sunday and takes advantage of other church programs. He uses church's recreational facilities and all of these programs or facilities are fee free. M is expected to contribute 5% of income to church and to contribute to overseas mission fund. Church members receive a monthly magazine and mission t-shirt. Can M deduct the amounts he contributes?

- If he got nothing in return, would he get deduction?
  - He contributed in taxable year…actually paid a QR (§170(b)(1)(A)(i)) and therefore qualifies for deduction.
- Is there any effect by items in return to M?
- **facilities, counseling, programs**
  - *Hernandez*: services were only available to paying participants. B/c of the "***quid pro quo***" nature, it was purchasing services not a charitable contribution. Any expectation of return services; if contribution is required in order to get return benefit…then NO DEDUCTION
  - However, under Revenue Rule 93-73, *Hernandez* is reversed to allow deductions for amounts "donated" to the Church of Scientology.
- M is <u>expected</u> to contribute, but not <u>required</u> to do so in order to use services. He is not purchasing services; the contributions are voluntary.
- **Magazine…**
  - Rev 90-12, so long as it is not a commercial quality publication and it is used to inform members of church of events/happenings…then treat as insubstantial fmv and it will not affect ability to claim deduction
- **T-shirt…**
  - Either deduct contribution less value in return, or deduct full contribution?
    - Rev 90-12…as long as value is insubstantial compared to contribution, it is not necessary to reduce amount M can treat as charitable deduction.
- **<u>M ENTITLED TO DEDUCT AMOUNT HE CONTRIBUTED DESPITE THE BENEFITS</u>**

To get a charitable deduction, it must:

1. be a contribution (meeting Duberstein test—donor's intent of providing benefit to another w/o expecting return),
2. actually paid, and
3. "to or for the use of" a Qualified Recipient

Under *Hernandez* case, "quid pro quo" (this for that)…is this relationship b/w M and church present?

- Educational programs provided but only to people who make payments to church, and no deduction in that case, a quid pro quo relationship existed. Not contribution, it was actually purchasing something.
- So does M have to make payment to get benefits?
  - NO…he expected to make contribution, but not required to.
  - NO quid pro quo…so M is treated as making a contribution, b/c he is not getting something in return.
- Availability and or receipt of facilities, programs, does NOT constitute quid pro quo that prevents M from taking a deduction.

What about the magazine?

- Look at quid pro quo…he must be member to get magazine. But he is NOT required to contribute to be a church member. He can get deduction.
- Should getting this mag be treated as considerable fmv and work to decrease amount that he is given to church?
  - NO…

What about the T-shirt?

- Only received by mission fund contributors, so there is quid pro quo going on.
  - Under Rev Rule 90-12…benefit must be insubstantial…meaning that
    - payment must occur in fundraising campaign, and
    - (a) that fmv of benefits received must be less than $50 and 2 % of contribution, or (b) contribution must be substantial, and item received must be considered token item (low cost item, and must have church's name or logo on it.)
  - T-shirt could be considered as insubstantial value, and ignored.

(8) Jessica, a student at private high school, wins national civics award, which includes an expense paid trip to Washington, DC to attend special White House leadership conference. Under award, J is entitled to invite to conference the high school teacher that most inspired her, but the teacher's expenses are not included in award. Ms. Hanson is asked to accompany J, and school board seeks contributions to defray Ms. H's costs. Explain tax consequences of each of the following contributions:

(a) Ms. H's neighbor writes check to Ms. H for $100 w/ note saying it is to help w/ expense of DC trip and have fun.
- Individuals cannot be "qualified recipients" so donation is not "to" a qualified recipient…however, if it could be "for the use of" the school, which is a qualified recipient, the contribution would be deductible under §170(a).
  - This may not be for the use of…
  - *Davis* defined "for the use of" as = in trust for. Person receiving money must have legal obligation to use funds for qualified recipient.
- Here, H has no such obligation to use contribution for benefit of school…b/c no obligation, then it cannot be considered "for use of"
- **NO CHARITABLE DEDUCTION; FAILED §170(a) REQ OF "TO OR FOR THE USE OF"**

- Requirement under §170(c), the gift must be to or for the use of **School** in paying for trip. They are the qualified recipient. However, this check was paid to individual. Check is not to QR…
- However, check could be considered for the "use of" a QR?? This language means "in trust for" the QR. The money must be used to benefit the school.
  - If "for the use of" was not a requirement and covered this use…if donor earmarks donation to benefit certain contributor, then no deduction is allowed.
  - Well this is NOT considered "for use of" b/c the note does not guarantee this use.
- NO deduction will be allowed to donor, the neighbor. No charitable deduction.

(b) J's parents contribute $500 to school to be used for Ms. H's travel costs and other expenses. J's parents cannot travel to DC and are relieved that Ms. H can.
- Even though J's parents might expect some benefit, they sent money to school (QR) [contribution paid during taxable year].
- Technically they are entitled to a charitable deduction…while money will be used for purpose of funding Ms. H's trip, parents did not put any limitation on contribution.
  - *Tripp* establishes the rule…problems occur where donor tells donee how it must be used (i.e., for use of my child). Where donor does the earmarking, NO deduction. If school earmarks…deduction is allowed (even if everyone knows that school will be earmarking it to benefit of parents).
- **UNDER CURRENT LAW, PARENTS ARE ENTITLED TO DEDUCTION**.
  - Policy reasons exist as to why this should not be…one argument b/c parents are expecting a return benefit and therefore fail the *Duberstein* standard of detached and disinterested contribution.

- Problem w/ taking the deduction is that any contributions earmarked to benefit a certain individual, even though money is going to QR, is improper earmarking and causes deduction to be disallowed.
- Could be question of fact as to whether there is any earmarking going on…
  - If there is earmarking by donor, then no deduction.
  - If there is earmarking by donee, then there is deduction to donor.

(c) Ms Hanson contributes $250 to school to help defray cost of airline ticket which school is purchasing.
- On its face, it looks like she should get deduction b/c she meets all requirements.
- But, if she thinks that she will have to pay if there are not enough deductions, it seems more like she is expecting a return benefit.
  - This would not be detached and disinterested generosity, and not a contribution.
- It would not be to QR, it would be to herself…an attempt to convert personal travel expenses into a charitable deductible contribution.
- **NO CHARITABLE DEDUCTION**
  - It would be more beneficial for H to treat it as a business expense and deduct it above the line.

- H is trying to convert personal nondeductible expense to a deductible donation….therefore, no deduction.

(9) Assume Peggy has contribution base of $250,000.

(a) What tax consequences to Peggy if she gives $150,000 to local college?
- This is a contribution paid during the taxable year to a qualified recipient.
- Under §170(b)(1) limits are placed on deductions to a percentage of taxpayer's contribution base.
  - Since this is a cash contribution to a listed organization…§170(b)(1)(A) limitation applies…deduction limited to 50% of taxpayer's adjusted GI in that year.
  - **$250,000 (cash base) x 50% (limitation)= $125,000**
    - this is the most he can deduct from the $150k donation
- The remaining $25,000 may be carried over for next 5 years under §170(d)(1).

- Contribution base is her adjusted GI (see §170(b)(1)(f))
- She is entitled to charitable deduction, but not in full.
- She has made contribution, actually paid it and to QR…how much can she deduct?
- Under §170(b), must see if it's a gift to listed org…is it listed in §170(b)(1)(a)? YES. Organized under paragraph (2)(ii). §170(b)(1)(a) limitation shall be allowed to extent that aggregate of contributions does not exceed 50% of taxpayer's contribution base for taxable year.
    - She gave $250k to local college…$125k can be deducted. The extra can be carried over to next year, but must meet those requirements in next year, subject to same limitations.
    - Can be deducted in following years, but 5 year maximum under §170(d)(1).

(b) Alternatively what tax consequences if P gives $25,000 to local college and $125,000 to Private Foundation (foundation under §170(c)(2), but not §170(b)(1)(A)(vii))?

- The $25,000 is a cash contribution to a listed organization
    - Therefore, the §170(b)(1)(A) limitation of 50% applies
    - The most that can be deducted is $125,000…this portion is well w/in the limit. ($250k cash base x 50% limitation)
    - **The entire $25,000 contribution can be deducted**
- The $125,000 to foundation is a cash contribution to an unlisted organization
    - Therefore, the §170(1)(b)(B) limitation applies…the lesser of:
        - 30% of contribution base ($250k x 30% = $75,000), or
        - the excess of 50% of P's contribution base ($125k) over amount allowable under 50% limitation ($25k) = ($100,000).
    - **P may deduct $75,000** of the $125k contribution…the remainder $50k can be carried over for 5 years under §170(b)(1)(D), §1.170A-8(d).

- $25k to local college…use 50% rule (cash contribution to listed org)
    - limited to $125k b/c cash base is $250k…so the entire $25k can be deducted
- §125 to private foundation….can't use 50% rule b/c it's not to listed org.
    - §170(b)(1)(B), this is cash to non-listed org…the excess of $125k over sub(a) $75,000, or over sub(b) is $100,000. so only $75,000 can be deducted. The other $50k can be carried over to next year, but w/ 5 year max carry over.

<u>DONATION ANALYSIS</u>…

- Must look at value of what was contributed?
- If property appreciated in value from when you contributed it, look at §170(e) and you may have to reduce deduction down to adjusted basis.
- Apply general % limitation under §170(b)…(4 of these)…depends on what you are giving and to whom.
    1. if cash to listed org
    2. if cash to non-listed org
    3. if appreciated property to listed org
    4. if property to non-listed org §170(b)(1)(d)

(10) William makes following donations to charity during year. Assuming adequate contribution base, what deductions, if any, may he claim:

(a) W owns a condo in popular summer area. He donates use of condo for one week during July. FmrentalV of condo for week is $2500.

- **<u>NO DEDUCTION</u>**
- §170(f)(3)(A) precludes deduction when giving any interest in property that is less than donor's entire interest.
- Since W is only donating a week, and not his entire fee simple, he will not receive a deduction for the contribution.
    - This is the equivalent of renting it for a week and donating the amount received in rent. If he did not recognize income, he cannot take the deduction. Cannot have an exclusion and a deduction (§1.170A-7(a)(1))

- When you're giving away something less then your whole interest in property, then you get no charitable deduction.

(b) W donates 30hrs of time to give advice to private college w/r/t college's capital campaign. He generally charges $200/hr for services. W also incurred $500 in unreimbursed travel expenses in providing these services to college, $300 attributable to W's own travel and $200 for travel of an associate who also is donating his time.

- **<u>The $6000 in services is NOT deductible</u>**
    - Rationale: if he had been paid for services, he would have to include it in his gross income. Then if he turned around and donated it back, he could claim a deduction. The exclusion and donation would cancel each other out.
    - So if he does not include it, he may not deduct it. §1.170A-1(g).
- Same regulation allows him to deduct unreimbursed expenses incurred in donating services—but only his own. ($300 is deductible)
- **<u>He cannot deduct as a charitable contribution any money paid to allow the associate to donate services</u>** (unless, assuming it furthers business, he can then claim it as business expense).

- *Davis*…only the contributor may deduct unreimbursed expenses incurred in donating services themselves, not expenses incurred by others.

(c) W owns a valuable 18th century painting and retains a life interest in painting but transfers remainder interest to local art museum. Remainder interest is valued at $50,000?
- Under §170(a)(3), he cannot deduct the value of the remainder interest at the time conveyed – not until all intervening interests are expired. (see §1.170A-5(b) examples)
- **So long as W or his relatives owns the life estate, no deduction**
- When W dies, his estate can take deduction of the value of the remainder interest at that time.
  1. No deduction b/c it is a remainder interest…even though he gives it away this year, and it can be valued at $50k, he is not entitled to the charitable deduction this year.
  2. Congress was attempting to prevent individuals from getting charitable deduction when they are still enjoying the property.
  3. when he dies, then his estate will be entitled to the deduction, after his life estate expires.

(d) Assume sale of painting would have generated long term income capital gain. What tax consequences to W if, in lieu of transfer in (c), he gives painting to his church? Would answer change if donated property were undeveloped land instead of painting?
- If W owned the painting more than one year, (and he did not paint it), if he were to sell it, the sale would generate long term capital gain.
- Since he gave it outright…contribution paid in taxable year to qualified recipient, then **DEDUCTION**
  - §170(3) applies if there is any gain other than long term capital gain or it is not used for the tax exempt status of the organization.
  - Start w/ FMV…reduce by sum of:
    - (A) gains that are not long term capital gain: gains from sale of property owned one year or less (short term capital gain) or ordinary gain (if he painted it himself).
    - (B) in the case of charitable contribution of (i) *tangible personal property*, if use by organization is not related to its tax exempt purpose, the amount of gain is long term capital gain.
  - FMV – gain = AB
    - (A) does NOT apply b/c there is only long term capital gain generated by sale of the painting
    - (B) applies b/c painting is going to church, most likely it will not be used for church's tax exempt purposes.
      - If it went to museum, (B) would not apply b/c it would be used for the museum's tax exempt status.
      - If church sold painting in order to generate money, §170(e)(1)(B) would apply. Assuming this provision applies, W would be able to deduct (FMV – long term gain) = AB.
  - If donation was land he had owned for more than one year, then (B) would not apply either. It only applies to *personal tangible property*. (A) would not apply b/c only long term gain would be generated by its sale. Therefore sub(e) would not be applicable.
  - If he owned the land less than one year, it would fall under (A), so sub(e) would apply…(FMV – short term gain) = AB.

1. Painting…it would generate long term cap gain under §170(e) b/c he's paying to QR in the current year.
2. Amount of deduction will be the fmv of whatever he gives, this amt he'll be able to deduct. This deductible will have to be reduced in some cases.
3. Look at fmv, then §170(e), then general % limitations of §170(b)
4. if §170(e) does apply, the effect is that it will reduce the amount deductible by either (A) or (B), the amt of gain that would have resulted had property been sold.
5. FMV – gain = AB
6. if §170(e) applies, he gets smaller deduction, if not, more deduction
7. §170(e) will apply if contribution is to:
   - (1)(A)—gain that would have resulted if sold for fmv must be something other than long term capital gain (such as, short term cap gain or ordinary gain)
   - (1)(B)—tangible personal property used by donee for something unrelated to charity's

charitable purpose (such as, donating to museum)

8. **§170(e) does apply b/c property is used for something other than charity's charitable purpose under §170(e)(1)(B)…not used for religious purpose.**
   - If it is used for religious purpose, then §170(e) would NOT apply and donee would get full fmv deduction.
9. As for land…§170(e)(1)(B) doesn't apply b/c land is not tangible personal property and can get fmv deduction.

(e) W sells $100,000 worth of XYZ stock to church for $50,000. W's adjusted basis in stock is $40,000.

- This can be considered a <u>*bargain sale to charity*</u>…so, special rules apply.
  - Need to compute gain/loss b/c it is a sale
  - Need to compute deduction for charitable contribution
- SALE…
  - AR – AB(gain)…§1011(b) has special rule for determining basis when bargain sale to charity is involved.
    - <u>AB(gain)</u> **x** = <u>AR</u> **<u>$50k</u>**
      AB(whole) **$40k** FMV **$100k**

- AB(gain) = $20,000
- GAIN = $50,000 – 20,000 = **<u>$30,000</u>**

- CHARITABLE CONTRIBUTION…
  - Contribution was $50,000…but if sub(e) applies, it must be reduced by AB of the gifted stock.
  - §170(e) applies if either (1)(A or B) applies.
    - (A) would apply if he held it less than one year
    - (B) doesn't apply b/c stocks are not *tangible personal property*.
  - So §170(e) does NOT apply and there is no need to reduce the amount of the deduction.
- **<u>HE CAN TAKE THE FULL $50,000 DEDUCTION</u>**
- **<u>REPORT A $30,000 GAIN AND DEDUCT $50,000</u>**

1. This is a bargain sale to a charity…and treated under §1011(b)

- Deduction under §170 is not allowed here b/c even though it is deduction meeting *Duberstein* test, paid during current year, it is a bargain sale to charity meeting special rules

2. Here there is donation of ½ stock for free, and selling other ½ for full market value. Two sets of tax consequences…
   - ½ for free will give rise to charitable deduction
   - ½ for sale must be computed to recognize any gain/loss
3. Under §1011(b)…(*see calculation above*)…

CHARITABLE DEDUCTIONS…BELOW THE LINE (SEE §62)

§170 requirements to take a CHARITABLE DEDUCTION…

- **There must be a contribution made**
  (Must meet *Duberstein* standard for a gift)
- **Must have actually paid the contribution**
- **Paid "to" or "for the use of" a qualified recipient**

(Individuals are not considered a qualified recipient. (Qrep §170(c))

Services…

- No charitable contribution b/c when it was contributed, no income was reported – cannot take an exclusion and a **deduction**
- Only deduction if expenses are for your own participation. If you pay for someone else as well, you cannot get deduction for expenses incurred for this person.
- What about cash….you get deduction

Property…

- Amount of deduction…
  - Start w/ FMV
  - Look to see if it's appreciated property (§170(e))
  - Must apply the general limitation provisions in §170(b)(1)(A,B,C,D)

    §170(b)(1) percentage limitations—related to GI…
    a. General limit – cash to a listed organization 50% of GI
    b. Cash to an organization not listed
    c. Appreciated Property to a listed organization instead of cash
    d. Appreciated Property to an organization not listed

Remainder Interest in Property…

- No charitable deduction until intervening interests are expired

Appreciated Property…

- Special rules – deduction limited §170(e) to taxpayer's basis in property
- Bought stock for $100k, now worth $1mill…then donate to charity…if stock would have provided short time capital gain, all to deduct is basis in property.

Bargain sales to Charity (i.e., property worth $10,000 for $2000)

i. It is in essence selling part of the property and making a charitable contribution of the other part.
ii. Tax consequences?
iii. Account for the sale portion and charitable contribution
iv. §1011(b) – basis for gain/loss on sale to charity

BASIC INCOME TAXATION

CHAPTER 27 – LIMITATIONS ON DEDUCTIONS

I. PROBLEMS

(11) Dennis sells 100 shares of XYZ stock to his g/daughter C for $12,000. D's adjusted basis in stock was $20,000.

(a) May Dennis deduct the loss realized on sale of stock?

- D's loss is $8000.
- Under §267(a)(1), the general rule is that no deduction shall be allowed for any loss from sale or exchange of property b/w persons in sub(b).
- Under §267(b)(1), no loss may be realized if sold to member of family. Sub(c)(4) also includes lineal descendants.
- Since C is member of D's family, she is a related person, and general rule applies.
- **NO DEDUCTION**

- D has sold stock at loss…$8000 this cannot be deducted b/c of §267(a)(1) b/c he sold it to related person
- C is related b/c under §267(c)(4), related includes bro/sis, spouse, ancestors and lineal descendants.
- C is lineal descendant of D and therefore, related.
- §267(b)(1)…members of family are considered related as per (c)(4)

(b) Would it make any diff if fmv of stock were only $12,000?

- **NO**, §267(a)(1) general rule still applies…even if true fmv is $12,000 and $8000 loss is generated, he cannot deduct it.

(c) What result if D sold XYZ stock to C's husband for $12,000?

- §267(a)(1) applies if they are related…so that is the question
- Under sub(b)(1), and (c)(4), the family of individual includes only his brothers, sisters (whole or ½ blood), spouse, ancestors, and lineal descendants.
- Granddaughter's husband is not listed, and is not considered member of same family.
- Since this is not a sale to a related person, **D MAY DEDUCT THE LOSS**

- Must determine if this is sale b/w related individuals.
- D and C's husband are NOT considered…
- Look to §267(c)(4), C's husband is not listed as member of family, and therefore not considered related.
- In-laws not included in sub(c)(4)
- D can then take a deduction…for $8000 loss.
- Can't this be viewed as sale to C under constructive ownership rules?
  i. Family attribution rules apply under §267(c)(1)…any stock that C's husband owns can be seen as owned by C. But this doesn't make C's husband and D related…the parties to the transaction are still UNRELATED.
  ii. Can't look to constructive SALE rules, just ownership.
  iii. The two parties to transaction must be seen as related, not parties to ownership.

(d) What result if D sold XYZ stock to ABC, Inc., a corp. in which D own 60% of stock?

- §267(a)(1) disallows a deduction of any loss from sale/exchange of property, directly or indirectly b/w persons specified in any paragraph of Sub(b).
- §267(b)(2) states that an individual and corporation more than 50% in value of outstanding stock of which is owned, directly/indirectly, by or for such individual, are considered related for purposes of Sub(a)(1).
- Since D owns 60% in ABC, he is related and §267(a)(1) provides that no loss is recognized.
- **NO DEDUCTION**

- Under §267(c)(1)—constructive ownership—D cannot get deduction.
- Selling to ABC corp…is there a relationship?
  i. Individual can be related to corp if more than 50% of stock is owned by individual selling property to corp.
  ii. D owns 60%…so any sale transaction b/c D and that corp are considered related parties.

(e) Assume D and C had not spoken for years. What result if D sold XYZ stock to DEF, Inc, a corp. in which C owns 60% of stock?

- Under §267(c)(2), constructive ownership of stock, an individual shall be considered as owning stock owned by or for his family. (rule mentions no exception for hostility or lack of knowledge)
- D is therefore treated as owning what C owns, 60%.
- Under §267(b)(2), if individual owns more than 50% of stock of corp he is considered related to corporation.
- §267(a)(1) general rule applies and no loss is recognized.
- **NO DEDUCTION**

- Can D be viewed as owning more than 50% of DEF?
  i. Under constructive ownership rules, he is considered related party under §267(c)(4) as a lineal descendant.
  ii. Two parties to transaction are considered related…and no deduction.

(f) What result if D sold XYZ stock to GHI, a corp. in which C's husband owns 60% of stock?

- Under §267(c)(4), the husband is not treated as a related person.
- But, under §267(c)(2) family attribution, C may be treated as constructively owning; b/c they are family members under (c)(4).
- Therefore, C is related to GHI under Sub(b)(2). However C will not be considered a constructive owner for purposes of again applying the family attribute to make D a constructive owner under (c)(5).
- Double attribution is not allowed…therefore, D is not related to GHI and is not treated as related.
- **D MAY DEDUCT THE LOSS**

§267(c)(5) has two parts:

1. If constructive ownership is a result of (1), then double constructive ownership is allowed
   [stock owned by or for a corp is treated as being owned by the corp's shareholders/owners]
2. If constructive ownership is a result of (2) or (3), then there is no double attribution.
   [(2) deals w/ family attribution; (3) deals w/ partners]

(g) What result if two weeks later GHI sells stock to Christina for $12,000?
- In substance, if really a direct sale from D to C, there is no loss deduction for D.
- The sale to corp could have been set up to avoid a sale directly to a related party. There would probably be litigation into purpose of first sale.
- If sale was just to get around §267(a)(1), the court would probably collapse the two sales into one.
- In substance, really D to C. But D could argue there existed an independent business purpose for first transaction.

(12) Same facts as Prob. 1. If C sells stock a year later to an unrelated 3rd party for $10,000, what loss, if any, may she deduct?
- Loss realized = $8000; but D cannot recognize this loss.
- For C…[AR $10,000 – AB $12,000 = -$2000]
- There is no code provision that prevents the deduction so long as she meets the requirements for loss under §165.
- **C MAY TAKE A DEDUCTION FOR $2000 LOSS**

(a) What result if she sells stock for $21,000?
- Under §267(d), you can only recognize gain to extent it exceeds the loss previously disallowed to D under §267(a)(1).
- Sub(d) is a relief provision to make (a)(1) less Draconian.
- C's $9000 gain – D's $8000 loss = $1000 gain which must be recognized.
- **C MUST RECOGNIZE $100 GAIN IN SALE TO 3RD PARTY**

(13) Dennis is 60% shareholder in corp. that provides tour guide and outfitting services in Pacific NW. Corp is a calendar year, accrual method taxpayer. D's son, M and wife are avid hikers. M and wife, who are cash method, calendar year taxpayers, are employed full-time by the corp. M owns 40% stock in corp. During current year, corp. fails to pay M and wife the $25,000 salary owning to each for services they performed. Payment of salaries does not occur until Feb of following year.

(a) When may corp deduct salaries owed to M and wife? When must M and wife include amounts owing to them?
- B/c M and wife are both cash method taxpayers, they include income when it is actually or constructively received. This would be in Year 2.

(b) When can Pacific NW deduct?
- Michael: Year 2 under §267(a)(2)
  - Is there a mismatch? PN – accrual; M – cash basis
    i. PN could usually deduct the salary in Year 1 – when incurred
    ii. M doesn't include until received – Year 2
    iii. Result: PN must take the deduction in Year 2
    iv. §267(a)(2) applies and PN must delay the deduction for the salary until the year that Michael includes it in income.
  - Are M and corporation related?
    i. YES…his dad owns 60% of stock, and under (c)(2), (4), M constructively owns 60% of the corp.
    ii. So according to (b)(2), M is related to PN b/c he owns 50+% of the corporation.
- M's wife: Year 1, but §267 does not apply.
  - There is a mismatch for the same reason; but
  - Wife is not related to PN. D is not a member of Wife's family under (c)(4). And there is no

double family attribution (c)(5), she does not constructively own more than 50% of PN.
    i. She could be treated as owning M's 40%, but this is not enough to call her related under (b)(2).
- Result: §267(a)(2) is NOT triggered – PN can deduct M's Wife's salary in Year 1, when the obligation accrued.

(c) Would answer change to (a) if it could be established that the corp was willing and able to pay M and wife the salaries owed them but that M and wife requested that the salaries not be paid until the following year?
- A cash method taxpayer does not recognize income until it is actually or constructively received.
- But b/c the delay was at their request, they are treated as having received it in Year 1. It must be included in their GI for Year 1. Receipt of taxable income cannot be delayed solely by requesting delay.
- §267(a)(2) is not triggered b/c there is no mismatching due to accounting methods. No need for PN to delay deduction.

II. CLASS NOTES

§267(a)(1)…abuse concerned about..
- If you have taxpayer owning property whose value has gone down. They don't want to sell, but if they do sell, a loss can be recognized.
    - Taxpayers holding property that went down in value sold property to recognize loss, but in order to keep control over it, they sold to relative.
    - They created a fake realization event to deduct the loss
- To prevent this, §267(a)(1) was passed disallowing deduction for loss on property if sold to relative or controlled entity.
- Who should be considered related, etc…
    - §267(b) & (c)
    - Under (d), the later gain will be recognized, but only as to how much it exceeds the loss

III. BOOK NOTES

§267(a)(2)
Is aimed at preventing abuse when different methods of accounting are used…b/c where two related taxpayers use diff acctg methods, it is possible for them to manipulate to detriment of treasury.

Normal:
A makes business payment to B
A would deduct at time of payment. B includes payment in GI.
Result: cost to treasury of A's deduction is made up for by B's inclusion.

But if:
A and B are related and use diff acctg methods, a different result is possible…
A makes business payment to B.
A uses accrual method. B uses cash method.

A has incurred expense and will pay B.
A can deduct immediately before payment is made, if legally obligated to pay, and amount can be determined w/ accuracy.
B however, will NOT include in GI until received….SO…

A	B
Deducts immediately	Doesn't include until year received

Problem for treasury: to extent that A gets deduction, A's taxes go down, but this is not made up by B.
As a group, A and B benefit temporarily at expense of treasury: time value of money.

§267(a)(2) was enacted to prevent this:
A party w/ deductible expense [A] cannot take a deduction until other party [B] must include the amount in GI. In order for this section to apply, two requirements must be met…
(1) the reason for the mismatching is the diff accounting methods
(2) the two taxpayers must be related [as under §267(b)(1), (c)(4).

BASIC INCOME TAXATION

CHAPTER 27 – LIMITATIONS ON DEDUCTIONS (PART B)

V. PROBLEMS
(1) Assume Bill applies for Social Security disability benefits, and his claim is denied. Bill then pays lawyer $1000 to appeal the denial. The appeal is successful, and Bill collects $6000 in disability payments for current year. Assume that pursuant to §86, half of benefits are taxable. May Bill deduct the $1000 paid to lawyer?
    (a) The ½ allocable to the taxable portion may be deducted ($500)
    (b) There was $6000 in income, ½ of which is tax-exempt.
    (c) Therefore, the ½ of $1000 incurred in producing that income is NOT deductible.

- We are taxed on **NET INCOME**, not on gross income. There is no need to reduce income by expenses incurred in production of tax-exempt income.

- NOTE: any interest expenses allocable to purchasing tax exempt securities is NOT deductible generally

BASIC INCOME TAXATION

CHAPTER 31 – CAPITAL GAINS AND LOSSES

I. PROBLEMS

(A) DEFINITION OF CAPITAL ASSET

(1) Margaret is an artist whose paintings command significant prices. Terry, her husband, is sole proprietor of retail hardware store. Determine which of the following are capital assets:

(a) The home owned by M and T and used exclusively for personal purposes
- Home is NOT listed, therefore it is a capital asset
- This is real property NOT used in a trade or business

(b) The inventory of T's hardware store
- Inventory is listed in §1221(1), so it is NOT a capital asset.
- Sale = ordinary gain

(c) The delivery truck Terry uses exclusively for business purposes
- Listed in §1221(2) – property used in trade/business and depreciable under §167
- NOT capital asset

Ask under §1221, is it cap asset?
- No, not listed…any gain is ordinary…
- Under quasi-cap, the property can be recharacterized to be treated as cap gain.
- Must consider whether depreciation applies and recharacterizes

§1245 can cause some capital gain to be re-characterized as capital income.
- T sells truck at gain…the gain is ordinary under §1221
- But under §1231 if it's re-characterized as capital gain…
- Calculate depreciation…AB goes down
- AR is sale price….gain is AR – AB
- Part of gain due b/c you took depreciation has to be recharacterized b/c rest of gain can retain character ordinary income.

(d) IBM stock owned by M
- NOT listed in §1221, therefore a capital asset

(e) M's paintings. If M gives one of paintings to daughter, would painting be considered a capital asset in daughter's hands?
- In M's hands it is NOT a capital asset listed in §1221(3)(A).
  - It is a painting that she created through personal efforts.
  - Money made is like a salary and should be treated as ordinary income.
- In D's hands, it is NOT a capital asset listed in §1221(3)(C).
  - The basis of property in D's hands is determined in reference to basis in M's hands [taxpayer that fits (A) or (B)]
- Gift…basis under §1015 is the basis in hands of donor.
  - B/c it is a gift, D's basis is determined by reference to M's basis, therefore, it is listed and NOT a capital asset.
    - This prevents conversion of ordinary gain…capital gain through gifts

(f) Accounts receivable of hardware store
- Accts receivable are listed in §1221(4), therefore NOT capital asset
  - Considered ordinary gain or loss

(g) Computer which T and M use exclusively to manage their stock investments and to account for their household expenses
- While it is depreciable and used to produce income, it is not used in trade or business.
- §1221(2) does NOT apply, therefore capital asset

(h) Commercial bldg and land owned by T and used in his hardware business
- §1221(2) does apply to both…
  - building is depreciable property—subject to wear and tear
  - land is real property—not depreciable, not capital asset
- both used in trade or business….NOT capital.

(B) SKIP…

(C) MISCELLANEOUS CAPITAL GAIN/LOSS ISSUES

(1) Heath, a newspaper publisher, purchased stock in ABC Newsprint Company in order to assure a supply of paper. H later sold stock at a loss.

(a) How would the loss be characterized?

- Stock is ordinarily a capital asset, but *Corn Products* held that if you buy what is ordinarily a capital asset, not for profit, but rather for ordinary business operations, then it is treated as ordinary gain or loss.
- *Arkansas Best* held that you no longer look at taxpayer motive in purchasing the asset, but then *Circle K* held that *Corn Products* is still good law when determining the character of gain/loss form an asset purchased to assure a source of supply (business purposes).
- H purchased stock to ensure supply…
    - Under *Circle K*, *Corn Products* still applies.
    - Stock purchased for business purposes, not profit is considered **ORDINARY LOSS**.

(b) What if, instead of purchasing stock, H had entered into a 10-yr contract w/ newsprint co whereby H agreed to purchase a certain amt of newsprint each year. Assume H periodically assigns his right to some of the newsprint to other newspaper publishing cos…how should H characterize payments received for these assignments?

- **ORDINARY**…Same theory under *Corn Products*.
- The investment is a contract and gain or loss is realized upon selling it to someone else.
    - The contract was for purpose of assuring a source of supply
    - Therefore, under *Circle K, Corn Products*, ordinary, not capital.

II. CLASS NOTES

Ordinary income…income from wages, cancellation of indebtedness
In this chapter, we see a special preferred income…CAPITAL GAIN INCOME
Capital gains…are preferred b/c

- They are taxed at less than ordinary income
- 28% tax rate for capital gain

Deductions…
Capital losses are deductible…

- but you want your losses considered ordinary losses
    - ordinary losses can be deducted in full
    - capital losses are limited…capital gains + up to $3000 in income §1211(b)
- if you have a gain, your incentive is to characterize it as capital gain
- your incentive for loss, is to characterize it ordinary loss to offset most expensive kind of income

Deduction for ordinary losses are not limited…
Capital losses are…

- you'd rather get the loss deductions up front…characterizing them as ordinary
- reduces more expense of income and deduction is not limited in same year

Just b/c it's your incentive…you still have to follow the rules for proper characterizing

- §1221
- **Corn Products**
- **Circle K**
- §1222

Diff b/w long term cap gain and short term

- long term capital gains only get the preferential rate
- short term is taxed at normal rate
- if you hold asset for less than year, then characterized as short term

What tax rate applies to your capital gains?

- The highest rate to long term cap is 28%
- Other rates…
    - §1(h)(A) excess of capital income minus net capital gains
    - …look at type of asset and how long you've had it
    - rates up to 39.6%
- 20% applies to any long term not covered in §1(h), or any 28% gain
- those pushed out of 15% bracket…get 20% on other long term capital gains
- §1(h)(1)(D)…
    - 25% do not worry about
- §1(h)(1)(E)
    - 28% rate on what's left…
    - what's left is gain on net collectibles…if you have a collectible that you sell at gain, provided it's long term you apply this rate

RATES THAT APPLY IN THIS CLASS…

1. ORDINARY
2. 10%
3. 20%
4. 28%
5. 8% or 18% rate

EXAMPLES…
XYZ stock for 6 mos

- full ordinary rate applies
- b/c you held asset for 1 yr or less
- this is short term capital gain

xyz stock for 2 yrs sold at gain

- 28% collectibles gain

- not short term gain
- under collectibles gain this applies

abc stock for 1.5 yrs sold at gain
- depends on tax rate
- either taxed at 10% or 20% b/c stock is not collectible
- and you haven't held stock for 5 yrs or more (no 8% or 18% tax)
- if ordinary income is low enough that you fit into 15% bracket, then 10% tax
- if income higher, then you're taxed at 20%

Painting for 10 months, sold at gain
- short term cap gain…ordinary tax rate
- collectible gain only applicable if long term

Painting for over a year, sold at gain
- collectibles gain – 28%

stock for 6 yrs, sold at gain in 2002
- §1(h)(2)(A) or (B) – 8% or 18% b/c held for more than 5 years
- depends on tax bracket…if low, then 8%
- if higher, 18%

Don't need to know how to allocate capital losses among these allocable gains

How do you characterize an asset…as either capital or not?
- In order to get capital gain, the item you sold must be capital asset
  - §1221 that lists the non-capital assets
  - judicial limits on capital assets, see Corn Products, Circle K
- computing certain mechanical amounts
  - choosing appropriate tax rate
  - net capital gain §1222(11)
  - how much of capital losses can be deducted in current year
    - capital losses to extent of cap gains + up to $3000 in income
      - any excess must be carried forward, unlimited carrying forward

Ordinary income = $30,000
Capital gains = $7000
Capital losses = $2000
- All capital losses will be deducted b/c the limit is the amount of capital gains + up to $3000 ordinary income.

Ordinary income = $30,000
Capital gains = $2000
Capital losses = $7000
- Only $5000 of capital loss can be deducted…the remaining $2000 must be carried forward to deduct in future year

Ordinary income = $1000
Capital gains = $50,000
Capital losses = $70,000
- How much of capital loss can be deducted in current year?
  - $51,000 b/c amount = to capital gains + up to $3000 of ordinary income.
  - Since you only have $1000 ordinary income, you can only get up to that much to apply to the deduction.
  - The remaining $19,000 must be carried forward to attempt deduction in future years

III. BOOK NOTES

Characterization…

Gains: capital gains are preferred over ordinary gains.
- If it is a long term gain (owned > 1 year),
  - The maximum tax rate on capital gains is 28%;
  - But ordinary gain may be up to 32%.

Loss/Deductions: ordinary loss is preferable
- The amount of capital loss is limited to amount of capital gains for the year + $3000 in ordinary income (excess may be carried over).
  - Further, ordinary income can be taxed at higher rate, so it is desirable to reduce ordinary income by characterizing loss as ordinary.

Incentive…to characterize gains as capital; losses or ordinary

Two important areas in the chapter:
1. How to characterize a gain or loss (capital or ordinary)
2. Mechanical issues…
   a. How much if any of the capital gain gets the preferential tax rate of 28%
      Net Capital Gain defined by §1222(1)
   b. When there are capital losses, how much of capital losses may be deducted:
      Capital gain for the year + $3000 of ordinary income
      Any excess carries over to next year

Characterization starting point…
- §1221 lists those items that are NOT capital assets.
  - If they are listed, the assets are ordinary gain or loss.
  - If you sell something that is not listed it is a capital gain or loss.

Judicial limits on characterization…
- *Corn Products*…denial of capital asset status to inventory-type items;
  - the taxpayer's purchases of future contracts had been found to "constitute an integral part of its manufacturing business"; they assured the holders of a source of supply;

    - Congress intended that profits and losses arising from the everyday operation of a business by considered as ordinary income or loss rather than capital gain or loss.
- *Arkansas Best*…rejected the motivation test: that a taxpayer's motivation in purchasing an asset could be critical to determination of whether it is a capital asset.
    - But as a result, the service issued temporary regulation excluding hedging???
- *Circle K*…purchased stock ownership in NCE to assure a sufficient supply of gas at its stations.
    - Never needed to exercise its option and sold stock at huge loss, which it sought to deduct as an ordinary loss.
    - Court held that the purchase of crude oil bore a requisite close relation w/ CK's business to justify the *Corn Products* inventory exception of §1221.
    - So despite *Arkansas Best,* the *Corn Products* gloss to §1221(1) lives on.

Regardless of its characterization, in order for a gain or loss to get preferential treatment, it must be sold or exchanged (which includes abandonment)

Under *Arrow Smith*…
Characterization of gain or loss may also depend on previous treatment of asset:
1. Was it a capital asset under §1221 or case law?
2. Was it sold or exchanged?
3. Does previous treatment change its characterization?

Other provisions:
- §1231 – quasi capital
- §1245, §1250 – recapture provisions

When determining the character of gain/loss (ordinary v. capital), start w/ §1221.
- If asset is capital asset under §1221, the gain/loss will be capital if asset is bought or sold under §1222.

§1221 – determines whether an asset is capital. If it is not, normally it will produce ordinary gain/loss. But…
§1231 – may cause the gain/loss to be recharacterized as capital gain/loss even though it is not a capital asset.
- Property described in §1221(2) [property used in trade/business which is depreciable; or real property used in trade/business] if held for greater than 1 year….§1231 will apply.
    - If §1231 applies, two categories of §1221(2) property…
        - Involuntary concersions…, i.e., fire, theft….losses/gains (insurance)
            - If the loss > gain….all losses and gains are ordinary
            - If gain are > or = to losses…going into preliminary hotch pot
        - Principle hotch pot…all gains or losses on disposition (includes abandonment, sale, preliminary hotch pot)…
            - If gain > losses…all gains are capital
            - If not….gains/losses are ordinary
        - The gains/losses will be characterized as capital even though the asset is not a capital asset.

§1231(c) – RECAPTURE…
- If the loss got the benefit of being ordinary b/c of application of §1231…
- If there is later a capital gain b/c of §1231 w/in the next 5 years, the IRS can recapture the loss.
    - Treat gain as ordinary to extent of ordinary loss

§1245
- Where depreciation is allowed on property owned, it reduces ordinary income, then you sell asset…Depreciation reduces the AB, which generates a greater gain upon sale.
    - When sold, part of gain exists b/c of depreciation
    - So the gain is not capital to extent of depreciation allowed.
- EXAMPLE…
    - You own depreciable property used in trade/business for 5 yrs. Part of gain resulted from depreciation deductions which reduced AB. That portion is treated as ordinary gain. The rest is long term capital gain.
    - This is excluded under §1221(2)…but under §1231 if the gains > losses…treat as capital

SUMMARY
Depreciable property used in trade/business…characterizing gains/losses…
- §1221…if denied capital status under sub (2),
- §1231…if held more than one year, this section applies. It may be quasi-capital gain. Look to preliminary hotch pot.
- Principle Hotch Pot…if gains> losses…gains and losses are capital. Assuming it is §1231 capital gain, part of the gain is due to the fact that depreciation deductions reduced the AB.
- §1245…recharacterizes the portion of gain due to depreciation as ordinary gain

BASIC INCOME TAXATION

CHAPTER 34 – ASSIGNMENT OF INCOME

I. PROBLEMS

(1) D is dentist, she has daughter, A, a young starving artist. A has some small parts but income is never more than $8000 - $10,000/year. A enrolls as full-time student as expensive college and will continue to act part-time during school. D will pay most of A's college expenses, estimated at about $30,000. B/c her practice in past yrs has been lucrative, D decided to reduce her taxable income. D wants to try a tax-saving plan, but asks my advice and tax consequences of plan…

Plan 1: Most of D's patients pay for her services by check, payable to her. D will endorse over to A total of $35,000 in checks, A will deposit to her own account and use for college expenses.

- General Rule…(if no statute applies) income is taxed to person who earns the income.
- D cannot deflect by endorsing over to A.

Plan 2:

a. D and A will enter into contract, which is valid and enforceable under stat law, providing that for next 2 yrs any income earned by either of them will be shared equally. In Y1, D expects to earn $140,000 and A $10,000. A's share of total, $75,000, will pay her first 2 yrs of college

- *Lucas v. Earl*…husband and wife had contract to share all income equally. Contract was enforceable under state law. But husband works and earn money and the full amount is taxes to him (even though under state law, it was owned by both). HELD: cant' sue contract to assign income to person in lower tax bracket (whether before or after services are performed).
- D earned the income…even w/ anticipatory contract, taxpayer cannot shift income for tax purposes.
- D is taxed on full $140,000, A is taxed on her $10,000.
- The person who performs the services is subject to tax

b. alternatively, D will request that certain of her patients make their checks for dental services payable directly to A so A will receive $35,000.

- Since D's services generated the income, she cannot deflect income by directing payment to A.
- D is proper taxpayer.

Plan 3:

a. D will advise ABC corp that, until further notice, all future dividends are payable to A w/ respect to her stock. D expects $40,000 in dividends this year.

- *Helvering v. Horst*…father owned bonds…he detached the detachable interest coupons and gave them to son, as means of assigning income to son. Son will be person collecting interest payments. HELD: father retained control over income generating property. Father still received enjoyment of income by being able to give it away
- GENERAL RULE: party who owns property that generates income is person taxed.
- D never gave underlying property interest in stock to A…
- D is person to be taxed—the property owner

b. Alternatively, D will sell to A the right to dividends for next 4 yrs. Selling price will be $90,000, present value of the next 4 yrs' dividends. Interest on selling price will accrue at rate of 10%/year. Sales price and accrued interest will be payable in 10 yrs. D may forgive all/part of principal and interest from time to time as gift to A, but there is no agreement.

- D continues to own stock and dividends go to A. A agrees to pay fmv for dividends in form of loan…$70,000 + interest over 10 yrs
- *Stranahan*…son paid fmv for dividend stream at time of transaction…there was no doubt whether or not he would pay b/c he already did.
- This could be argued either way…A has agreed to purchase right to dividends for next 4 yrs…but since D still is property owner, she is appropriate taxpayer.

c. D will give A right to next year yrs' dividends…D will give ABC stock itself to D's husband

- D's husband now owns the stock, but never had any rights to dividends. He owns stock minus

rights to dividends for 4 yrs. D's husband will not be taxed.

- D no longer owns the underlying property generating income…HvH rule, is that owner of underlying property is taxed.
- A…the only potential taxpayer on dividend income.
    - Under today's law, A is most likely to be taxed. This is one type of arrangement that may work to shift income…

Plan 4: D owns off bldg where dentist office is located. D has almost fully depreciated the build. There are five other medical offices located in two-story bldg. D will convey bldg to A as gift and then will lease back office that D uses for dental practice.

- Who ever owns property that generated income is taxed on that income:
    - If D owns and other rent, D should be taxed on amount
    - If A owns, she should be taxed on all rent
- D is almost out of depreciation deductions, so she may be trying to get rental deduction as business expense (under §162)…
- Income shifting…
    - If D pays rent and gets business deduction, her taxes will go down and A's will go up.
    - W/ D in higher tax bracket, her taxes will go down a lot
    - W/ A in lower bracket, her taxes will go up a little

Plan 5: D's ABC stock has dramatically increased in value since D has owned it. One of D's friends wishes to buy the stock and D is prepared to sell, at price that will result in substantial gain to D. colleague suggests that D instead give stock to A and let A make sale and report gain. Given A's tax bracket, some useful saving results.

- If D held >1 yr, any gain on sale/exchange would result in long term cap gain—max 28% tax rate. D's ordinary rate is more than that.
- If A pays taxes on gain, it would be taxed at her rate, which is prob lower than that (15%)…as unit, A and D would enjoy 13% savings

II. VOCABULARY

III. CLASS NOTES

Looking at the question of WHO is the proper taxpayer?

- IRS cares b/c it wants to avoid shifting of income to lower tax brackets.
- If as a group, two people involved in shifting have more money at end of year, the gov't ends up w/ less.
- Taxpayers would like to shift income to family member in lowest bracket and shift deductions to person in highest tax bracket
- Kiddie tax - next time
- Case law applies

BASIC INCOME TAXATION

CHAPTER 35 – KIDDIE TAX

I. PROBLEMS

Assume that §63(c)(5)(A) limitation on basic standard deduction, adjusted for inflation, is $700.

(1) J, who is 12 and lives w/ both parents, eared $2000 working during summer of Y1. H deposed money in saving acct where it earned $100 in interest in Y1. In addition, J had income of $700 in Y1 from trust. Assuming J has no itemized deductions does kiddie tax apply in Y1?

- Does Kiddie Tax apply?
  a. Under 14
  b. Parents alive
  c. There must be net unearned income….
- Defined under §1(g)(4)
  a. (gross unearned income) – 2 x (child standard deductions)
  b. (800) – 2(700) = NO NET unearned income
- Therefore, there is NO amount to which the kiddie tax is to be applied.

(2) Assume same facts, except that trust income has $2500 instead of $700. Does kiddie tax apply?

- Does kiddie tax apply?
  a. Under 14
  b. Parents alive
  c. Net unearned income???
     i. Gross unearned income – 2 x (child standard deduction)
     ii. (2500 + 100) – 2(700) = $1200 net unearned income
- Therefore, kiddie tax applies b/c all elements are met.

(3) How does answer change if J had $800 in deductions directly connected w/ $2000 earned in summer, and another $800 in deductions directly connected to trust?

- §1(g)(4)…net unearned income = (gross unearned income) – (standard deduction + [greater of standard deduction or itemized deductions]).
  a. Usually it will be gross unlearned income – 2 standard deductions….in this case, he itemized and it is more than $700.
- $2500 trust + $100 interest = $2600 unearned income
- ($2600) – ($700 + $800) = $1100 net unearned income
- Kiddie tax applies**…$1,100 is taxed at parent's top rate**

(4) Assume that J's parents, who are in 40% tax bracket, establish separate trusts for J and three sibs, bro (11), sis (15), sis (8), each in 15% tax bracket. Each trust earns $3200 of interest and dividend income, taxable to child for whose benefit it was established. J's only other income is $500 from newspaper route and $1000 from winning grand prize in community raffle. J does not itemize deductions. His sibs have no other income.

i. What is the allocable parental tax and what is J's share of it?

- Kiddie tax applies to J b/c he is under 14, his parents are alive and unearned income totals more than $1400 (2 standard deductions).
  a. Unearned income = $3200 + $1000 = $4200
- Kiddie tax also applies to bro and little sis…each has unearned income of $3200. However, since older sis is 15…she will be taxed at normal rate.
- Net unearned income…
  a. Junior: $4200 – 2(700) = $2800
  b. Bro: $3200 – 2(700) = $1800
  c. Sis: $3200 – 2(700) = $1800
  Total = $6400
- $6400 is amount subject to tax at higher parent rate.
- Allocable parental tax is ($6400 x 40%) = $2560
  a. If parents were not in highest bracket, we would need to use formula to figure out what was taxed in each bracket.
- Each child's share…based on respective share of net unearned income:
  a. Junior: 7/16 x $2560 = $1120
  b. Bro: 9/32 x $2560 = $720
  c. Sis: 9/32 x $2560 = $720
  (+ each are taxed on rest of income)
- Bro and Sis...
  a. Tax on rest of their income means the $1120 taken out less one standard deduction ($700) = $420
  b. $420 x 15% = $63
  c. Therefore, their total tax liability = $783/each
- Junior…
  a. $2800 was taxed at top rate (40%) = $1120

b. His other income is $500 earned + 1120 of unearned subtracted out = $1620
c. J gets a $700 deduction once…= $920
d. $920 x 15% = $138
e. $1120 + 138 = **$1258 total tax liability**

ii. What election is available to J's parents and what are the consequences?
- Requirements for parents to take election…
  a. Gross income must only be from interests and dividends;
  b. Gross income must be greater than one standard child deduction amount ($700) and less than 10 x that amount ($7000);
  c. No estimated tax payments in child's name; and
  d. Parents elect and use the special form.
- This applies to bro and sis only, b/c J has income from sources other than interest and dividends.
- If parents elect for bro/sis, §1(g)(7)(B) is formula for tax:
  a. Gross income for each child to whom election applies ($3200 each) – 2 x (standard deduction $700 or $1400 each) = $2500 each
     i. $5000 total at 40% (parents top rate) = $2000
     ii. for each child, 15% of lessor of…
        1. standard deduction ($700 x 15%) = $105, or
        2. GI – standard deduction (3200 – 700) = 2500
        3. lessor is $105 each…
     iii. $2000 - $210 = **$1790 tax consequences if parents elect**

II. BOOK NOTES

Does the Kiddie Tax apply at all…and if so, to which children?

Three conditions for it to apply:
(1) child must be under 14
(2) at least one parent alive
(3) child has NET unearned income
   a. gross unearned income – 2 child standard deductions (700 x 2 = $1400)—essentially, so long as child has gross unearned income greater than $1400, the third element is met.

Whether it applies or not, what are consequences?
- If it does NOT apply, child is taxed on his own income at his own tax rate
  - This rate will prob be 15%
  - Otherwise, it will fall w/in standard deduction and not taxed at all
- If it DOES apply, child will be taxed on his NET unearned income at higher of child's tax bracket or parent's tax bracket.
  - The rest of income (the $1400 exclude from net unearned income + any earned income) minus one standard deduction ($700) will be taxed at child's normal rate.

Computation:
(1) determine each child's net unearned income
(2) compute tax on total amount at parent's top rate
   a. if this pushes parents into next higher tax bracket, determine allocable parental tax
      allocable parental tax
      tax on (parents income + child's net unearned income)
      - tax on (parents income)
      tax on (children's total net unearned income)
   b. if parents are already in highest bracket, there is no need to do this b/c children's unearned income will not push them any higher.
   c. This formula tells how much is taxed at the lower and higher rates.
(3) Divide up tax amount among children to whom Kiddie Tax applies in proportion to their net unearned income.

Election:
§1(g)(7)…if chosen, the income will be included w/ parent's and child does not have to file. (see prob #4 for specifics)

BASIC INCOME TAXATION

CHAPTER 37 – TAX CONSEQUENCES OF DIVORCE

III. PROBLEMS

Frank and Maureen married 15yrs. Nov 15 Y1 they separate. M remains in family house and F moves to apt. Enter written agreement on Jan 1 Y2 and divorce decree incorp'ing terms of agreement on July 1 Y2.

(1) Assume that in Oct Y1, prior to separation, F writes letter to M in which he says that starting Oct 1 Y1 he will pay M $2000/month. M does not respond to letter and F makes payments. Do Y1 payments count as alimony?

- §71 defines alimony…payment of cash if:
  a. received by spouse under divorce or separation instrument
  b. instrument does NOT designate payment as non-includable in GI
  c. payee spouse and payor spouse are not members of same household at time of payment, and
  d. no liability to make payment after death of payee spouse
- Element (a) is not met…
  a. Is this a divorce or separation instrument as defined in §71(b)(2)?
     i. There is no decree yet, so it could not be incident to
  b. Is this a written separation agreement?
     i. No, not any agreement, but statement of his intent…
     ii. Under *Estate of Hill*, "written separation agreement" cannot be unilateral.
- Element (c) is not met for first two payments b/c F had not moved out of the house yet. **NO ALIMONY**
- F does not get a deduction and M does not include in GI.

(2) Which of following payments in written agreement constitute alimony?

i. Starting on Jan 1 Y2, F will pay M $2000/month
- Yes…**ALIMONY**
  a. Cash
  b. Received by M under written divorce agreement
  c. Not same household
  d. No liability to pay after death
  e. Not designated to be omitted from GI

ii. On Jan 1 Y2, F will transfer to M parcel of land purchased by F some years ago as investment (value = $100k, basis = $75k)
- No…**NOT ALIMONY**
  a. Not cash….this is land transfer
- This is considered property transferred b/w ex-spouses incident to divorce (§1041)…under this provision the transferor recognizes no gain/loss. The transferee takes a carry-over basis.
- This is non-recognition even for F…M takes F's $75k basis and will recognize gain upon its eventual sale.

iii. Starting in Jan Y2, F will pay landlord the monthly rent of $1000 on home M lives in. (Starting in March Y2 at M's request and since they are on good terms, F also pays the $200/month utility bill on Ms home to help her out).
- RENT…
  a. Yes…**ALIMONY**
  b. Under §71(b)(1)(A)…rent payments are allowed **on behalf of spouse** under property settlement agreement.
  c. All other elements for alimony are satisfied.
- UTILITY…
  a. NO…**NOT ALIMONY**
  b. This is not a term of the agreement…since M simply requested it and there is no indication that it was put into written agreement form.
  c. No deduction for F; and not included in M's GI (§1.71-1T(b)(Q&A7)

(3) Assume instead that their written agreement requires F to pay M the following amounts: $5000/month, beginning Jan 1 Y2 and continuing until Jan 1 Y3, at which time payments will decrease to $4000/month. On Jan 1 Y4, payments will decrease again to $1500/month. On Jan 1 Y5 payments will decrease to $1000/month and continue through Dec Y5 at which time they stop. Assuming all payments are made as scheduled, what tax consequences from payments?

- §71(f) deals w/ excess front-loading
- §71(f)(1) states the consequences:
  a. add excess payments into the income of payor in third post-separation year and deduction from payee's GI in the third post-separation year.

Y2 = $60,000
Y3 = $48,000

Y4 = $18,000
Y5 = $12,000

NOTE: this is only done in 3rd post-separation year.

(Y2 is considered 1st post-separation year b/c 1st yr alimony paid)

- §71(f)(4) excess payments for 2nd post-separation year…
  a. (A) amt paid in 2nd p-s year – (B) amt paid in 3rd p-s year + 15,000
  b. $48k – ($18k + $15k) = **$15,000 excess payments from 2nd p-s year**
- §71(f)(3) excess payment of 1st p-s year…
  a. (A) amt paid 1st p-s year – (B) [average: (amt paid 2nd p-s yr – excess 2nd yr)&(amt paid 3rd yr)] + 15,000
  b. $60k – ($48-15)&(18) + 15
  c. 60 – [(33 & 18) ÷ 2] + 15
  d. 60,000 – (25,500 + 15,0000) = **$19,500 excess pay for 1st p-s year**
- Total excess alimony = $15,000 = $19,500 = **$34,500**
- Include in payor's income in 3rd p-s year (Y4), and deduct from payee's income in that year – above the line.
- NOTE…
  a. If there is excess only in one year (not both), still treat as excess alimony payment.
  b. There is no provision preventing back-loading: so pay $50, $40, $30, and in 4th p-s year you can pay $1million.

(4) Assume F and M have 2 children: Sam (14 on Feb 1Y1) Donna (12 on Sept 15 Y1). Their written agreement provides that parents will have joint custody of children, who will reside w/ M and also provides that:

i. F will pay M $500/month per child for child support, begin Jan 1 Y2 and continuing until each child reaches 18. What tax consequences from payments?
- §71(c)(1) any payment fixed as child support cannot get alimony treatment.
- M need not include in GI and F cannot deduct.

ii. In addition to payments described in (i), F will pay M $1500/month as alimony. What tax consequences from these payments, assuming that pursuant to agreement:
- Alimony payments cease at:
  a. End of Y3?
    i. Sam is 16 yrs 11 mos—there was one reduction in amount of payment but it is not w/in six months of either child turning the age of majority (18). Neither presumption applies so full amount was property characterized as **ALIMONY**.
    ii. F gets deduction; M includes in income.
  b. End of Y4?
    i. Now Sam is 17 yrs 11 mos.
    ii. One reduction would occur w/in 6 months of child turning 18. this would be situation one presumption that alimony is actually child support.
    iii. *The reduction amount is recharacterized as child support.*
    iv. F can try to rebut, however conclusive rebuttal is not available b/c it is not the 6th p-s year.
      1. Any relief??
      2. Perhaps coincidence that Sam was going to turn 18 at that time. If F can show another reason it will serve to rebut the presumption
      3. (i.e., when M finishes grad school and can work again)
      4. see presumptions below
  c. End of Y7?
    i. S is almost 21, D is 18 yrs 3.5 mos.
    ii. This is another situation one presumption…
      1. Not situation two even though both children are implicated…b/c there are not two or more reductions

iii. There was one reduction w/in 6 months of turning 18, so **payments are presumed to be child support**.
iv. F can try to rebut, he has conclusive rebuttal available to him: complete cessation of payments in 6th p-s year.
1. Available b/c the payments appeared in 6th p-s year and there was complete termination of alimony

- Alimony payments are reduced to $1000/month at end of Y4 and cease at end of Y7?
  a. Situation two presumption…there were two reductions each w/in one year of each child turning 18.
     i. Presumption is that the payments are child support. The entire $1500 should not be given alimony treatment.
  b. F can try to rebut, but conclusive rebuttal is NOT available to situation two presumptions.
     i. If you can show that the reductions times where chosen for some other reason…rather than the kids turning 18
     ii. Other rebuttals available but not conclusive
     iii. Under presumption, F treated as paying child support unless he rebuts successfully one of other non-conclusive rebuttals

iii. To assure payment of child support and alimony, F will buy and maintain term life ins policy on his life, face value in amount of total required future payments, naming M as beneficiary. F pays $250/year to ABC life ins co for policy. What tax consequences result?
- §71(a)(1) allows cash payments on *behalf* of spouse and payment is provided by separation instrument…and other elements of alimony are met.
- §1.71-1T(b)(Q&A 6) indicates that premiums paid by payor spouse for life ins on payor's life WILL QUALIFY as payments on *behalf* of payee spouse if:
  a. it was made under terms of divorce/separation agreement
  b. to extent that payee spouse is <u>owner</u> of policy
- Ownership of ins depends on control and incidents of ownership, one being ability to name a beneficiary.
  a. F owns b/c he has power to name beneficiary…so the reg does not apply to say that he is making payments on M's behalf. Therefore, it can't be considered alimony…so treatment for alimony when he pays the ins premium
     i. To protect against this, this provision should have been included in divorce agreement.
- **M does not own it, so payments are not on *behalf* of M, do NOT qualify as *alimony*.**
  a. No deduction for F, M does not include GI.

iv. Each party will claim for Federal tax purposes the dependency exemptions to which he is or she is entitled to.
- Who is entitled to dependency exemptions?
  a. Dependency issue:
     i. §151 allows deduction for each dependent.
     ii. §152 defines dependent
     iii. §152(a)(1)…son or daughter over ½ of whose support comes from taxpayer.
     iv. §152(e)(1)…support in the case of divorced parents – treat as parent w/ custody for greater portion of year.
        1. if M has physical custody, then she gets deduction
  b. Wouldn't it be advantageous if F could get deduction?
     i. He's in higher bracket b/c he's the one w/ alimony obligations to M.
     ii. §152(e)(2)…allows custodial parent to release their claim to exemption. Parents can opt out.

iii. But F would need written agreement attached to taxes every year.

- What is filing status of F and M?
  a. §2 Filing status
    i. M: under §2(b) will receive head of household status:
      1. not married (2B legally separated treated as not married)
      2. not a surviving spouse
      3. maintains household where children reside most of year
    ii. D: single status – unmarried

(5) What are tax consequences to F and M of following property transactions?
  i. F and M jointly own some ABC stock (value = $30k, purchased for $45k) and parcel of land (value = $60k, subject to mortgage = $30k). during Y2 F transfers to M his interest in land, subject to mortgage, and M transfers to F her interest in ABC stock. In Y4, F sells ABC stock for $40k and M sells the land for $10,000 cash, but subject to $30k mortgage.
    - Y2 transfers: §1041(a)(2) – no gain or loss recognized on property transferred b/w two spouses or ex-spouses if incident to divorce.
    - §1041(c) defines incident to divorce…
      a. this transaction fits b/w it occurred w/in one year of F and M's marriage ending.
    - Y4: F will get to recognize loss
    - §1041 does not apply when re resells property later to third person
    - §1041(b)(2) defines his basis…basis of transferee is basis in hand of transferor
      a. AR (40k) – AB (45k) = 5k loss
    - M: also gets carryover basis…(20k) per §1041(b)(2)
      a. AR (40k) – AB (20k) = 20k gain in Y4 when she sells the land
    - Was this property transfer fair?? Or is attorney liable for malpractice

IV. CLASS NOTES

ALIMONY…

What counts as alimony?
- If payment is alimony, why is this relevant from tax perspective?
  --payor gets a deduction above the line; payee must include in gross income.

Requirements to constitute alimony: §71

(1) Payment must be cash
(2) Received by spouse/ex or on *behalf* of spouse
(3) Payment must be made pursuant to divorce or separation instrument
(4) Payment cannot be designated as something other than alimony (i.e., non-deductible by payor, non-includable by payee)
(5) If spouses are legally divorced or separated, two spouses cannot be living in same household as each other
(6) No liability after recipient spouse dies.

Why would husband and wife want to call it alimony if it would mean extra income for her to report?
- B/c it may increase the money available…if payor is willing to pay more b/c he can take a larger deduction.

Excess front-loading of alimony:
- Trying to get alimony treatment for what is really a property transfer (going for a deduction)
- Why?
  i. A property transfer gets no deduction…
  ii. High earner gets deduction for alimony payment…and the tax reduction will exceed the increase in tax by low earner.
  iii. As a unit, there is a tax savings.
- §71 disallows front-loading
- If early payments are substantially greater than later payments, in the 3rd post-separation year, they must undo the excess payments.
- Whatever is deducted in Y1 and Y2 are recaptured in Y3.
- The person receiving the payment should not have been taxed on it, so in year three that person gets a deduction. The excess is undone.

Child Support:
If payment is truly child support, there is no deduction for payor and payee does not include in GI.
- This cannot meet definition of alimony.
- There is no deduction and no inclusion in GI
- There is an incentive to characterize alimony as child support, to save taxes as unit.
  - Alimony gets the favored tax treatment

Child support in disguise….
When dealing w/ alimony, always ask: Does it really represent child support?

- §71(c)(2): if what is called alimony payments are reduced on happening of contingency relating to child (child gets job, graduates, turns 18), or at time clearly associated w/ child related to contingency, the amount of reduction is actually child support and payor gets NO deduction for amount.

HYPO #1: *explicit reference to child related contingency*
"I will pay $X until J turns 18."
- This is not entitled to deduction.
- The parties would have to go back and correct earlier returns.
- There is no rebuttal to this situation; it is explicit.
- The payor cannot get alimony treatment.

HYPO #2: *presumption of child support*
"I will pay alimony until April 1999"
- This is when J turns 18. the time seems clearly related to child related contingency.
- Under §1.71-1T(c)(Q&A 18), there are two situations which allow rebuttals to presumption that payment refers to child support.
    - There was one reduction in amount of alimony that occurred not more than six months from time child reaches age of majority (6 months before or after)
        - Three ways to rebut:
            1. Show that time of reduction was determined unrelated to any contingency related to child (i.e., mortgage expired same time J turned 18)
            2. Show that the alimony payments are to be made for specified time due to local rule that requires the alimony to end after certain number of years (*rehabilitative alimony*)
            3. Conclusive rebuttal: if the reduction in alimony was a complete cessation of alimony, and if it occurs during the 6th p-s year, then presumption is conclusively rebutted, and can treat payments are conclusively rebutted when made…Payor automatically wins.

    - There were two or more reductions in amount of alimony; each occurred w/in one year before or after different children attained an age b/w 18-24 (i.e., payment reduced each time child reached 19).
        - Two ways to rebut this situation:
            - There is no conclusive rebuttal in this situation, but the other two methods apply.
                1. Local laws
                2. Showing that the dates chosen to stop payments was not related to children reaching age of majority

EXAM

- MPC test
    - No essay
    - 55-60 questions
    - 3 hrs
    - problems will not build on each other (generally)
    - each question counts for same amount of points
    - questions from each chapter
    - each mpc question will either ask to work problem or provide information
        - what types are not included in GI?
        - Each question wiill involve at most 2 issues…
        - Answer based on current doctrine
    - Code book and calculator allowed
    - If time is limited…
        - Go over problems
        - Above the line and below the line deductions