

# FEDERAL PERSONAL INCOME TAX

## Pike - Fall 2003

### I. GROSS INCOME

#### A. Introduction - §61

- i. **Def. General** – all income from whatever source derived, including (but not limited to) the following items:
  - (1) Compensation for services
    - (a) Employer does not have to classify it as compensation for it to be compensation
      - a. Old Colony Trust – company paid executive’s taxes
        - a. **Q:** Was it income or withheld taxes?
        - b. **H:** Court held that was income b/c part of the employment (p. 39)
      - b. Frequent flyer miles – are they a benefit from the airline or the company that paid for the ticket? IRS ruled not taxed.
      - c. Bonuses are income - Regulation 1.61-2(a)(1)
    - (2) Gross income from business
    - (3) Gains derived from dealing in property
    - (4) Etc.
  - ii. **Questions:**
    - (1) Has there been an accession of wealth?
    - (2) Has the taxpayer clearly realized the gain?
    - (3) Did she have complete dominion?

#### B. Form of Receipt

##### i. Cases

- a. Rooney (available in Course Documents portion of Blackboard)
  - (1) **Facts:** Accountants accept goods in lieu of payment, but don’t use the shelf price of the goods when calculating their income.
  - (2) **Q:** How do you determine the price of goods received?
  - (3) **H:** The court used fair market value - “the price a willing buyer would pay a willing seller, with neither under a compulsion to buy or sell, and both having reasonable knowledge of relevant facts.” Cannot use a subjective test.
- b. Glenshaw Glass
  - (1) **Q:** Should punitive damages be treated as income?
  - (2) **H:** Yes. The test is whether you have an instance of (1) undeniable accession to wealth, (2) clearly realized, and over which the taxpayers have (3) complete dominion.
- c. Cesarini v. U.S.
  - (1) **Facts:** Found money in an old piano they purchased
  - (2) **Q:** Is this income?
  - (3) **H:** Apply the Glenshaw test. Yes. The purchase gave rise to an income gain, and it was realized when they found the money.

## C. Tax-free Fringe Benefits

### i. Meals and Lodging - §119

#### a. Reg. §1.119-1

#### b. Cases

##### (1) Benaglia v. Commissioner

(a) **Facts:** Benaglia gets suites for free at the hotel where he works

(b) **Q:** Is this compensation?

(c) **H:** No. Under these circumstances it is not income even though it relieves him of expenses he would otherwise have to bear. He is there at the convenience of his employer, not for his own benefit. It is beneficial to his employer to have him on the premises at all times and he could not perform his services otherwise.

(2) **Problem** – attorney is given \$15 per diem for dinner for working late. That is income b/c the meal is not provided on the business premise. Can only exclude *in kind* meals and lodging. If the employee must spend the night, then they may be able to deduct the payments made for meals. §162(a)(2)

#### c. Test:

(1) Are the meals and lodging for the convenience of the employer?

(2) Are the meals provided on the business premises?

(3) Is the lodging a condition of employment?

(4) M/L provided to the employee?

(5) Who qualifies as an employee – spouse/dependent?

(6) Are the meals provided by the employer or on behalf of the employer?

d. **Remember:** If more than half of the employees receiving meals qualify for exclusion, meals provided to the rest of the employees will qualify as well (even if those employees could not meet the convenience of the employer test on their own). §119(b)(4)

e. **§119(b)(3)** – fixed charges for meals furnished for the convenience of the employer are excludable from the employee's gross income, provided the employee is required to make the payment whether or not he accepts the meals. This rule applies whether the employee makes the payment out of his compensation or his own funds.

### ii. Work Related Fringe Benefits - §132(a)-(e)(1), (f)(1)-(f)(5)(C), (h)(1) and (2), (j)(1); Reg. §1.132-6(d)(2)

a. **Leg Hist.** – Congress wanted to codify acceptable fringe benefits b/c (1) employers and employees were negotiating for too many benefits, (2) too hard administratively to account for them, (3) IRS does not audit enough people to catch them

#### b. §132(e) – De Minimus Fringe

(1) **Def.** - Any property or service the value of which is so small as to make accounting for it unreasonable or administratively impracticable (ex. internet access, office supplies)

**c. §132(a)(1)(B) - No Additional Cost Service**

**(1) Def.**

- (a) Offered by the employer to the employee
- (b) Must be used by the employee (§132(h)(2)(a) – any use by spouse or dependent child is treated as employee use, same sex partner is not a spouse)
- (c) Must be offered to customers in the ordinary course of business
- (d) Employer must not incur substantial additional cost in providing that service (including foregone revenue)
- (e) Cannot discriminate in favor of highly compensated employees (See (j)(1))

**(2) Ex.** Airline company attorney flies standby with her husband. Ok b/c even though she does not directly work in the airline department, her services benefit the whole company

**(a) Line of business requirement** - Reg. 132-4(a)(iv) – if an employee performs a line of business that benefits all lines of business

**(b)** No additional cost *service* – must be a service, a clothing discount does not count

**d. Qualified Employee Discount - §132(c)**

**(1) Def.** -any property or services which are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.

**(2) How much discount?** Can deduct 20% of the price at which the services are offered by the employer to customers. For property, the deduction cannot exceed the gross profit percentage of the price at which the property is being offered by the employer to customers.

**(a) Gross profit percentage** = percent which the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer (GPP=aggregate profit/aggregate price)

- a. Aggregate sales price is the total sale of goods for the year for the store.
- b. Aggregate profit is how much the store makes in profit on the items computed above

**(3) What is the price?** The advertised price. (i.e. full fare airline ticket)

**(4) What is line of business?** Can store give discounts at every store it owns?

**e.** Difference b/w service and discount - If it is a qualified employee discount, there is a limit to how much can be excluded. If it is a no additional cost service, there is no limit there is a monetary limit on the amount of discount, but not on services.

**f. § 132(j)** - Exclusions cannot discriminate in favor of highly compensated employees, but only applies to qualified employee discount and no additional cost service.

**g. § 132(f)** - Qualified transportation fringe - encourages mass transit. Does not have to be offered to all employees. No exclusionary rule.

- (1) **§ 132(f)(5)(A)** - Transit Pass is any pass, token, farecard, voucher, or similar item entitling a person to transportation. Limitation is \$100 per month for transit parking.
  - (2) **§ 132(f)(5)(C)** – must be on or near the business premise and must be provided to the employee and not be used as residential parking. Limitation is \$175 per month in qualified parking
- h. § 132(f)(5)(C)** \*If you have a spot not near the business premises, you have to take carpool or public transit from that spot

### iii. **Other Statutory Fringe Benefits**

**a. Group-term life insurance purchased for employees - § 79**

- (1) **Rule** – cost of group term life insurance, up to \$50,000 per employee, purchased by an employer for an employee is not includable in the employee's income as compensation, even though the employer receives a deduction for the premiums. But the coverage must be available to all employees.

**b. Health Insurance - §106(a)**

- (1) **Def.** - Except as otherwise provided in this section, gross income of an employee does not include employer-provide coverage under an accident or health plan = If the employer is paying the premium, none of it is taxable for the employee.
- (2) Also, if the employer directly pays for the medical expenses of employees or their dependents, the employees are not taxed on these payments except to the extent that they deducted the costs. But, insurance plans cannot favor highly compensated employees. 105(g)

**c. §105(a)-(c) – Amounts received under accident and health plans**

- (1) **Rule** - Amounts to you as reimbursement for doctor's visits or amounts paid directly to the doctor are not taxable as income to the taxpayer.
- (2) **Disability payments** - Are not included as gross income if they satisfy 105(c)(1) and (2) (see below). If they don't satisfy 105(c)(1) or (2) they are includable as income under 105(a). Disability payments are generally taxed.
- (3) **105(c)** – an employee can exclude from gross income amounts received from the employer or from insurance paid by the employer that are payment for the permanent loss of a function of the body if it is based on the injury and not on the time lost from work.

**d. Medical Care defined - §213(d)(1) and (9)**

- (1) Doesn't include cosmetic surgery.

**e. §162(l) – Health Insurance for Self-Employed**

## II. **GIFTS, INHERITANCES, AND SCHOLARSHIPS**

### A. **Gift or Compensation?**

- i. §102** - gross income does not include the value of property acquired by gift, bequest,

- devise, or inheritance.
- ii. **§102(c)(1)** – employer cannot transfer any amount to or for the benefit of an employee without including it as gross income.
- iii. **Reg. 1.102-1** - When determining testamentary capacity, one criteria is that the recipient is a natural objects of bounty of the testator.

iv. **Cases**

a. Commissioner v. Duberstein

- (1) **Facts:** Duberstein given a car by a grateful business associate. Claims it is a gift. Business associate deducts it as a business expense.
- (2) **Q:** Is this a gift or compensation for services?
- (3) **H:** Court says there must be an objective inquiry by the trier of fact as to the donor’s intent. Need a “detached and disinterested generosity.” Donor cannot be doing it for the donor’s benefit. Donor claims he was doing it as a gift, but the Court finds that the donor was doing in the hopes that Duberstein would continue to give him tips. Resolution of the issue must be “based ultimately on the application o the fact-finding tribunal’s experience with the mainsprings of human conduct to the totality of the facts of each case”

v. **§274(b) – Disallowance of certain entertainment expenses – see below?**

**B. Treatment of Inherited Property**

i. **§102 -**

**C. Scholarships**

i. **Rul. 77-263**

- ii. **Reg. 1.117-3** – determines if you are a qualified scholarship candidate, must be an accredited university

iii. **§117 –**

iv. **§117(b)(2) – What is covered?**

- a. Qualified tuition and related expenses
- b. Books, fees, supplies and equipment.
- c. Meals, housing, and misc. expenses are *not covered*. Reg. 1.117-3 says housing is not included, but an argument could be made that it is required by the school and is therefore excludable. Misc. expenses is a factual question according to (b)(1) the student must establish that the money is used for qualified tuition and related expenses.

- v. **117(d)(1)-** gross income shall not include any qualified tuition reduction. A qualified tuition reduction means the amount of any reduction in tuition provided to an employee (or a person treated as an employee) of an organization for education at such organization (below the graduate level)

vi. **§127(a), (c)(1) and (7)**

### III. GAINS DERIVED FROM DEALINGS IN PROPERTY

#### A. Introduction to the Realization and Replacement of Capital Principles

- i. §61(a)(3) - Gross income includes *gains* derived from dealings in property
- ii. \*\*§1001(a) - *Gain* from the sale or other disposition of property is the excess of the **amount realized** there from over the **adjusted basis** provided in § 1011
- iii. §1001(b) - **Amount realized** from the sale or other disposition of property is the sum of any money received plus the fair market value of other property received.
- iv. §1001(c) - Except as provided elsewhere, the entire amount of gain or loss determined under this section shall be recognized (taxed now)
- v. §1011 - adjusted basis shall be the basis (under § 1012 or elsewhere) as adjusted under § 1016
- vi. §1012 - Except as otherwise provided, **basis shall be the cost** of the property (the financing vehicle does not matter)

#### B. Basis of Property

##### i. Case

##### a. Philadelphia Park Amusement Co. v. U.S.

(1) H: “When two tax payers exchange property in a fully taxable transaction then the tax payer’s cost basis will be the fair market value of the property acquired in the exchange.”

#### C. Basis of Appreciated Property Acquired by Gift

- i. §1015(a) and (d)(1) – gift recipient gets the same basis as the person who gave her the gift.
- ii. No realization event when the gift is transferred or when the gift is received. Only when the recipient sells or transfers the property. Then use the givers basis to calculate the gain.
- iii. §1015 rule overtaxes the recipient of property. Creates a substituted basis and takes the donor’s basis and transfers it to the donee. Encourages taxpayers to transfer property to family members in lower tax brackets.
- iv. §102(a) – gross income does not include the value of property acquired by devise or bequest. Real property is devised.

#### D. Property Acquired from Decedent -- Stepped-Up Basis:

##### i. §1014(a)(1), (b)(1), (e)

- a. §1014(e) - can’t transfer an appreciated property to a dying family member to avoid the appreciation taxes. Must be transferred to decedent more than one year prior to death.

## IV. TREATMENT OF THE OWNER OF ANNUITY AND LIFE INSURANCE CONTRACTS

### A. Life Insurance

- i. § 101(a) – proceeds from life insurance are not taxed

### B. Individual Retirement Accounts – deferred annuities – see handout

- i. §219(a)-(b)(1)
- ii. §72(t)(1), (2)(A)(i), (iv), (2)(E) and (2(F)
- iii. **Roth IRA** - If you predict your income to rise, Roth IRA is the way to go. Your income is taxed at a lower rate now, and you don't pay taxes later when you are in a higher tax bracket. But, there is a penalty for taking money out early – 10% - if it is not withdraw for education expenses or first time home buying.
- iv. **Deductible IRA** - If you predict your income to decline in later years, deductible IRA is preferred b/c you will withdraw the money at a lower taxable rate.

### C. Annuities/Pensions

- i. § 72(a)-(b)(2), (c)(1), (e)(1)-(3), (q)(1)
- ii. **Def.** – An annuity is an account that pays out a certain amount of money each year for a certain period of time. Generally, a taxpayer pays a certain amount for the annuity and the company pays the taxpayer a specified amount monthly or annually for the rest of the tax payer's life. After the taxpayer's death, specified amount of \$ would be paid monthly/annually to tax payer's surviving spouse. Paternalistic system.
- iii. **Ex.** – You pay \$100,000 for an annuity. At retirement, the taxpayer gets \$10,000 per year and tax payer's life expectancy is 25 years. Total payment = \$250,000. You can exclude some of the payments from income during retirement years.  
**Exclusion ratio** – compare what the taxpayer paid for the contract divided by what the taxpayer is expected to get out –  $100,000/250,000 = 40\%$ . 40% of each payment is excluded from income. (\$4,000)

## V. TRANSACTIONS INVOLVING INDEBTEDNESS

- ### A. Loans: Legal and Illegal – code does not distinguish b/w legal and illegal loans. Loans are not taxed b/c they are not an accession to wealth under the Glenshaw Glass analysis. You have an offsetting liability.

#### i. Case

##### a. James v. United States

- (1) **Q:** Should criminals have to pay taxes on their income?
- (2) **H:** Yes, they shouldn't have an additional benefit just b/c they acquire their goods through illegal means. Must report illegal income and can report it on the "other income" line of form 1040. This does not violate 5<sup>th</sup> amendment protection b/c you don't have to report the source. No self-incrimination.
- (3) Overrules Wilcox (embezzled money) and Rutkin (extorted money). Court claims there is no difference b/w extorted money and embezzled money b/c there was no intent on the company's part to lend money and the embezzler generally doesn't intend to pay it back.
- (4) Why is the result in James unfair to the victim? B/c the taxes are treated as superior to the victim's claim to the funds. Victim is not repaid the full

amount stolen. After the taxes are paid, there may not be enough to pay back the victim. Embezzlers generally use the money so there is not as much to pay back anyway. Victim of embezzlement can take a deduction when the money is returned and amends the return from the year the tax was embezzled.

- b. Wilcox
- c. Rutkin

## B. Cancellation of Indebtedness

### i. §108(a)(1), (b)(1), (c), (d)(1)-(3), (e)(5), (f)

#### a. **Rule:** Discharge of indebtedness could be income.

- (1) **Ex.** - if your employer loans you money and forgives part of your debt, could be discharge of indebtedness or compensation.
- (2) **Ex.** – if you borrow money from your parents and they forgive it, then it is probably a gift under §102(a)
- (3) **Ex.** – first month’s rent and deposit to landlord. If there is an expectation that it will be paid back, it is loan. If it will be applied to last month’s rent, it is income.

#### b. **Exceptions**

- (1) Title 11 case – bankruptcy proceeding
- (2) Tax payer is insolvent both before and after the discharge
- (3) Qualified farm indebtedness
- (4) Qualified real property business indebtedness

#### c. **Cases**

##### (1) U.S. v. Kirby Lumber Co.

(a) **Facts:** Kirby Lumber issued Bonds worth \$12 million and repurchased them for 11.5 million. (Bond – when a commercial entity borrows money, the promissory note is a bond)

(b) **Q:** Did they have any income?

(c) **H:** Yes. Even though normally when you pay off your loans you do not receive any income because your liabilities and assets are reduced, Kirby Lumber realized a gain b/c they paid back less than what they borrowed. As a result of this transaction, Kirby Lumber was richer.

(d) **Explanation:** Bonds go down due to the credit risk of the borrower and interest rates changed. For a \$1000 bond, the bond purchaser has the right to get repaid \$1000 of principle and the right to get interest (5% - \$50 per year). If the interest rates rise to 15%, a new bond issued and \$1000 is paid back at maturity plus \$150 year in interest. In order to get someone to purchase the old bonds, you have to lower the price. So as interest rates go up, new bonds are worth more. When they go down, fixed rate instruments are worth more.

(e) **§108(e)(5)** – Ex. you buy a car and find a defect in it. You report it to the car dealership and they lower the amount of your loan. This is not loan forgiveness. Probably renegotiation of the principle price. Either lowers your basis in the car or constitutes income. Deb must be owned to the seller.

- ii. §1017(a)

## VI. TREATMENT OF DAMAGE RECOVERIES

### A. Damages to Property or to Business Interests

- i. **Question:** How do you tax general business damages?
  - a. Answer the following questions:
    - (1) In lieu of what were the damages a substitute for?
      - (a) If it was for lost property – then treat it as if the property had been sold/disposed of
      - (b) If it was for lost profits – then treat it as if it were the income derived from profits

- ii. **Ex. - Raytheon**

### B. Damages for Personal Injuries

- i. §104(a)(2) - Damages received, whether in lump sum or as periodic payments and whether by judgment or settlement, on account of personal physical injuries or physical sickness are excluded. Does not include punitive damages.
- ii. §104(a)(3) - benefit payments received under a medical or disability insurance policy *purchased by the taxpayer* are *excluded*, whether or not the taxpayer deducted the premiums paid to purchase the insurance. But, if medical expenses were deducted, the insurance reimbursements for the expenses must be included as income.
- iii. **?Rule:** Lost wages are excluded b/c they are directly tied to the physical injury “on account of physical injuries.” Doesn’t include employment discrimination suits. There must be a physical injury.
- iv. This would seem to give the injured taxpayer a windfall, but juries typically reduce the payment for lost wages to the after-tax amount of wages. For example, if the guy made \$80,000 a year at a 30% tax rate, the insurance would only have to pay \$56,000. The insurance company actually reaps the benefit of paying less.

## VII. TAX EXEMPT INTEREST

- A. §103(a) – excludes interest on state and local bonds
  - i. **Policy:** Benefit to the states is that they are allowed to offer these bonds at a lower interest rate than federal bonds. Subsidy to the states implemented through the tax code. Encourages purchase of these bonds over federal ones.

## VIII. SOCIAL SECURITY PROCEEDS

- A. §86(a)-(D)(1) – Social Security benefits (both old age and disability) are partially taxable. Supplemental Security Income payments, which are based on need, are nontaxable. [§86(d)(1)(A)]

- B. **Rule:** SS benefits may be taxable in an amount equal to **the lesser of** (1) one-half of the

benefits received during the year **or** (2) one-half of the amount by which the sum of 50% of SS benefits plus taxpayer's **modified** adjusted gross income exceeds a statutory floor. (Modified AGI = AGI + tax-exempt interest)

### C. Floors

- i. Married couples - + \$32,000
- ii. Singles - + \$25,000
- iii. Excess = (50% of SS + Modified AGI) – Floor Amount. The lesser of 50% of excess or 50% of SS benefits is taxable.

D. <b>Ex.</b> – SS benefits =	\$ 7,200
Mod. AGI =	\$22,000
Sum (mod AGI+1/2 SS)	\$25,600
+\$600 above floor of \$25,000	

Amount taxable is lesser of 50% of benefits (\$3,600) or 50% of the excess (\$300). Tammy includes \$300 income.

E. Taxable Amount at higher levels of modified AGI - Up to 85% of SS benefits received during the year are taxable. The income levels (the adjusted base amount) are \$44,000 on a joint return and \$34,000 on the return of a single taxpayer. The calculation of the amount taxable at higher levels involves a complex phase-in as modified AGI rises above the base amount or the adjusted base amount.

## IX. PROPERTY TRANSACTIONS: REALIZATION, RECOGNITION, ETC.

### A. Introduction

### B. Realization When Property Transferred as Compensation

- i. §83 (a)-(c), (h) – When is gain from property realized?
- ii. Reg. §1.83-4(b)

### iii. Cases

#### a. Eisner case

(1) **Facts:** Two shareholders each own 50% of a company. Company gives each shareholder 10 shares instead of compensation.

(2) **Q:** Was there a realization event?

(3) **H:** No. Not taxed unless there is a significant occurrence. Nothing really happened. Something more than a technical change must occur.

#### b. Cottage Savings case

(1) **Facts:** Lent money to people in exchange for mortgages. The instruments went down in value and if they had sold them they would have realized a loss – losses are deductible. They sold some mortgages and purchased others. They substituted them basically.

(2) **Q:** Was this a realization event?

(3) **H:** Yes. The Court found that their holdings were materially different legally and they had realized a gain.

- iv. **Recognition** – when the gain or loss is included in income
- v. **Non-recognition** – those events will happen in the future
- vi. **Four issues to look at to see how § 83 applies**
  - a. Does § 83 apply to a transaction?
  - b. Who has income?
  - c. When is there income?
  - d. How much income does the tax payer have?

**Missing notes 10/2**

**C. Non-recognition of Gain or Loss in Certain Property Dispositions**

**i. Property Settlements in the Context of a Marital Dissolution**

**a. §1041(a)-( c)**

**ii. Like-kind Exchanges** – the regulations under 1031 are particularly helpful.

**a. § 1031 – Exceptions to taxable exchanges - Exchange of property held for productive use or investment**

**b. In order to qualify must satisfy all four:**

**(1)** There must be an exchange of property

**(2)** Must be held for use in a trade or business or for investment

**(a)** Does it matter if the person trading the new trucks intends to sell the old trucks? No. Only matters if the taxpayers' purposes for holding the old property are different that the purposes for acquiring the new property. The taxpayer cannot determine the other person's intent.

**(3)** Exchanged solely for property of like-kind

**(a)** all real estate is like-kind, doesn't matter its form (improved-unimproved, beachfront-woods)

**(b)** Regs. impose stricter standards for personal property.

**(4)** Which is held either for productive use in trade or business or for investment

**c. For each problem we must determine:**

**(1)** Gain realized?

**(2)** How much?

**(3)** Like-kind?

**(4)** Amount not like-kind?

**(5)** Amount of gain recognized?

**(6)** Basis of new property?

**d. Remember** – Fair market value of blackacre is fair market value of whiteacre or 100. Since it is an arms length transaction and both parties seek to get equal value from the transaction, in-kind transfers are viewed as equal in value if no money changes hands.

**e. § 1031(b)** – Gain from exchanges not solely in-kind – “boot” is extra property or money. Also includes assumed liability – i.e. if buyer/traders takes over part of

your mortgage it's the same as receiving cash.

- f. **See problems in notes**
  
- iii. **Involuntary Conversions - § 1033(a)(1), (2)(A) and (B), (b)**
  - a. **Rule:** Follow the same procedures as like-kind exchanges
  - b. **Def.** -Occurs when taxpayer's property is taken and the property owner takes the money and buys similar property. If the taxpayer does not take the money to buy similar property, it is not an involuntary conversion. Sec. 1033 is more permissive than 1031 because the property owner does not have a choice.
  - c. All real property is considered "similar"
  - d. **Problem** – Betsy's property is taken. Govt. gives her \$600,000 for it and her basis was \$350,000. She buys new property for \$525,000. She has a recognized gain of \$75,000 and a realized gain of \$250,000. She has \$75,000 of cash in hand after the transaction. Postponed paying taxes on the rest of the \$250,000 until she voluntarily sells the property.
  
- iv. **Transactions Involving Residential Property - § 121**
  - a. **Exclusion of gain from sale of principle residence** - "Gross income shall not include gain from the sale or exchange of property" if the taxpayer owned and used the residence as their principle residence for 2 of five years
  
  - b. **Gain excluded** - \$250,000 for singles, \$500,000 for married couples
  
  - c. **§121(b)(2)(A)(i)** – Even if the house is only titled in one spouse's name, the married couple can still exclude \$500,000 of gain.

## X. DEDUCTIONS AND CREDITS

- A. **Personal Living Expenses – § 262** – no deduction for person or living expenses
  
- B. **Business Expenses**
  
- C. **Overview and General Principles**
  - i. **§162(a), (c), (e), (f), (g), (m)**
  
  - ii. **§162(a)(1)-(3)** – allows a deduction for most business expenses (i.e. salaries, travel, rentals)
  
  - iii. **§162(a)(2)** – payments for meals may be deductible if the employee stays overnight
  
  - iv. **Cases**
    - a. **Welch v. Helvering**
      - (1)**Facts:** Petitioner works for a business that went bankrupt and pays off some of the corporation's debts even though he was not liable for them.
      - (2)**Q:** What are "ordinary and necessary" business expenses? Are his payments

deductible?

(3)**H:** Court defines them as “appropriate and helpful”

**D. Reasonable Compensation:**

**i. Cases**

**a. Harold’s Club**

(1)**Facts:** Father and sons run a casino. Father’s salary is \$10,000 plus 20% of net profits = \$350,000 – \$500,000.

(2)**Q:** Is this reasonable compensation?

(3)**H:** Look to the relationship between the parties. Court is worried about income shifting between generations. This looks more like dividends or corporate profits than a salary. Can’t shift income and then claim a compensation tax benefit. Taxpayer could only deduct a portion of the payment.

(4)**Reasoning:** In an arms length employer/employee relationship, there is tension – company wants to maximize profits while still paying you enough to keep you. There was no arms length in the Harold’s case.

**E. Employee Remuneration – §162(m)(1)**

**i. §162(m)(1)** – disallows certain excessive employee remuneration

**ii. Def.** - No deduction shall be allowed under this chapter for “applicable employee remuneration” with respect to any “covered employee” to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds \$1,000,000

**iii. Covered employee** – employee is the chief executive officer of the taxpayer or acting in that capacity or one of the 4 highest compensated officers for the taxable year

**iv. \*Remuneration** – 162(m)(4) - Performance based contingencies are exempted

**F. Employee Business Expenses**

**V. THE DISTINCTION BETWEEN DEDUCTIBLE BUSINESS AND INVESTMENT EXPENSES AND NONDEDUCTIBLE CAPITAL**

**A. Introduction:**

**B. Defining Capital Expenditures - §263**

NOTE: Regulations §263(a)-4 provide lengthy (and quite technical) interpretations of these requirements – and lessen the impact of *Indopco*.

**i. §1.263A-1** – a capital expenditure brings about the acquisition of an asset or some advantage to the taxpayer having a useful life in excess of one year. The business cost of these expenditures can be deducted through depreciation, loss, depletion or bad debt, but not as a business expense.

- ii. **§1.263A-2**
- iii. One exception to deductibility of business expenses is capital expenditures. In order to qualify, value of the property must reasonably extend beyond the current taxable year.
- iv. A tax shelter means using an inappropriate deduction to avoid taxes.

v. **Cases**

a. INDOPCO

- (1) **Facts:** Corporation incurred significant costs during a friendly takeover and tried to deduct these costs.
- (2) **Q:** Are these expenses deductible since they did not produce a tangible capital asset?
- (3) **H:** No. Doesn't matter b/c the expenditure still resulted in a long-term benefit to the company. If the expenditure was incurred to unsuccessfully fight a hostile takeover, then the expenses would be deductible.

b. Idaho Power

- (1) **H:** §263A requires capitalization of various items of overhead such as rent or depreciation on buildings and equipment used to produce property. (i.e. Depreciation on construction machinery cannot be deducted but must be added to the basis of produced property.)

vi. **What is capitalization?**

- a. Capitalization merely tells you that a tax payer can not deduct certain expenses
- b. Capital asset is one which, when sold, qualifies for capital gain or loss treatment. Expenditures must be capitalized if they create an asset or advantage lasting beyond the taxable year, whether or not they produce a capital asset.

vii. **What are capital expenditures?**

- a. Capital outlays are not deductible, capital expenses are.

b. **Acquisition and Disposition of Assets**

- (1) Can you deduct the purchase office building for \$100,000. No.
- (2) Can you deduct the cost of paying a real estate agent to find the building? No. It is part of the expenditure that you knew would be incurred locating the property.
- (3) Can you deduct the cost of hiring someone to manage the business? Yes. It is deductible b/c it is a day to day business expense.
  - (a) Why is this different from hiring a real estate agent? Agent is part of the same transaction. If it is separate, like the hiring of a manager, then § 162 qualifies it as a necessary business expense.

c. **Repair vs. Improvements - §263, §263A(a)-(b)**

- (1) Tearing down the interior of a building is an improvement b/c it is part of the improvement process. Improvements are capital expenditures.
- (2) Hiring a construction manager to oversee the process is a capital expenditure b/c it is part of the cost relating to the acquisition of property. Normally this

is deductible as employee salary.

- (3) Maintenance and repair costs are “current expenses” and are entirely deductible in the year paid. If the repairs make the property more valuable than it already is, make it suitable for a different use, or extend its useful life, it is a capital improvement, not an expense. Black letter - cost of incidental repairs which neither *materially* add to the value of property nor *appreciably* prolong its life, but merely keep the property working efficiently may be deducted. **Reg. 1.162-4**
- (4) The cost of cleaning up an environmental hazard is deductible even if it improves the property. Ex. Cost of installing a concrete basement to stop oil seepage was a deductible repair. Midland Empire Packing Co.
- (5) Compare with Mt. Morris Drive-In Theatre Co. v. Comm. The court rules that the installation of a drainage ditch was a foreseeable expense and should have been included with the start up costs even though it was constructed 5 years later.

**d. Start-up Expenditures § 195** – no deduction for startup expenses

- (1) Must be the start of entirely new business. Tearing down the school interior and rebuilding it is not a start up expenditure.
- (2) Aims to keep all business, new and old, on the same playing field.
- (3) § 195(c) – specifies the type of things that may be deducted over the first five years of operation - allowable for the 5 year period.

**e. Overhead**

- (1) §263A requires capitalization of various items of overhead such as rent or depreciation on buildings and equipment used to produce property.

**Treas. Reg. §1.263(a)-1, -2**

## **VI. RECOVERY OF CAPITAL EXPENDITURES**

### **A. Depreciation and the Accelerated Cost Recovery System:**

- a. **Def. of Depreciation** – measures the wearing out of an asset used in business or for investment. The taxpayer owning the asset deducts annually an arbitrary percentage of the cost of the asset.
  - i. **Cost** – is the unadjusted basis of the asset plus subsequent expenditures that were capitalized
  - ii. Rules set forth in **§168** – also called the accelerated cost recovery system
  - iii. Theory was that you should offset depreciation deductions against the income the asset produces in a given year. ACRS front loads these deductions to encourage businesses to invest in plants and equipment.
  - iv. All physical property (except land) used in a trade or business or held for production of income and that has a *limited useful life* may be depreciated. Assets other than intangibles that do not wear out (e.g. works of art, land) cannot be depreciated. So you must allocate the cost between the land and the building.

**b. Cases**

i. Frank Lyon Co. v. U.S.

1. **Facts:** A bank constructed a building and sold it to Lyon. Then Lyon leased the building back to the bank. A third party had loaned Lyon the money to buy the bank. Lyon could still deduct the depreciation.
2. **H:** When an owner of a building “sells” it to an investor and then leases it back, the investor can claim depreciation only if he is treated as the **owner** of the building. If the investor is regarded as a mere **lender** he is not entitled to the depreciation deduction.

**c. Computation of depreciation**

i. Recovery periods - **§168(e)(3)(A), (i)(14)**

1. residential real property – 27.5 years
2. nonresidential real property – 39 years
3. tangible personal property – 3, 5, 7, 10, 15, and 20 years.

ii. **Half year convention** – personal property is deemed to have been acquired and sold exactly halfway through the year, regardless of whether it was purchased or disposed of at the beginning or the end of the year; therefore, the first year’s depreciation will be half of a full year’s depreciation. **§168(d)**

1. **Exception:** If more than 40% of the assets are bought during the last three months of the year, *all* assets acquired during the year are deemed to have been purchased in the middle of the *quarter* when they were purchased.

d. Straight line depreciation over short life – provides for the same deduction every year during the recovery period

- i. Straight line election – A taxpayer can elect to use straight-line depreciation instead of accelerated depreciation. **§168(a)(3)(C), (a)(5)**.
- ii. **Example:** Delivery truck is 5-year property worth \$15,000. Straight-line is 20%

Year	Depreciation	Basis – \$15,000
1	½ \$3,000 = \$1,500	\$13,500
2	\$3,000	\$10,500
3	\$3,000	\$7,500
4	\$3,000	\$4,500
5	\$3,000	\$1,500
6	\$1,500	0

e. Accelerated depreciation - provides for a greater deduction in early years and a lower deduction in later years.

f. Double-declining balance method of depreciation - In the 15-year and 20 year classes, 150% declining balance depreciation may be used.

- i. To calculate, first compute the straight-line rate. Then increase that factor to the adjusted basis each year. Eventually the basis will be reduced to the point that straight line depreciation would provide a larger allowance. At that point, the taxpayer switches to straight line. **168(d)**
- ii. **Example:** Delivery truck is 5-year property worth \$15,000. Straight-line is 20%

Year	Depreciation	Basis – \$15,000
1	½ \$6,000 = \$3,000	\$12,000
2	\$4,800	\$7,200
3	\$2,880	\$4,320
4	\$1,728	\$2,592
5	\$1,036.8	\$1,556

g. **§168(k)(1)-(2)(A), (4)**

- i. 2002 legislation provides an additional first-year depreciation.
- ii. **Applies to:**
  - 1. Tangible personal property acquired between Sept. 11, 2001 and Sept. 11, 2004.
  - 2. Certain leasehold improvements to nonresidential real property.
- iii. **Provides:**
  - 1. Taxpayers may claim depreciation of 30% of the adjusted basis of the property in the year the property was placed in service. The adjusted basis is reduced by this bonus depreciation.
  - 2. Taxpayer then takes the normal depreciation for the year of acquisition, but computes it with regard to the reduced adjusted basis.
  - 3. **So** taxpayer gets the bonus and the first year depreciation in the first year of ownership and service.

h. **§§167(a)-(b)(1)** – Depreciation, expenses, and losses can be deducted with respect to transactions entered into for profit, even though the activity does not rise to the level of trade or business. But treatment of this type of transaction is not treated as favorably. [162, 165(c)(1)]

- i. Net operating losses arising out of non-trade or business activity cannot be carried forward or backward. [172(d)(4)]
- ii. Some of the deductions arising from such activity are “below the line” and subject to the restriction on miscellaneous itemized deductions. [62, 67]
- iii. Home office cost dedicated to non-business activities are not deductible.

§168(a)-(c)(1), (d)(1), (e)(1)

**B. Other Depreciation Matters:**

- a. **§197(a), (c), (d)(1)** – intangible assets, including goodwill that have a basis can be amortized/depreciated over an arbitrary 15-year life. Contract rights, such as covenants not to compete, are also amortized

- over a 15-year life, regardless of the actual term of the covenant.
- b. **§167(f)** - The production costs of books, films, recordings, or other copyrighted material produced *by the taxpayer* are amortized over the period during which they are expected to produce income.
- c. **§179 (a)-(b)(3)(A), (d)(1)** – Code allows taxpayers to expense (deduct immediately) a maximum of \$24,000 (\$25,000 after 2003) of the purchase price of tangible personal property used in business. For every dollar of qualifying investment in excess of \$200,000, the maximum figure is reduced by one dollar.
  - a. During the first year after a car is purchased, no more than \$2,560 can be claimed as depreciation.
  - b. No ACRS deduction, **§179** year-of-purchase deduction, or rental deduction is available to an employee for listed property purchased for use in her job unless the use is for the convenience of the employer and required as a condition of employment. If same equipment is provided at work, probably not deductible.
  - d. Note that if the property is not used entirely for business purposes, then you cannot depreciate its entire value. **§280(F)(b)**

### C. Deductibility of Losses:

- a. **§267 (a)(1)** - no deduction shall be allowed for a sale/purchase between certain persons – husband/wife, family members, adopted children. **Regs. 1.267(c)-1 (a)(4)**
  - i. What is wrong with you taking the deduction?
    1. May not be an arms-length transaction
    2. The price might be partly a gift. Cannot deduct the price of gifts.
- b. **§267 (b)(1)-(3)**
- c. **§165 (a)-(c)** - general rule, if uninsured, § 165 allows a deduction for the basis of the product as a result of casualty or theft. It tries to distinguish b/w losses in value of property.
  - i. **§165 (c)(3)** – if losses arise from fire, shipwreck, storm, or other casualty or theft.
  - ii. **§165(h)** – limits on the deduction to events that exceed \$100. Net casualty losses must exceed 10 percent of your adjusted gross income

### D. Bad Debts:

- a. Generally, debts are considered assets b/c the taxpayer expects to be repaid. But sometimes they are not repaid and those are deductible events.
- b. **§166** - non-business bad debts are defined as bad debts that are not business

### c. Cases

- i. U.S. v. Generes
  1. **Facts:** Generes and his son each own 44% of a company. Generes' salary is \$12,000. He loans the company \$300,000. He is never paid back.
  2. Q: Is this a bad business debt?
  3. H: No. Not a bad debt until it is clear that it will never be paid

back.

4. Court asks several questions:

- a. Was this a bonafide loan? Yes.
- b. Was this economic or non-economic activity? Economic.
- c. What the dominant motivation of the taxpayer was when the money was advanced/loaned?
  - i. To help his son.
  - ii. Wanted to protect the integrity of the business
  - iii. Protecting the stock interest - investment, non-business interest
  - iv. Which interest dominated?
  - v. Not to preserve his salary, which would have been a legitimate business interest.
- d. Was the loan business? Court says no. The dominant interest was not to protect his salary.

5. **Rules:**

- a. If it is a bad business debt – deduct in full.
- b. If it is bad non-business debt, treat it as a capital loss/investment gone bad (capital gains are treated well, but capital losses are treated badly. Generally, capital losses can only be used to offset a capital gain)
- c. Taxpayer has the **burden** of establishing that the dominant motive was a business.

d. **Example:** Peter loans Paul \$25,000 and he becomes insolvent. Can Peter deduct anything?

- i. §267 does not apply.
- ii. Does §166 apply?
  1. **Def.** of non-business bad debt – debt other than that incurred in his business
    - a. Peter is a surgeon so loaning money to his brother in not part of his trade or business. Not even arguably a business bad debt. This is an investment in his brother, Paul's business.
- iii. Consequence of the non-business bad debt classification
  1. Treated as a capital loss;
  2. Deductible only if the loss is total – worthless
- iv. What does it mean to be insolvent?
  1. Your debts exceed your assets. Paul's debts exceed his assets.

## VII. **DISTINCTION BETWEEN DEDUCTIBLE BUSINESS OR INVESTMENT EXPENSES AND NON-DEDUCTIBLE PERSONAL, LIVING, OR FAMILY EXPENSES**

- a. **Travel Expenses** (including amounts expended for meals and lodging if not lavish)– deductible only if
  - i. Incurred while away from home

- ii. In the pursuit of a trade or business
  - 1. Only 50% of the cost of food and beverages is deductible. [274(n)]

**b. Local Travel and Commuting – §262**

- i. **Rule:** No deduction is allowed for personal living expenses. Commuting costs are never deductible, no matter how far you travel or for what reason.
- ii. Transportation between businesses is deductible (ex. the lawyer traveling from his office to the courthouse)

**c. Food and Lodging – Away from home?**

**i. Requirements of §162**

- 1. Paid or incurred during the year in connection with a trade or business
- 2. trade or business rather than personal expense
- 3. current expense rather than a capital outlay
- 4. ordinary and necessary
- 5. does not violate public policy

**ii. §162(a)(2)- You are not away from home when you are only away for a business day and not a night.**

- 1. Is travel away from home an ordinary and necessary business expense? Is it helpful? Usually.
- 2. Meals are not considered personal expenses if you are traveling for business (away from home), but you must be gone for more than one night.
- 3. Cleaning clothing may be included as a business expense for business travelers.
- 4. Miscellaneous cash – amounts paid *in cash* to compensate an employee for meals and lodging must be *included* in income. They cannot be excluded under Sec. 119 since those meals and lodging must be furnished in kind.

**iii. Cases**

**1. Flowers v. Comm.**

- a. **Facts:** Man commuting from Jackson to Mobile for business every day.
- b. **Q:** Was this a legitimate business expense?
- c. **H:** No. There was no business purpose to live in a different city than your work. Fact based test depending on the circumstances of the case.
- d. Questions the court asked:
  - i. Incurred in pursuit of business? - Must be away from home overnight
  - ii. Are there duplicate expenses?
  - iii. Reasonable and necessary? – Are the expenses reasonable?

**2. Correll**

- a. Test that you have to be away over night?
  - b. Can deduct the cost of the travel and the business related costs, but usually can't deduct meals and other sundries along the way
- d. §82
  - e. §217
  - f. Also see §132(d) - working condition fringe benefit
- g. **Entertainment and Business Meals - §162**
    - i. **Cases**
      - 1. Moses v. Comm.
        - a. **Facts:** Defense attorneys had lunch at an average place to discuss their cases when court was not in session. The time was reasonable, but not the only time they could meet.
        - b. **Q:** Can they deduct the lunch expense?
        - c. **H:** No. Although this appears to be deductible under **Sec. 162** because it is entirely business related, the court saw no reason to encourage social behavior. Also, it was not deductible under **§119** because they were not provided on the business premises, and Moses was a partner rather than an employee. Meals were too often and with the same people. They could have met at another time and not had lunch.
        - d. **§ 262** disallows personal, family, or living expenses.
      - 2. **Q2:** Could the firm have deducted it if it had been structured another way?
        - a. What if the firm had brought in food to the conference room every day? Would that be an ordinary business expense?
          - i. Look to § 119 – no, it merely excludes the meal from the gross income of the *employee*
          - ii. § 162- ordinary and necessary business expense?
            - 1. Would be appropriate and helpful
            - 2. Other businesses might do the same thing
            - 3. Less convenient to have it at the law firm than at the café around the corner
      - 3. Givens
        - a. Always a personal benefit
        - b. Almost impossible to know on an objective basis whether the event was really business or really personal
    - ii. §212
    - iii. §262

iv. §274(a), (c)-(e)(3), (h)(1), (2) and (7), (k) and (especially) (n)

1. **General** - §274 does not authorize any deduction. The deduction is allowed only *if* the expenditure is ordinary and necessary (under 162), then, § 274 is a limitation on what can be deducted. It is an additional test that must be met.
2. § 274(a) – deals with activities that are generally considered entertainment, recreation, amusement. Must meet one of the two following criteria:
  - a. **Directly related test** - must be directly related to the conduct of the taxpayers trade or business
    - i. to be *directly related* must be more than a general expectation that business will be generated at some point in the future, future goodwill is not enough
    - ii. during the entertainment period, **some business discussion** must take place for the purpose of generating business
    - iii. So, taking the facts as a whole, the **principle character of the event** must be related to the business
  - b. **Alternative test – Associated business test**
    - i. Entertainment either immediately precedes or follows a bona fide business discussion – must be a **time connection**
3. §274(d) – **Substantiation** - must keep records demonstrating the amount of expense the time and place of the entertainment and the business relationship b/w the parties, what is going on
4. §274(h)(1)
5. §274(k) – **Business meals** – no deduction is allowed unless the expenses are not lavish or extravagant and the taxpayer or an employee of the taxpayer must be present at the event.
6. 274(n) – **Amount allowable as a deduction** – only 50% of expenses otherwise allowable is deductible. So if \$100 dinner would be treated as a §162 expense that satisfies the §274 requirements, \$50 is deductible. Over-taxing the employer and under-taxing the employee.
7. **Reg. §1.274-2** –

## VIII. DISTINCTION BETWEEN DEDUCTIBLE BUSINESS OR INVESTMENT EXPENSES AND NONDEDUCTIBLE PERSONAL, LIVING, OR FAMILY EXPENSES

### a. Education Expenses

- i. **Reg. 1.162-5(a)** education expenses are deductible if they (1) maintain or improve skills obtained by an individual required for a job, or (2) meets the express requirements of the individual's employer or are imposed as a condition to retention of a job.
  1. Cannot deduct college expenditures – you benefit rather than your employer
  2. Cannot deduct law school
  3. Cannot deduct law school even if you are a paralegal – still a new trade or business
  4. Can deduct a few classes if your employer requires them-not a degree
- ii. **Reg. 1.162-5(b)** – The inseparable aggregate of personal and capital expenditures is not deductible
- iii. **Education Assistance Programs - § 127**
  1. Employer can exclude up to \$5,250 and George can exclude the same amount as the employer.
  2. Used to be only graduate education, now it can apply to undergraduate as well.
  3. **127(c)** – education assistance does not include sports, games, or hobbies
- iv. **§274(h)(1), (h)(7), (m)(2)**
- v. **Hope Scholarship Credit and the Lifetime Earning Credit - §25A(a)-(b)(2)(A), (b)(2)(C), (b)(4), (c)(1), (d)(1)-(2)**
  1. **Hope** - enacted to enable federal government to pick up the cost of community college tuition at a standard rate available for 2 taxable years and is the first two years for post-secondary education
    - a. **Amount of credit** – 100% of first \$1000 and 50% of the next \$1000
    - b. Dollar per dollar tax savings, not a deduction reducing the amount of income
  2. **Lifetime Learning** – tax credit for 20% of qualified tuition and related expenses for first \$10,000.
    - a. Available to people with incomes of less than modified adjusted gross income of \$40,000 for an individual or \$80,000 for joint returns.

**vi. Qualified tuition and related expenses - § 222(a)-(C)(1)**

1. Same as the Lifetime learning credit except raises the income level.
2. Not available to people whose incomes singly exceed \$65,000 or jointly \$135,000
3. Applicable deductions
  - a. 2002-2003 - \$3,000
  - b. 2003-2004 - \$4,000

**vii. Education savings account - §529(a)-(b)(1), (c)(1)**

1. A plan can be established that taxpayers can put money into. The interest is not taxable to the owner of the funds, if the funds are withdrawn to pay for education.
2. The accumulated interest is never taxed.

**b. Child Care Expenses - §21(a)-(d), 129(a), (d)(1)**

**i. § 21 – Expenses for household and dependent care services**

**1. Elements:**

- a. All get credit, high and low income. More help for working poor, much less for high income earners.
- b. For first two kids get \$3000 of subsidy a piece after that, no additional subsidy.
- c. Applies to in house or daycare.
- d. Must be an employment-related expense – means amounts paid for the following expenses, but only if such expenses are incurred to enable the taxpayer to be gainfully employed for any period for which there are 1 or more qualifying individuals with respect to the tax payers.
- e. Only applies to an eligible child – must be under 13 at the end of the year.
- f. Also covers a dependent or a spouse if they are incapable of taking care of themselves.

**2. Computation for child care:**

- a. 35% for people with income of \$15,000
- b. 20% for \$45,000 – in between is graduated.

3. The credit reduces the amount of tax liability dollar for dollar.
  - a. If the same amounts were deductible, what would happen?
  - b. When you give a deduction, the economic benefit of the deduction depends on the tax bracket of the taxpayer. When you are trying to deliver social benefit, Congress opts for a credit b/c gives the lower income folks the advantage.

- ii. Facts:** Beginning after December 31, 2003, Family A has taxable income of \$15,000 and is in the (hypothetical) 10 percent tax bracket. Family Z has taxable income of \$50,000 and is in the (equally hypothetical) 40 percent tax bracket. Each family has two young children. Family A pays

\$6,000 for childcare expenses; Family Z pays \$10,000. Consider: (1) the amount of the tax credit that each family would receive under §21; and (2) the tax savings that would result if the taxpayer took advantage of §129

iii. §129?

c. Legal Expenses

i. **Reg. 1.262-1(b)(7)** – Payment for legal services that originate as business litigation are deductible

ii. Cases

1. U.S. v. Gilmore

- a. **Facts:** Gilmore sued by his wife for divorce. He claims he is defending the suits and trying to protect his stock in GM from being qualified as community property. If she takes half, he would no longer own it and could lose his income.
- b. **Q:** Can he deduct the legal costs of defending the suit?
- c. **H:** No. The deductibility of these expenses not upon the consequences to the respondent, but upon the origin and nature of the claims. The community property claim originated in the marital relationship. The dispute must arise from the business dealings.

d. Clothing Expenses

i. Cases

1. Pevsner v. Comm.

- a. **Facts:** Taxpayer worked at Yves St. Laurent and is required to wear clothing from the store while she is working. She deducted the \$1,621.91 for the cost of the clothes and maintenance. She claims she has a simple life style and does not wear it out of the store.
- b. **Q:** Can she deduct it?
- c. **H:** No. The test is whether the clothing is
  - i. of a type specifically required as a condition of employment
  - ii. **not adaptable for general use**
    - 1. Appeals Court held this was an *objective* test of whether the clothing is suitable for general or personal wear.
  - iii. and not worn for general use

## IX. PERSONAL DEDUCTIONS

### a. Overview

- i. Vertical equity – people at different income levels have appropriately different tax levels. This is accomplished by allowing 2 different deductions.
  1. Personal Exemption - \$3050 per person.
  2. *In addition*, people can take the standard deduction.
  3. Combined effect – exempts people whose incomes are at or below poverty levels.
- ii. Horizontal Equity – two taxpayers with comparable resources should pay the same amount of tax

### b. Standard Deductions and the Personal Exemption

- i. **Note** – A deduction is either subtracted from gross income or from adjusted gross income. A deduction reduces taxable income and a credit reduces the tax that is payable, dollar for dollar.
- ii. **Note 2:** As an alternative to the standard deduction, can take itemized deductions. Purely personal expenditures that Congress has authorized deductions for.
- iii. **§ 151** – taxpayer is allowed a deduction for himself, his spouse and his dependents.
  1. **Dependents**
    - a. Children for whom the taxpayer provides more than half of their support. Loans don't count.
    - b. Must be a student under age 24 - **§151(c)(1)(B)**
  2. **Personal Exemption** – \$3050 for 2003
- iv. **§ 63(a)** – generally tax payers itemize their deductions.
- v. **§ 63(b)** – applies to individuals who do not itemize.
- vi. **Computing tax liability** – start with the income that a taxpayer has, deduct the business expenses, and compute gross income. After you determine gross income, then you can deduct itemized personal expenditures.
- vii. **Standard deduction for 2003** - \$7950 for married people, \$4750 for unmarried.
- viii. **Child Tax Credit - §24** – See p. 1828 for rates
  1. In 2003-2004, families get a credit of \$1000 per child who is under 17 and is a dependent. This credit can offset up to \$2000 worth of taxes.

- ix. **§62** – A few expenses that Congress viewed as the type that the standard deduction substitutes for. If you don't take the standard deduction, they can be itemized.
- x. **Earned Income Tax Credit - An Implicit Deduction for Miscellaneous Expenses of Low and Moderate Income Employees? - §32(a), (b), (c)(1)(A), (3)(A)-(B)(i), (3)(C)**
  - 1. Negative income tax/Refundable credit – if the amount of the credit exceeds your liability the IRS sends you a check.
  - 2. **Why is this implemented?**
    - a. Designed to reduce the tax burden on the working poor. It is calculated in reference to the taxpayer's income – must have a job in order to get a credit – so it encourages people to work.
    - b. Even though most families are not paying taxes, they are still paying Social Security, Medicare, etc. This offsets those costs.
  - 3. **Who is eligible?**
    - a. Qualifying Child
      - i. must have the same principal place of abode as the taxpayer
      - ii. must be under 19 years of age unless a full time student
    - b. People between the ages of 25-65
      - i. Get a small earned income credit
  - 4. **What is the credit?**
    - a. Credit percentage is 34% for one child and 40% with two or more.
    - b. Maximum income that counts is \$7,490 for one kid (34%=\$2,500 credit), and for two or more \$10,510 (40%=\$4,000 credit)
  - 5. **Observations**
    - a. Earned income credit is the only provision of the code that gives taxpayers an incentive to claim more income than they have.
    - b. These provisions are for the working poor – low income tax bracket – and are eliminated as incomes increase. Earned income tax credit affects the family that makes \$20,150 because it creates a credit.
    - c. IRS audits a higher number of the recipients of the earned income tax credits – suspicion of people who receive a check from Congress
    - d. These benefits eliminate the income tax for close to half of the population.

**xi. Personal Itemized Deductions** – cannot deduct unless the code specifically says so.

1. § 63(a)-(c)(2), (c)(4)
2. §151(a)-(c)(4), (d)(1), (3)(A)-(C).

**NOTES:**

(1) The standard deduction and the deduction for the personal exemptions are adjusted annually to reflect inflation. For 2003, the deduction for each personal exemption is \$3,050. The standard deduction for married taxpayers filing a joint tax return is \$7,950 and for unmarried individuals the standard deduction is \$4,750.

(2) §151(d) reduces (or eliminates) the deduction for personal exemptions for high-income taxpayers. Do not worry about the details of these provisions.

**3. § 163 – Deduction for interest paid during the taxable year for indebtedness**

- a. **Policy** - Congress expressed concern over whether something is really interest, about whether they want all interest to be deductible, and whether it is really paid or accrued.
- b. **Def. of interest** - The money that you pay on borrowed funds.
- c. **Conditions:**
  - i. Must be a “true loan” in existence.
  - ii. Payment must be made by the person obligated to repay the loans
  - iii. Has the interest really been paid or accrued?
  - iv. Are there any limitations that prevent the taxpayer from deducting the interest in question?
    1. usury laws?

**4. Cases**

- a. Davison v. Comm.
  - i. **Facts:** Partnership Whitetail owed John Hancock (insurance company) \$1,587,310.46 in interest and \$7,707.5 in principal for a real estate loan. Whitetail did not have the money to pay so Hancock loaned them some more money. Whitetail used the money to pay the interest
  - ii. **Q:** Is the loan/interest paid deductible?
  - iii. **H:** No. Factual issue is whether not they had paid interest. You have to make an actual payment if you are a cash basis organization. The taxpayer did not have total dominion and control over the money.

It was part of the deal that they would use it to repay the loan. Court says depends on the meaning of the word “paid.” Rationale of the court – looked to the substance of the transaction to see if it was consistent with form put forward by the taxpayer. Before and after the transaction the taxpayer owed John Hancock \$6.5 million. If Whitetail had borrowed money from another lender, then it would be ok b/c the actual positions of the parties had changed.

**5. Other interest deductions**

- a. **§ 163(h)** - All personal interest used to be deductible, but Congress felt that when interest rates are high, the deduction of interest encouraged people to spend rather than save.

**6. Exceptions that are deductible:**

- a. trade or business interest
- b. investment interest
- c. passive activity
- d. qualified residence interest
  - i. qualified residence –
    - 1. principle residence
    - 2. 1 other residence chosen by the taxpayer which is used as a residence (w/in 280A(d)(1)) (vacation home)
  - ii. Acquisition indebtedness with respect to any qualified residence (§ 163(h)(B))
    - 1. is incurred acquiring, constructing, or substantially improving any qualified residence *and*
    - 2. must be secured by such mortgage on the residence
    - 3. Limited to \$1,000,000
  - iii. Home equity indebtedness with respect to any qualified residence (§ 163(h)(B))
    - 1. Cannot exceed the taxpayer’s equity in the property, *and*
    - 2. is reduced by the amount of acquisition indebtedness with respect to such residence, *and*
    - 3. is secured by a qualified residence, *and*
    - 4. does not exceed the fair market value of the residence, *but*
    - 5. is limited to [\$1,000,000]

7. **§163(h)(2)** – doesn't do anything, merely definition. Term "personal interest" means other than **§163(h)(2)(A)**

c. **Taxes - § 164(a)-(b)(2), (c)(1)**

d. **Casualty and Theft Losses - §165(c)(3), (h)(1)-(3), 4(e)**

- i. General rule – if uninsured, § 165 allows a deduction for the basis of the product, but you cannot deduct the depreciation of a personal asset.

ii. **Requirements:**

1. Loss must arise from fire, shipwreck, storm, or other casualty or theft [§165(c)(3)]
2. Limits the deduction to events that exceed \$100 [165(h)]
3. Net casualty losses must exceed 10 percent of your adjusted gross income
4. § 165 tries to distinguish b/w losses in value of property.

iii. **Rev. Ruling 72-592** – casualty is the complete or partial destruction of property resulting from an identifiable event of sudden, unexpected, and unusual nature and requires a showing of physical damage

1. sudden – swift and precipitous and not gradual or progressive
2. unexpected – one that is ordinarily unanticipated that occurs without the intent of the one who suffers the loss
3. unusual – extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred and done that does not occur in the ordinary course of day-to-day living

iv. **§ 165(c)(3)** - Casualty loss is the lesser of the adjusted basis of the property and the difference b/w the fair market value of the property beforehand and the fair market value afterwards.

a. **Medical Expenses - § 213(a), (b), (d)(1)-(3), (9), § 162(L)**

- a. **General rule:** if it costs extra *and* is prescribed by a doctor, then it *may* be deductible
- b. **§ 213(a)** – Allowance of deduction for medical expenses paid during the taxable year, **not compensated for by insurance** or otherwise for medical care of taxpayer, his spouse, or a dependent –“to the extent **such expenses exceed 7.5 percent of adjusted gross income**”
- c. **§ 213(b)** – limitation with respect to medicine and drugs – for prescription drugs or insulin
- d. **§ 213(d)(1)** – medical care means amount paid for diagnostics, cure, mitigation, treatment, prevention, or prevention of disease, for transportation, for long term care services, for insurance

- e. § 213 (d)(2) – Amounts paid for certain lodging away from home treated as paid for medical care (not to exceed \$50 per person per night)
  - f. § 213(d)(3) – Prescribed drug – requires a prescription
  - g. § 213 (d)(9) – cosmetic surgery – medical care does not include cosmetic surgery unless it ameliorate a deformity
  - h. § 162(l) – special rules for health insurance costs of self-employed individuals
  - i. §1.213-1(e)
    - i. an expenditure which is merely beneficial to the general health of an individual, such as an expenditure for a vacation, is not an expenditure for medical care.
    - ii. For special diet requirements
      - 1. Must be medically proscribed *and*
      - 2. Must cost more than a normal diet
      - 3. Can be deducted above what a normal diet costs.
- b. **Charitable Contributions - § 170 (a), (c)(1)-(2), (e)(1)-(2), (f)(8)(A)-(B), (L)**
- a. **Elements**
    - i. Amount of deduction is limited to the fair market value of goods donated
    - ii. No deduction is allowed for the value of one’s services given to charity
    - iii. Charities include the U.S. govt., states, cities, or 501(c)(3) organizations
    - iv. When a contribution is made and you get something back, the contribution must be reduced by the fair market value of what you get back
    - v. Must get a receipt for any charitable in excess of \$250,000
  - b. **Requirements**
    - i. Be made to or for the use of a qualified recipient
    - ii. constitute a transfer of money with no expectation of a return benefit
    - iii. actually be paid *and*
    - iv. not exceed certain percentage limitations
  - c. **Rev. Ruling 67-246** – burden is on the tax payer to show that the amount paid is not the purchase price of the privilege or benefits and that part of the payment in fact do not constitute a gift
  - d. **Cases**
    - i. Duberstein
      - 1. **H:** Whether or not it is a gift depends on the givers intention
      - 2.
    - ii. Hernandez
      - 1. **Facts:** Church of Scientology case
      - 2. **H:** Court denied deduction b/c there were fixed price schedules. Can’t get something for nothing in the church of scientology. Court said this is quid pro quo
      - 3. **But,** the court has announced that they will not enforce Hernandez

if the donation is tied to a tenant of the religion. If you are getting a gym membership or tickets to a concert, that's not deductible

**iii. U.S. v. American Bar Endowment**

- 1. H:** Two part test – the donor must *intend* to make and, in fact, *make* a payment in excess of the fair market value of the goods and services.

- e. Rev. Ruling 83-104** – no expectation of procuring a financial benefit commensurate with the amount of the transfer
- f. 170(b)** - caps the amount donated to 50% of the taxpayer's contribution base for the taxable year
- g. 170(f)(8)(A)** – requires that the donation be substantiated if it is more than \$250
- h. Rev. Ruling 90-12** – insubstantial market value
  - i.** paid in context of fund-raising campaign in which the charity informs patrons of how much is deductible
  - ii.** is not more than 2% of payment or \$50
  - iii.** payment is \$25 or more and the item is a token item
  - iv.** fund raising campaign must meet two criteria
    - 1.** distributes free unordered items
    - 2.** patron may retain the item whether or not the patron makes a donation
- i. 170(l)** - only 80% is allowable
- j. Reg. 1.170A-1(c)(1)** - If a taxpayer contributes property to a charitable organization, the amount of the contribution will be the fair market value of the property
- k. 170(e)(1)**
  - i.** Start with the fair market value of the property.
  - ii.** Shall be reduced by the sum of A and B.
    - 1. A** – The amount of gain that would not be long term capital gain.
      - a.** Three instances where something is not long term capital gain
        - i.** short term gain
        - ii.** sale of certain assets
        - iii.** other?
      - 2. B-** Must be tangible (not stocks, bonds, copyrights) personal property.
      - 3.** Does not apply to real estate or stocks and bonds.
      - 4.** So if this is tangible personal property and is unrelated to exempt purpose, the deduction is limited to the basis.

## X. LIMITATIONS ON DEDUCTIONS, LOSSES, AND EXPENSES

### a. Requirement of Profit-Seeking Activity – §183(a)-(d)

- i. Cannot deduct expenses incurred pursuing a hobby by claiming that they were a business venture
- ii. §183(a)- simple disallowance provision
- iii. §183(b) – limits the amount of the disallowance. Certain deductions are still allowed.
- iv. §183(b)(1) – deductions under the income tax are allowable whether or not they are for profit (ex. interest on a home mortgage, casualty losses, medical expenses, charitable contributions)
- v. §183(b)(2) –also allowed to deduct an amount that will offset any otherwise taxable profit that arose from this activity. (ex. see syllabus)
- vi. \*no limit on real estate taxes – can deduct it no matter what
- vii. **Rule:** Taxpayer cannot deduct any amount not attributable to a trade or business unless the tax payer happens to make profit from this non-profit seeking activity

### viii. Cases

#### 1. Dreicer v. Comm

- a. **Facts:** independently wealthy man travels and writes books that lose money.
- b. **Q:** Can he deduct the cost of his travels?
- c. **H:** No. He never expected to make a profit off of his books. Subjective test based on whether the taxpayer thought he would make money.

### b. Home Office Expenses § 280A (a)-(c)(1), (c)(3), (c)(4), (c)(5), (d)(1)-(3)(A), (e), (f)(1)

#### i. Cannot deduct for a vacation home or a home office unless

1. it is a dwelling unit *and*
2. used as a residence
  - a. 14+ days per year *or*
  - b. 10% of the rental time, whichever is greater

#### ii. Exception for interest, taxes, casualty losses, etc

1. Real estate taxes, property taxes, or mortgage interest are always deductible
2. Casualty losses are deductible if they qualify

- iii. Can deduct a portion of the taxpayer's residence for business use if that portion is used
  - 1. Exclusively/on a regular basis
  - 2. as the taxpayer's principle place of business
  - 3. as a place of business by patients, clients, or customers
  - 4. Separate structure in connection with taxpayer's trade or business
  - 5. storage of inventory
- iv. **Vacation home**
  - 1. deductions must be prorated between personal and rental use *and*
  - 2. if the dwelling is used as a residence, business and investment deductions are limited to income generated by the property
- v. **Cases**
  - 1. Popov v. Comm
    - a. Violinist wants to deduct her living room b/c she practices there.
    - b. **H:** It is deductible. **Court asks:**
      - i. Was it her principle place of business?
        - 1. What did she do there?
        - 2. How much time was spent there?
    - c. Most important activities to her career took place in her home

## **XI. WHEN IS IT INCOME? TAX ACCOUNTING : IS IT INCOME OR DEDUCTIBLE**

- a. **The Cash Method of Accounting**
- b. **Income Under the Cash Method**
  - i. **Reg. 1.451-2**
- c. **Deductions under the Cash Method**
- d. **The Accrual Method of Accounting**

## **XII. INTRODUCTION TO CAPITAL ASSET TRANSACTIONS**

- a. **Capital Gains and Losses**
- b. **History and Policy**
- c. **Torture is the Price Paid for Tax Relief: Current Statutory Provisions – §1(h)**
  - i. **§1221**
  - ii. **§1222**
  - iii. **§1202(a)-(b)(2), (c)(1), (d)(1)**
- d. **Limitation on the Deduction of Capital Losses – §1211**
- e. **Definition of Capital Assets – §1221**
  - i. **Inventory and Property held for sale to customers**
- f. **Quasi-Capital Assets §1231(a)(1)-(3), (b)(1)**
- g. **Recapture of Prior Depreciation Deductions - §§ 1245(a)(1),(2)(A), (3)(A), 1(h)(7)**
- h. **Transactions Involving Liabilities and Property Subject to Liabilities**

## **XIII. TAX CONSEQUENCES OF DIVORCE**

**a. Alimony and Child Support Payments – §71(a)-(c)(3), 215(a)-(b)**

**XIV. ALTERNATIVE MINIMUM TAX**

Not on Final