

Federal Personal Income Tax

I. INTRODUCTION

- A. Regulations = regulations are used to help interpret statutes.
- Statutes > Regulations. If inconsistency between the two, then the statute will win.
- Cases = another form of guidance to statutes.

Tax Systems:

Marginal Tax Rate – Taxpayer's tax rate is determined by the amount of income they earn

e.g. First \$X → tax = 0%; Income > \$X → tax = 20%.

Progressive Tax Rate – Tax rate increases with income. Deemed to be more fair as it taxes the rich more than the poor.

Head tax – a set tax that for every person → ONLY tax that does not create a disincentive to work.

Policy – if tax rates are too high, it creates a disincentive to work (look to Laffer curve).

II. GROSS INCOME

A. INTRODUCTION

§61 – Gross Income Defined (p.59)– Unless Stated otherwise in another statute, gross income means *all in come from whatever source derived*, including but not limited by the following:

1. Compensation for Services (including fees, commissions, fringe benefits, and similar items)
2. Gross income derived from a business
3. Gains from property dealings (ie selling property)
4. Interest
5. Dividends
6. Discharge from Indebtedness

- more included inside of Internal Revenue Code (I.R.C.)

Regulation §1.61 (p.902) – Compensation: value of services that are given to a charity for free are not recognized as income; Compensation paid other than cash: if property received for compensation the fair market value will be included as compensation, life insurance paid by employer is included in income.

Old Colony Trust v. Commissioner

Facts

Taxpayer paid a salary of 1 million dollars, in addition his employer paid for all of his income taxes (\$400,000).

Is the tax paid by the employer also included in the taxpayer's income?

Rule

If employer makes a payment to satisfy a employee's obligation, it will be included as income. Income from a job is not limited to the salary received, certain benefits can also be included as income.

Problems: (p.21 in casebook)

1)

a) Taxpayer paid a salary of \$75,000. Only takes home \$50,000 after her employer withdraws \$25k for federal taxes and social security taxes. The taxpayer must report the entire \$75,000 as her Gross Income even though her obligation has already been fulfilled. (Different then old colony because that was in addition to salary)

b) Taxpayer (TP) receives a \$5,000 bonus. Under §61, this must be included as income under "similar items" for compensation received.

c) TP receives opera tickets valued at \$300 from a client. This is not party of the TP's compensation, it is considered a gift.

d) TP purchases \$500 worth of furniture from the office for \$50. This is taxable. One factor is that this is from the employer (under services in §61). This is a benefit because the price the taxpayer pays is much less then the fair market value of the property.

f) Taxpayer gets free tickets from frequent flier miles which was paid for by the law firm. The value of the tickets is \$3,000. Depends, probably a fringe benefit from employer. **ASK**

B. Form of Receipt

Rooney v. Commissioner

Facts

Taxpayer was an accounting firm which was normally paid in cash. Taxpayer would go the restaurants and stores of clients and would deduct what they bought from the client's businesses from the debts the clients owed to them. Taxpayer thought client's prices were too high, so when they reported their income they did not accurately report the prices of what they received (ie. If TP got a \$100 mean, would only report it as \$50). Can the Taxpayer determine the amount of the benefit received for a service performed?

Rule

The value of a benefit received is equal to it's fair market value. So the Taxpayer would have to report the full value of whatever benefits they received from clients and could not determine what they thought the benefits were worth.

Commissioner v. Glenshaw Glass (most modern definition of income)

Punitive damage – a damage meant to punish and deter behavior.

Compensative damage – a damage meant to compensate for a loss.

Facts

Taxpayer received punitive damages from a lawsuit.

Issue – should punitive damages be treated as income?

Rule

Punitive Damages are included part of income.

Factors that something is income:

- 1) Taxpayer has an undeniable accession to wealth
- 2) The wealth is clearly realized
- 3) Taxpayer has clear dominion over the wealth

C. Tax-Free Fringe Benefits

1) § 119 – Meals and Lodging Furnished for Convenience of Employer

Factors (need ALL of them for employee to exclude from income):

- 1) Are meals and lodging for convenience of employer?
- 2) Are Meals on the business premises?
- 3) Are the lodgings are condition of employment? (employee HAS to accept the lodging as a condition of his employment)
- 4) Are the meals and lodging provided to an employee (or their spouse or dependant)?
- 5) Are the meals paid for the employer?

- **(this ONLY deals with employees)** employer tax consequences not part of this section

- If more then half of employees receive meals on the premises then it is automatically for the convenience of the employer.

- (Educational) Campus lodging given to employees is excluded from income.

Benaglia v. Commissioner

Constrained Choice – constraint or limits placed on a benefit. The greater the constraint, the less a benefit is worth. Eg cash is totally *unconstrained*.

Facts

Manager of a hotel had to live in the hotel as a part of his employment.

Rule

If for convenience of employer then not taxed ?????????

- applying a §119 analysis: all are answered yes, 3 is also yes because even though it the employee's condition, since it was part of the contract it is considered to be a condition of employment

Problems (p.197)

3) Law firm has unwritten policy that young associates should spend evenings working at the office. Firm gives associates \$15 for an evening meal so they can take a break and eat nearby.

- a) Associates should include the meal money in income because of §119(factor 2), the meals are NOT on the premises.
- b) If an associate keeps the money, that is treated as income under §61.
- c) Firm now provides meals to the employees in a cafeteria on the premises: this is excludable, meets all 5 factors of §119.

2) Work Related Fringe Benefits

- Goal of Congress was to codify acceptable tax deductible benefits, all other benefits would be taxable.

§ 132 – Fringe Benefits

Six Fringe Benefits are Excluded from Gross Income:

(Spouse and dependants of employee are included (more in statute))

1) No-additional cost service – 5 Requirements:

- a) Must be offered to Customers
- b) Employer must NOT incur a “substantial” additional cost (this includes forgone revenue) by giving this service to employee.
- c) Must be in the line of business the employee works in.
Reg. §132 – general counsel presume to work for in all branches because it benefits all branches.
- d) Must be offered by employer to employee
- e) Can NOT discriminate the benefit in favor or highly compensated employees

- Note: This is for SERVICES

2) Qualified Employee Discount

- Services:

- a. can NOT exceed 20%
- b. must be offered to customers

- Property – use Gross Profit Percentage (GPP)

GPP = total profit/total sales

I.e. Total profit = \$500,000; Total Sales = \$1,000,000 then

GPP = .50; so can give a discount of up to 50% of the price offered to customers.

3) Working Condition Fringe Benefits – property or services provided to the employee by the employer that are used to facilitate the employee’s work (i.e. tools, supplies, office space, etc)

4) De minimus fringe – any property or service that an employee gets from an employer where the value (after taking into account the frequency) is so small that accounting for it in income would be “unreasonable or impracticable”.

- i.e. making copies at work

- 5) Qualified Transportation Fringe – employer provides to employee any of the following:
- a) “commuter highway vehicle” if between work and home
 - b) transit pass
 - a) and b) can NOT be more than \$100/month
 - c) Qualified Parking
 - can NOT be more than \$175/month
- 6) On Premises Gyms and other Athletic Facilities (under “special rules”) – deductible only if used by employees, their spouses, and dependents.

Policy

- 1) Congress was worried that employers and employees would negotiate to include more compensation in fringe benefits and less in compensation so that the employees could avoid income taxes.
- 2) “Administrative” people do their own taxes and will interpret the law in their own benefit, this was in reaction to that by codifying what were acceptable tax exempt fringe benefits.

Problems (p.198)

- 4) Company operates both hotel chain and airline chain. Employees can have a 50% discount at hotels and 50% discounts for flying on reserved seats and free when flying on standby.
 - a) Lawyer for company gets free flight on standby (save \$1000) and free food and drinks on flight, excludable? Yes, under §132 “no additional cost service”, passes all of the factors.
 - b) Now lawyer reserves seat and gets a 50% discount (saves \$500). Reserves and stays at hotel and get 50% discount on stay (save \$600). Hotel’s average occupancy rate is 75% and some rooms are always available; excludable? Flight is not excludable because company forgoes revenue and thus incurs a substantial cost. Hotel is probably OK because always some rooms free, so no forgone revenue. §132 No Add’t Cost.
 - c) Lawyers buys jewelry at hotel for \$500 (50% off of \$1000). Sells to sister at \$700. Need to know the GPP under §132 “qualified employee discount” to see if deductible. If discount is greater, then can only deduct amount under GPP, everything above is taxable. The profit from the sale is clearly income under §61.
 - d) Flight attendant of air division of company has gay domestic partner who receives a free flight on standby (saves \$450). They then save 50% (\$250) at the hotel. Is gay dude a spouse? Not under federal law, so not deductible for airline. Hotel not deductible under §132 “No Add. Cost” because it is not in his line of business (hotel, he is in air division)
- 5) Law firm pays \$150/month for parking of employees in a garage across the street. Also, the firm pays \$25/month to buy a pass for those who take the bus. Both are excludable under §132.

Hypo: Is the school provision of office, internet, and Xerox to professors taxable?
- No, work done by these services and property, the school benefits and is part of the job.

Hypo: Free food at a restaurant, can take it at will. Can Exclude under §119 (not §132 because it is not a service).

3) “Other” Fringe Benefits (outside work)

§ 79 Group-term life insurance purchased for employees

Employee must include in gross income (and thus pay taxes on) his employer provided group-term insurance the following costs:

- 1) The amount by which the policy exceeds \$50,000 **AND**
- 2) The amount paid by the employee towards that policy.

Health Insurance

Generally, employer paid health insurance is not taxable to the employee (different result however if that insurance begins to paying out, i.e. for injury, etc.)

§ 106 CONTRIBUTIONS by employer to ACCIDENT and HEALTH plans

- Generally **NOT** included in employee’s gross income

- 1) If employer pays premiums to the insurance company that covers employee (and his family), those payments are NOT included in gross income.
- 2) Insurance sold from employer to employee NOT included in gross income.

§ 105(a)-(c) Amounts RECEIVED under accident and health plans

(a) Money *received* under health or accident plans are INCLUDED in gross income. This includes both 1) money paid by insurance to doctors or hospitals **AND** 2) money paid directly to health provider by employer. (**huge ass exceptions in (b) and (c)**)

(b) Money received under (a) is NOT included in gross income IF it is to pay for medical care as defined in §213.

(c) Money received under (a) is NOT included in gross income if:

- 1) it is to pay for the permanent loss of a “member or function of the body” or “permanent disfigurement” of the taxpayer (and spouse and dep). **AND**
- 2) the money is only for the injury and does not take into account how much work the employee has missed

Policy

§105 (compensation is compensation) covers injuries but not disability insurance. The reasoning is that normally salary is taxable so there should be no difference if that salary is received from the insurance company instead of an employer.

The benefits of excluding payments for medical care are:

- 1) Healthy workforce
- 2) More production from the economy
- 3) Government doesn't pay for health insurance

Drawbacks of this are that because healthcare is not paid for by employees it change their behavior and causes a overconsumption of health care (caused because the tax system creates an incentive for employers to consume employer provided health insurance) which then causes healthcare to be too expensive to employers (leaves people out in the cold for health insurance).

Who should pay for health insurance, employer or employee (currently employer)?

§ 213 Medical, Dental, etc., expenses

(d)(1) Definition of "medical care" = for diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure of the body

(9) Cosmetic Surgery = "medical care" does NOT include cosmetic surgery UNLESS it is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury from accident or trauma, or disfiguring disease.

Definition of cosmetic surgery = procedure to improve the appearance of the body without meaningfully improving or fixing it's function

§ 104 Compensation for Injuries or Sickness

The following are NOT included in gross income:

- 1) worker's compensation (
- 2) damages (**except punitive**) received on account of personal physical injuries or sickness
- 3) amounts received under accident health insurance coverage for personal injuries or sickness UNLESS all or some of that money came from employer provided coverage OR that money is paid directly by the employer

§ 162(l) Health Insurance Costs for Self Employed Individuals

Self employed individuals can deduct the percentage of the amount allowed under the statute.

Problems (syllabus)

- 1) University pays \$6,000 to pay for the health insurance of a professor. The entire amount is excludable under §106.
- 2) Same professor is now injured in a car accident. The insurance company pays \$800 to the hospital and will also receive her salary for the year.
 - a) the 800 for injuries is NOT included in income under §105(b) + 213
 - b) salary is excluded under worker's compensation §104
- 3) Now the professor is paid compensation to NOT teach (*disability insurance*). Is disability insurance excludable? Taxed under §105, not under the exceptions so it is taxed.

What if the injury was permanent? Taxable under §105(c), money is related to period missed from work, thus not part of the exemptions.

4) Employer has plan that covers hair transplants (employee must look good in this industry, is this taxable? Yes, §105(b) covers “medical care” under §213, however cosmetic surgery is only covered if it is from a deformity or other exceptions and this does not qualify.

D. Gifts, Inheritance, and Scholarships

1) Gifts

- gratuitous transfer – generally a transfer made without any consideration.

§102 Gifts and Inheritances

a) A gift, bequest, or inheritance are generally not included in gross income **UNLESS:**

1) income received from any property received under a) OR

2) if the gift or inheritance is income from property. OR

****3)** any gift from an employer

Test(3) – if the employee can show that gift was not related to a recognition of their employment, then it will be excluded from income (i.e. family relationship where the transfer is because they are family and not because of their business relationship). Reg. § 1.102-1

§274(b) Gifts (Deductions)

Can not deduct any gift that is more than \$25.

Transfers made between Non-Family Members:

Duberstein v. Commissioner

Facts

Business partner gave a tip to his other partner, who then gave him a Cadillac as a gift for that tip.

Issue: Is the car a gift or compensation?

Holding: It was compensation

Rule

Test: Look to Donor’s intent

- to be a gift it needs to be detached and disinterested generosity.

- court felt this was compensation for the tip.

To determine intent, make “objective inquiry” → look to mainsprings of human conduct based on trier of fact’s experience

Problems (p.87)

Hypo: Rich Uncle has \$1 million in the bank, gives all of it to nephew, who will make \$50,000 of interest from that money in the bank. If money stayed with the

uncle only the \$50,000 would be taxable. What are tax consequences? The transfer is NOT taxed under §102. The money made from the interest is taxable under §102's exceptions.

Hypo: Employee works at treasury gets flowers for birth of daughter from coworker → gift

Hypo: Same Transaction but get teddy bear from a lobbyist → gift

Hypo: Again, get teddybear from lobbyist, but not for birth. → gift

Rule: the more significant the transfer the less it feels like a gift.

1) Employee receives cash presents from her employer at a holiday office party. Other employees in similar positions but with less experience receive lesser amounts of money.

a) Cash presents are included in gross income. §102

b) Employee also receives money from other people she works with. Also included under §102

c) Also receives money gift from client → probably included, can argue.

2) Girl will get \$25,000 from will of grandfather IF she acts as the representative of his estate. Under state law representatives of estates can not receive more than 4% of gross estate (iow \$10,000). Is the \$25,000 excludable?

- The 1st \$10,000 is income. Remaining \$15,000 is a bequest and is excluded under §102.

Hypo: Professor does the estate for his uncle. Uncle leaves all the income that his property earns for the rest of her life (\$6,000/year). Professor and his brother both get 50% share of assets.

a) When professor and brother get assets is that included in income? No, it is a bequest.

b) How is girlfriend taxed? Money is taxed under exceptions under §102.
- reasoning – can shift “assets” among family but can not hide the income that results from those assets → fair result

2) Scholarships

§117 Qualified Scholarships

Qualified scholarships NOT included in gross income.

Qualified Scholarship – any amount received for scholarship or grant that is used for “qualified tuition and related expenses”

Qualified Tuition and Related Expense:

1) tuition and fees required to enroll or attend a educational institution

AND

2) fees, books, supplies, and equipment required for course at a educational institution

Limitations (Does NOT apply for the following):

- payments for teaching, research, or other services by the student required as a condition for receiving the scholarship

These payments will be excluded if within the exceptions in the statute code

Qualified tuition reduction (reductions in income for employees who work at a school) are NOT included in gross income. Only works for tuition for education BELOW the graduate level.

§127 Educational Assistance Programs

(a) the first \$5,250 paid by an employer for a qualified educational assistance program to an employee is NOT included in gross income

(c)(1) Educational Assistance – payment by an employer to an employee for expenses for education (including but not limited to tuition, fees, and similar payments, books, supplies, and equipment).

- This does NOT include payments for tools or supplies that can be retained after the course of study is complete, or meals, lodging, or transportation, nor anything involving sports, games, or hobbies.

(c)(7) Employee can NOT deduct any amount that is excluded from income under this section.

Problems (syllabus)

Student receives scholarship which consists of the following:

Tuition:\$25,000; Housing:\$4,000; Meals:\$4,000; Books:\$1,000; Misc:\$1,000.

- 1) Student is high school senior and receives this as a merit scholar
 - tuition and books are excludable, the rest is taxed under §117
 - **R:** “equipment required for courses of instruction” and “fees required for enrollment”
- 2) Student receive scholarship as outstanding athlete
 - same answer as 1)
- 3) Student is an employee of a university who is going to attend law school
 - None is excludable because it is not below graduate level §117.

Hypo: Miss America Scholarship → not excludable because providing compensation for tuition, §117 limitation (can’t get scholarship for services, becomes compensation then)

Policy

Is it fair to tax room and board?

Congress was concerned about stipends for grad students where they get a stipend in addition to free tuition.

E. Gains Derived From Dealings in Property

1) Realization and Replacement of Property

§61(a)(3) Gains derived from dealings in property are included in gross income

§1001 Determination of amount of and recognition of gain or loss

(a) Computation of Gain or Loss

$$\text{Gain} = \text{Amount Realized} - \text{Adjusted Basis}$$

- same method to compute loss

(b) Amount Realized = “Fair Market Value of property received other than money” + “any money received from sale”

(c) UNLESS another provision says otherwise, the ENTIRE gain or loss from a sale or exchange of property will be recognized.

Exception: §102 “Gifts” – when the transfer of property is done gratuitously then the recipient does NOT have income.

- Note – easy to see the tax implications when cash is exchanged, harder to see when there is an exchange of property that has appreciated in value

§1011 Adjusted Basis

Adjusted Basis is the basis from §1012, or something else depending on the relevant section. (NOT SURE ABOUT THIS, ASK??)

§1012 Basis of Property

The Basis of the Property is the cost of the property

Problems (p.71)

Hypo: I buy property in 1985 for \$1000, sell it today for \$1500.

Gain = AR - AB = \$1500 - \$1000 = \$500 §1001

Taxed on Gain Exception: §102 “Gifts” – when the transfer of property is done gratuitously then the recipient does NOT have income. 61(a)(3)

2) Girl buys a home for \$200,000. She pays \$50,000 in cash and borrows the remaining \$150,000 from the bank.

a) Basis? \$200,000

§1012 → basis = cost

What is the basis if she buys the home under a contract where she pays \$50k upfront, and the remaining \$150k over 10 years with interest. Basis is STILL \$200,000.

R: Financing is irrelevant in determining the basis.

b) Five years after the purchase, she has paid \$25,000 on the loan balance reducing the mortgage to \$125,000. Basis? STILL \$200,000.

c) Mortgage down to \$125,000 from last scenario, now borrows additional \$50,000 from bank, increasing mortgage to \$175,000. Uses that \$50,000 on the house. \$40,000 to remodel kitchen and \$10,000 to buy a piano.

Basis in house? \$40,000 spent on house increases cost of home by \$40,000 and thus the basis increases by \$40,000 too → basis = \$240,000.

\$10,000 on piano does not change the money spent on the home. That is the basis in the piano.

d) Two years later after the remodeling, she sells the house for \$140,000 in cash and buyer assumes the remaining \$160,000 of the mortgage. Gain for girl selling? AR = \$140,000 (cash) + \$160,000 (fmv of property received other than money) = \$300,000. Adjusted Basis = \$240,000. Gain = AR - AB = \$300k - \$240k = \$60,000. Basis of purchaser = amount paid = \$300,000.

4) M exchanges a yacht worth \$100,000 for empty property owned by P worth \$100,000. M paid \$75,000 for the yacht 5 years ago and only used it for personal purposes, P paid \$40,000 for the empty lot 10 years ago. Two years after this exchange, M sells the empty lot she received for \$140,000.

a) M gain at time of exchange?

$$G = AR - AB = \$100,000 - \$75,000 = \$25,000$$

P gain at time of exchange?

$$G = AR - AB = \$100,000 - \$40,000 = \$60,000$$

M gain 2 years later at time of sale?

$$G = AR - AB = \$140,000 - \$100,000 = \$40,000$$

*****Rule:** When 2 taxpayers exchange property in a fully taxable transaction, the *taxpayer's basis* in that acquired property shall be the *full market value of the property acquired*. "Philly Amusement"

2) Basis of Appreciated Property Acquired by Gift

§1015 Basis of Property Acquired by gift and transfers in trust

(a) If property is acquired by gift (has to happen after 1920) then the basis is equal to the *basis of the donor* UNLESS that basis is greater than the fair market value at the time of the gift THEN the basis is equal to the fair market value.

- Substituted Basis – transferring the donor's basis to the recipient

(d)(1) Increasing the basis by the gift tax (look in statute for guidelines, does not seem important)

Problems (Syllabus)

Hypo

X buys 100 shares for \$4,000. Value of stock increases (no realization yet until he sells it). X transfers the stock to his daughter, at this point it is valued at \$10,000. Leah later sells the stock for \$18,000.

- This is a gift §102.

- Daughter's basis = \$4,000 (same as donor under §1015)

- Gain = AR - AB = \$18,000 - \$4,000 = \$14,000

Rule: Generally no realization in property until you sell it or exchange (some gain has to be "realized")

Policy

The current rules defer the entire tax to the gift taker, allows the donor to escape the tax burden. Otherwise you could always avoid paying property taxes by transferring it within your family.

3) Property Acquired by Decedent – Stepped-Up Basis

§1014 Basis of Property Acquired by Decedent

- (a) The basis for property acquired by will is the Fair Market Value of the property at the time of death
- *** Thus NO income tax on property received through a will
- (b) “Property Acquired by Decedent” = bequest, devise, or inheritance or from the decedent’s estate
- (e) Appreciated Property acquired by decedent by gift within one year of the decedent’s death the basis is the adjusted basis of the decedent at the time of death (decedent huh? Which is which?)
- policy – the limit is one year so as to prevent abusive transactions, they thought that the one year limit would do that.

Policy

It is unseemly to tax after death. Also death is not desirable, so people won’t die to escape paying taxes.

Counterpoint – this law encourages people to sit on property until they die to give it to their kids and avoid paying taxes, this is bad for the market. Also, this disproportionately benefits the rich.

Problems (p.88 + syllabus)

3) B buys vacant lot for \$20,000. Lot increases in value to \$50,000. Gives lot to son as gift through her will.

B’s income? None.

Son’s basis = fmv = \$50,000.

Son’s Income? None, basis = AR.

Hypo (Syllabus)

D owns property with fair market value (fmv) = \$1 million dollars and his basis was \$100,000. D’s relative M is about to die, D transfers the property to M and receives it back shortly thereafter in M’s will. What is M’s basis?

- M’s basis = \$100,000 (gift §1015). D’s basis is the basis of the decedent right before his death, so D’s basis = M’s basis = \$100,000.

Rule: If property is received within one year of death and is by gift, then the basis is adjusted basis of the decedent’s basis right before his death **§1014(e) →this explains the statute**

F. Treatment of the Owner of Annuity and Life Insurance

1) **Life Insurance** – a form of income that the insured individual would have generated if they continued to live.

§ 101 Certain Death Benefits

(a)(1) Gross income does NOT include life insurance proceeds.

- applies to both term and other types of life insurance (ie both single and term life insurance)

term life insurance – i.e. pay \$500/year; death benefit = \$500,000

single premium – pay \$200,000; death benefit = \$500,000

Advantage of single premium is that there are no premiums and if you want to get out insurance, you get the \$200k + interest. §101 includes both the \$500k and the interest you get (**WTF????**)

2) Individual Retirement Accounts

IRA – a type of savings/investment that is mainly used for retirement purposes and is encouraged by preferential tax treatment

Look in Handout

- Tax code creates incentives to make investments in certain tax preferred areas.

Deductible IRA v. Bank Account

- In a bank account you will pay taxes on the interest, in a IRA you only pay taxes on the gain when the money is withdrawn, then all of it is taxable both the interest and the income.

- Thus you make more money in a deferred account than a bank account even with identical interest rates because the tax is deferred and that marginal tax is earning money in the deferred annuity.

Roth IRA v. Bank Account

- Roth IRA – only taxed on income “the year it was earned”

- The interest is tax deferred

- When money is withdrawn **NO PART IS TAXED.**

Roth IRA = Deductible IRA

- Older people will want a deductible IRA, because it earns the most money, want to be taxed later when their income is lower and thus their tax rate will also be lower.

- Young People want Roth IRA, because earn more money now, because taxed at the beginning when their income is the lowest.

§ 219 Retirement Savings

(a) Allowed to deduct up to \$3,000/year for “qualifying” contributions to an IRA

- The amount will change from \$3,000 to \$8,000 in 2004

3) Annuities

- an amount that you pay out every year (generally to a insurance company), historically money was paid to a insurance company and after the taxpayer’s death a specified amount of money would be paid monthly or yearly to the taxpayer’s surviving spouse.

Advantages:

1) These payments are guaranteed to continue for the rest of the surviving spouse’s life

2) Takes the spending control out of the surviving spouse’s hands, it is governed by the insurance company.

Tax Consequences:

- Ex. – individual invests \$100,000 in an annuity, at retirement the taxpayer receives \$10,000/year (at that point his life expectancy is 25 years).
What is the appropriate way to tax that annuity? One way is to say that the expected return will be \$250k over 25 years, thus realized a profit of \$150k off of his initial investment, could tax that gain.

§72 Annuities

A certain portion of annuity payments is treated as a *return* on the taxpayer's investment

Excluded portion = basis/expected income = $\$100,000/\$250,000 = 40\%$
- so under §72, 40% of the annuity payments in our example would NOT be taxed (thus under §61, would be taxed on remaining \$6,000).

G. Transactions Involving Indebtedness

1) Loans: Legal and Illegal

- Forgiveness of loan from employer = compensation
- Forgiveness of loan from family = gift

Rule: Sometimes under §61, if a loan obligation is discharged, it can be considered income.

- Sometimes it is compensation(taxed), sometimes it is a gift(not taxed), sometimes it is discharged(taxed)

James v. U.S.

Facts

Required by law to repay embezzled funds, is it a loan?

Rule

Embezzled funds are included as income.

When there is no *intent* to loan someone money, it is not a loan even if there is a legal obligation to repay.

Hypos

- Professor borrows money from employer to pay for kid's tuition. NOT income, because he will pay it back.

- No increase in wealth *Glenshaw*

- Professor borrows \$100k for tuition, then told later on that he only has to pay back \$80k. This IS income, of \$20k.

What if employer said at the outset, that he only had to pay back \$50k?

Then it is clearly compensation under §102(c)

- What if parents loan child money for college? It is still a loan and if it is not repaid then it is a gift

- When renting apartment, I pay \$1,000 for first month's rent and another \$1,000 as a security deposit. Landlord includes months rent as income (does not matter if

lease has not start, it is NOT loan) The deposit might not be included (depends, could be a loan)

- L.L. Bean will refund at any time for any reason. Is this a loan? NO, it is income, no obligation to repay unless something changes (different then security deposit, where if nothing changed then had to return the money).

2) Cancellation of Indebtedness

Rule: If the Creditor relieves you of your obligation to repay a loan, then the remaining amount on the loan becomes income.

§ 108 Income from Discharge of Indebtedness

- Four Exceptions to a Discharge of Indebtedness that **are not taxed**:

1) Discharge occurs in a title 11 case (bankruptcy)

2) Discharge occurs when the debtor becomes insolvent (debts>assets)
- Reasoning - in this case, not having to repay the loan does not enrich

3) Discharge of "Farm Indebtedness"

4) Qualified Real Property Business Indebtedness

(c)(1) The amount excluded under (a)(4), a Qualified Real Property Business Indebtedness. The taxpayer's basis in that property will be reduced by the same amount.

(e)(5) If the debt of the purchase of *property* is reduced, that reduction is treated as income.

§ 1017 (guh?)

- If under §108, the exclusion from a discharge of indebtedness reduces the basis, then that reduction in basis occurs the year after the discharge occurs.

United States v. Kirby Lumber

Facts

Kirby issues \$12 million in bonds (in other words borrows \$12 million). Then repurchases the bonds for only \$11.5 million (he is getting \$12 million, but only paying \$11.5 million for it). Bonds generally decrease in value because of interest rates changing.

Holding: Not a normal load because Kirby is enriched by this transaction and thus had to pay tax on the income that was realized.

Problems (p. 157)

1) D borrowed \$5,000 3 years ago to help pay for his daughter's legal expenses. After repaying \$3,000 of the loan, D leaves job due to health issues. Though he is not technically insolvent, D is unable to continue paying for the loans. Lender forgives remainder of loan because of the circumstances

- a) What are tax consequences if the lender is a local bank? It is income, not under §108 exceptions (not insolvent).
- b) What are tax consequences if the lender is D's employer? It is income, a form of compensation (not a gift because it was him employer)
- c) What are tax consequences if the lender is D's brother? Probably a gift.

A buys a car for \$20,000. Makes down payment of \$5,000 and borrows remaining \$15,000 from the car dealer. A learns that dealer lied about the engine. What are the tax consequences if:

(1) Dealer reduces balance of loan from \$15,000 to \$12,000? Basis in the car has changed, but no benefit to the buyer UNLESS he sells it. So no tax unless he sells the car and make a profit.

Rule: Renegotiation in terms = change in the basis.

(2) Finance Company agrees to reduce the balance of the loan?

Ask professor

Airline company buys planes worth \$100 million. To help pay for this, borrows \$80 million from a Junk Bond Savings and Loan. During a bankruptcy proceeding, the \$80 million debt is reduced to \$25 million.

(1) What was airline's basis in the planes prior to the discharge? \$100 million

(2) What was airline's basis AFTER the discharge assuming that §108(b) applies and that the company has no other depreciable assets? Taxpayer will end up paying \$45 million for the planes, thus basis = total cost = \$45 million. §108(c)(1).

H. Treatment of Damage Recoveries

1) Damages to Property of Business Interests

Raytheon v. Commissioner

Facts

Raytheon receives money won from a antitrust suit.

Issue: How to tax general business damages

Holding: Damages were for a "good will injury", thus not taxable.

Rule

Test: In lieu of what were damages substituted for.

- If damages were to compensate for lost profits, then tax them like profits
- If damages were to compensate for damaged property, then tax it like property

If suit is for injury to good will, then the recovery represents a return to capital and is **NOT taxable**

Problems (Syllabus)

- L pays \$40,000 for a new car. B rents the car from L for \$100/day and is liable for any damage to the car while driving. B wrecks car.

- 1) What are tax consequences if B has to pay L the full \$40,000?
- this money is in lieu of the car, equivalent to a sale. Get \$40k for a broken car. Look to §1001: AR = 40k, basis = 40k → NO income realized, thus no taxes.
- 2) \$5 part not available for one week, B pays \$700 in damages. \$700 in lieu of lease, lease payments under §61, thus taxable.

2) Damages for Personal Injuries

§ 104 Compensation for Injuries or Sickness

Gross income does NOT include damages for personal injuries by suit of agreement of the following:

- 1) worker's compensation as compensation for injuries
- 2) damages on account of physical injuries or physical sickness
- 3) damages for personal injuries paid by insurance where insurance was paid for the employer
- 4) Pension payments for personal injuries from armed services
- Punitive damages ARE included in income though, even if they are derived from a personal injury suit

Problems (p.175)

2. T is self-employed, injured by drunk driver. Files suit for negligence against driver and his ins. Co. for \$2 million in compensatory and punitive damages. Parties settle out of court for \$900,000.

Damage:

Pain and suffering = \$500,000 (\$100k/year for 5 years)

- excludable under §104

Medical Expenses = \$100,000

- excludable

Future Medical Expenses = \$50,000

-excludable

Lost Wages = \$80,000

- excludable, were on account of personal injuries

Punitive Damages = \$150,000

- INCLUDED in taxes

Damages to Pickup Truck = \$20,000

- ??????

I. Tax-Exempt Interest

§103 Interest on State and Local Bonds

Gross Income does NOT include interest earned from state or local bonds
- exceptions – this does NOT apply to: private activity bond which is not qualified, arbitrage bonds, or bonds that are not in registered form (seems worthless)

Policy

Is this a good thing? Do States really benefit?

- Allows states and local governments to get their money through a lower interest rate than the federal government (because the gains are not taxed so they can give a lower interest rate and it is still worth buying them because of the gains from not paying taxes).
- This is an indirect subsidy.
- Inefficient because some of the benefits will go to the purchaser.

J. Social Security Proceeds **IMPORTANT******

§ 86 Social Security (LOOK AT AGAIN, MISSED SOME)

- At most only 50% of SS payments are includable as gross income
 - If single, nothing is included unless gross income >25k
 - If married, nothing is included unless gross income >32k
- For higher income individuals, may be included as much as 85% of payments
- (c)(1) look in statute book to determine **base amounts**

Policy

- Are these welfare payments? No, not for entire population. Then what are they?
- For most people FICA is a larger tax burden than their income tax.
- Most of the FICA payments are not invested, only used to pay for the current year.
- Medicare is for people over 65 (paid by feds)
 - Will not have enough by end of decade, 2 options increase taxes or decrease benefits
- Medicaid is for lower income people and is paid by states

Problems (Syllabus)

- Grandma receives \$8,000 in SS, her “modified adjusted gross income” for the year is \$30,000. She is unmarried. What portion of her SS is included in her gross income?

- **Rule:** pay tax on SS IF:

“modified gross income” + (1/2)(Social Security) > Base Amount

$$30,000 + 4,000 = 34,000$$

(c)(1) base amount = \$25,000

34,000 > 25,000; Thus §86 applies. Now determine the tax rate on that.

§86(a)(1) Gross Income Includes social security benefits in the amount equal to the LESSER of:

1) $(1/2)(\text{Social Security Benefits}) = \$4,000$

2) $(1/2)(\text{Excess}) = 1/2(9,000) = \$4,500$

Thus, \$4,000 of SS is included in gross income

- Unless S payments > \$25,000, they are not taxed. §86 only taxes people with additional income.

III. PROPERTY TRANSACTIONS: REALIZATION, RECOGNITION, ETC.

A. INTRODUCTION

When does taxpayer realize income on property?

- Realization – only taxed once it is “realized”, Not taxed on changes in the value.

Eisner v. McColmer

Facts

Taxpayer received more stocks as a shareholder.

Rule

Receiving more stocks did not result in any income.

Increases in value are not taxed until a **significant event** occurs.

- All he got was more stock, nothing was realized. He had more shares, but his percentage of the ownership did not increase.

Cottage Savings

Facts

Bank lent money to people to buy house and in return got mortgages. Bank owned these mortgages. In this case the mortgages decreased in value. IF they were sold, it would be a loss and would be a deduction. Had to maintain a certain level of risk and sold some mortgages for others.

Rule

This substitution of mortgages was a realization because they were **materially different risks**.

Two Requirements Before a Gain/Lost can be Included in Income:

1) Gain/Loss must be realized.

2) The Loss must be “recognized”.

Recognition – IRS determines if gain/loss has tax consequences.

Realization – Whether or not taxpayer has changed economic position.

B. REALIZATION WHEN PROPERTY TRANSFERRED AS COMPENSATION

§ 83 Property Transferred in Connection with performance of services

(read regs online)

4 Issues:

1) Does §83 apply to the transaction?

- If property is transferred in connection with services performed (**except to person who gets the services**) → include “fair market value of property” – “what was paid for that property” as gross income.

- 2) Who has income?
- 3) When is there income?
- 4) How much income does the taxpayer have?

(b) Employee can elect to include income in the year of the transfer.

(h) Employer can deduct an equal amount to whatever employee includes in gross income from the transaction.

Hypos (syllabus):

- X works at law school and receives \$100,000 in cash and \$400,000 in stocks. What is X's income? All 500k is included, DO NOT look to property tax code until they are clearly an owner.

- **Rule:** Taxpayer has income whenever there is a transfer of property that is connected with services.

- Lawyer goes to work as in house counsel for a new company. The company transfers 10,000 shares of stock to the lawyer who pays \$1,000 for the stock.

How much can the company deduct and how much income must the lawyer include IF:

1) FMV of stock was \$10,000 when received.

- factors of test show lawyer includes \$9,000 in gross income and the company can deduct \$9,000

2) Company transfers stock to a bank to pay off lawyer's student loans.

- §83 applies, lawyer still has \$9,000 of income from the benefit and company can deduct \$9,000 as well.

3) Lawyer will be required to sell the stock back to the company for \$1,000 if she leaves within first 3 years. After working for 10 years, the stock is worth \$10 million.

- Lawyer includes it in income after 3 years (**substantial risk of forfeiture**). After 3 years includes \$9,999,000 as income.

4) Same facts as 3), but Employee decides to apply §83(b), election to include in year of transfer.

- ONLY has to pay \$9,000 from initial transfer.

- After this, she must include in her income any money she makes when she sells the stock, because she is now recognized as the owner of the property.

D. NONRECOGNITION OF GAIN OR LOSS IN CERTAIN PROPERTY DISPOSITIONS

1) Property Settlements in the Context of Marriage Dissolution

Arms Length Transaction – on equal terms with adverse interests.

United States v. Davis

Facts

2 spouses get divorced. In the settlement, husband transfers Dupont stocks to his wife. Wife in return gave up marital rights. Stock was worth more when the husband gave it away than when he received it.

Issue: What was the amount realized?

Holding: In situations where parties operate at arm's length, the value of what the husband receives is equal to what he gives up.

§1041 was enacted to basically overrule Davis (no longer good law)

§1041 Transfer of property between spouses OR incident to divorce

NO gain or loss recognized for transfers between spouses or former spouses.

- If after a divorce to qualify it must be:

- within one year of marriage
- related to the cessation of the marriage

(b) These transfers that qualify are treated as **gifts**.

Basis of transferee = adjusted basis of transferor

Problems (syllabus)

1) Prior to marriage, C buys land for \$100,000. C holds title as the sole owner. 6 months after the divorce, C sells the property to her ex husband Z for \$150,000. The FMV of the land was \$150,000.

(a) How much gain does C recognize on this transaction?

- None. §1041(c)(1) applies, it is a gift.

(b) What is Z's basis in the land? \$100,000

2. Like-Kind Exchanges

§1031 Exchange of Property

Requirements:

- 1) Exchange of Properties
- 2) Property given up must be used for "business or investments"
- 3) Property acquired must be used for "business or investments"
- 4) Properties are of "**Like Kind**"

IF Requirements met then **no gain or loss is recognized**.

Rule: ALL real estate is like kind.

(b) Gain from Not Like Kind = money received plus FMV of not like kind property received

Policy

Hard to value properties accurately, this is an unfair burden. Should have to sell property to pay for taxes for the exchange. The purpose is to avoid tax on the exchange but retain that tax revenue once it is sold.

Problems (Syllabus)

Hypo – Exchange vacation home in Florida for one in California.

- §1031 does not apply, not used for business or investments

Hypo – Businesses exchange x number of old trucks for one new truck. Both are used for the same use. Does it matter that the other truck deal simply wants to sell the old trucks after he gets them? **No, only look to the taxpayer's purpose**, the other party does not matter.

Look in notes for more depth on problem

1) A transfers Whiteacre to B for Blackacre. A's basis in Whiteacre was 60 and the fmV of Whiteacre was 100. How much gain does A have and what is his basis in Blackacre?

- Gain? Yes, §1001. It was an arm's length transaction so you assume equal value.

A's basis in White = 60, value of Black = 100

They are like kind because it is real estate

Amount not like kind = 0

Amount of gain recognized = 0 → §1031

Basis of new property = old basis = 60

- amt. money received = 0

+/- Gain Recognized = 0

= **60**

Check:

Gain recognized + Gain Preserved = Gain Realized

0 + 40 = 40

100-60 = 40

(this preserves the gain that would be taxed once it was sold)

2) A transfers Whiteacre to C, C gives A Yellowacre and \$15. A's basis was 60, the fmV in Whiteacre was 100. What is A's gain and his basis in Yellowacre?

Amount not like kind = 15 → §1031(b) not like kind gain

Gain recognized = 15

Basis of new property = 60 - 15 + 15 = 60

3) Same facts, but A's basis is 90.

A/R = 85 + 15 = 100

Gain Realized = 100 - 90 = 10

Amount not like kind = 15

Gain Recognized = 10 → **§1031(b) can not be in excess of actual gain.**

Basis of new property = 90 - 15 + 10 = 85

Check → 10 + (85-85) = 10

Optional – A transfers Whiteacre to D, in exchange D transfers purpleacre to A and D assumes an existing mortgage on Whiteacre of 15. A's basis in Whiteacre was 60: the fmV of Whiteacre = 100. A's gain, what is A's basis in Purpleacre.

§1031(d) assuming liability is treated the same as giving cash

Same answer as problem 2

3. Involuntary Conversion

§1033 Involuntary Conversion

If involuntarily converted by destruction, theft, seizure, requisition, condemnation, or threat AND it is converted into similar property and NO GAIN IS RECOGNIZED. If it is converted into unsimilar property or money, then the gain is recognized.

- This applies if you believe that the government is about to take away property and you deal it, then you are not taxed if you use the cash to replace with similar property (if you keep tax then you are taxed).

(a)(2) If money is used to buy similar properties, the gain will be recognized to the extent realized upon conversion exceeds the cost.

Look in §1033 to see if both properties apply

Problems

B owns a parcel of undeveloped real estate in the suburbs. She leases the property to a parking lot operator. The state has decided that it needs this land for a new baseball stadium. Rather than use condemnation proceedings, she agrees to give the land to the state for \$600,000, her adjusted basis in the property was \$350,000. Eight months later she buys new property for \$525,000. What are the tax consequences if the property she buys is:

1) Stock and securities that will generate the same amount of money as the parking lot?

- treated as a sale, properties too different, gain recognized, §1033 does not apply.

2) Undeveloped property in the suburbs, homes to build a commercial building on this property?

- §1033 applies, like kind property §1033(g)

he does a problem here which I don't understand????? (in notes 10/9)

- so if it is a like kind of property, the \$75k that is left after she buys the new property is treated under §1031.

§1033(b)(2) Basis = cost of such property – decrease in the gain not recognized

→ $\$525,000 - (\$525,000 - \$350,000) = \$350,000$

4. Transactions Involving Residential Property

§121 Exclusion of Gain from sale of principal residence

Gross income will NOT include sale or exchange of property IF:

1) Taxpayer must own the property for 2 out of 5 years

2) Taxpayer must use the property for “principal residence” for 2 out of 5 years.

THEN no portion of the gain is included in income (up to the limits)

Limit = \$250,000 for single, \$500,000 for married people with joint return

(5 years which ends on the date of the sale)

Problems (p.111)

1) Husband and Wife purchase home in 1993 for \$350,000. It was their principal residence until 2002, when they purchased another home for \$250,000. In 2003, they sell their first home. The purchaser paid them \$500,000 in cash and assumed

a \$250,000 mortgage on the property. Husband and wife had an adjusted basis in the first home of \$400,000.

a) What are the tax consequences for the husband and wife on the sale of their first home?

$$GR = AR - AB = (\$500,000 + \$250,000) - (\$400,000) = \$350,000.$$

They are married so can exclude up to \$500,000, in this case can exclude the entire amount.

b) What if the first home was only owned by the wife? Can still exclude the entire amount, meet requirements.

What if it was owned by a single person? Can exclude the first \$250,000.

What if 2 unmarried people jointly owned it? Each can report their gain separately (half of \$250,000 for each)

Policy

Is this fair?

Government tries to encourage home ownership. Wants to encourage people to own property.

This is unfair to single people as married people can exclude more.

Real reasons behind this is that congress does not want to anger home owner or discourage moving.

IV. DEDUCTIONS AND CREDITS

A. BUSINESS EXPENSES

1. Overview and General Principles

- Allows certain business deductions (a form of government subsidy)

2 Big Problems with the Deductions:

1) Capital Expenditures – amount paid to acquire assets that will last for a significant amount of time.

- What is a Capital Expenditure and how to make sure the taxpayer is treated fairly over multiple years?

2) Quasi Personal Expenses - §262: No deductions for personal living or family expenses

- These are difficult questions, many expenses are in between both business and personal

§162 Trade or Business Expenses

- Allows Deductions for all “**necessary and ordinary business expenses**” from carrying out the business during the tax year

- Includes:

1) Salaries or Compensation for Business Services

2) Traveling Expenses in Pursuit of Business

3) Rentals and Payments to use property which is used for business

(m) For publicly held companies, NO deduction is applicable for employee (CEO) remuneration that exceeds \$1 million.

Exception- Commissions based on performance ARE deductible.

- i.e. 10 million bonus if profits increase 30%
- This would not apply to Julia Roberts \$20 million salary, because it only applies to CEO's

Welch v. Helvering (defines "ordinary and necessary")*****

Facts

Works for company that goes bankrupt (it's debts are thus discharged). Welch pays off those debts in order to get the companies clients (he was only an employee). He had no legal obligation to pay those debts. He wants to deduct those payments under §162.

Issue: are they ordinary and necessary?

Holding: The expense was necessary but NOT ordinary (most people would not pay for a debt they were not liable for)

Rule

- Necessary – Appropriate and Helpful (very low standard)
To see if the standard is met, the court looks to "life in all of it's fullness"
AND "if it was reasonable for a businessman"
- Ordinary – something encountered in the normal course of business
Would the reasonable business person when encountered with this situation make this expenditure?

Problems (Syllabus, p.231)

- Self employed lawyer, receives \$200,000 for compensation of all of her legal services. She pays \$20,000 for rent and her secretary's salary of \$40,000. Assume these expenses are ordinary what is her gross adjusted income for 2003?
 - She can deduct both the rent and salary (40k + 20k), so she can deduct \$60,000 from her income of \$200,000 = \$140,000

- 1) K is the sole shareholder of a company that operates 5 pharmacies in the suburbs. The company incurs the following expenses, are they O&N?
 - a) Pays \$150,000 to rent an office in the city because her son prefers to manage from the city.
 - Necessary, in other words helpful? Yes
 - Ordinary (Reasonable)? Yes, most people like convenience.
 - b) pays \$50,000 for her son to do janitor services he is supposed to provide for each pharmacy store, he is paid to work for 40 hours but only works for 10 each week. As a result, had to hire a additional janitor to finish the work.
 - §102 probably not deductible, the excess money would be seen as a gift.
 - If NOT providing valuable services it is NOT deductible.

a) \$150,000 in salary and bonuses to her daughter, a pharmacist. That amount includes a bonus of \$75,000. Other pharmacists averaged a bonus of \$75,000.

- bonus not deductible, not reasonable compared to other pharmacists.
(look to factors)

2. Reasonable Compensation

Harold's Club

Facts

Casino was owned by son's and run by their father. Father was promised \$10,000 a year plus 20% net profits. Total Compensation was \$400,000. The father actually ran the business and helped make it successful.

Holding: Taxpayer (the company, the employer, aka the sons) was only allowed to deduct a portion of the salary under §162.

- Reasoning – most compensation is negotiated at arm's length, this was not a normal relationship between and employee and employer

Rule

If there is a reason why the transaction between an employer and employee is not negotiated as much as is normal, it will be scrutinized.

Problems

Hypo

Is Julia robert's \$20 million per picture reasonable? Yes, she is worth it because that is what it is worth

What if she has to give back a portion of the salary if the movie bombs? If salary goes back to the employer, generally it will be scrutinized.

Factors that may warrant a higher level of compensation

- 1) May Bring in more money
- 2) Extra Duties and Responsibilities
- 3) Low Turnover because of the higher salary

V. THE DISTINCTION BETWEEN DEDUCTIBLE BUSINESS AND INVESTMENT EXPENSES AND NONDEDUCTIBLE CAPITOL

A. INTRODUCTION

B. DEFINING CAPITAL EXPENDITURES

§263 Capital Expenditures (generally no deductions for purchases of property)

- NO deduction for new buildings or permanent improvements to property
- Exceptions (mines, expenditures for farmers for fertilizers, etc., **look in statute for the rest**)

- If determined to be Capital under the tax code THEN:
 - 1) NO Deduction
 - 2) The Cost is added to the basis of the property
 - 3) At some point in the future, the business can deduct some of the cost in the future by:
 - a) Depreciation
 - b) Reduction in the Amount of Gain when Sold

- Example in notes (10/14)

Capital Expenditures ????????

Acquisition Cost – the cost of acquiring an asset that has value beyond the taxable year → NOT deductible.

Indopco (lessened by §263)

Facts

Target company of a possible takeover pays consultants \$2 million to see if the price offered was fair. If the purchasing company paid this, it would clearly be part of a capitol expenditure.

Issue: What happens to the company being acquired?

Holding: It is still a Capitol Expenditure even when there is no acquisition because the expenditure produced **long term benefits**. → **TEST**

- Their products would benefits from being part of the larger company, which would then produce benefits for the shareholders

Some confusion in what is meant by “long term benefits”, in the business world lots of long term benefits are produced by many things i.e. advertising, which is treated like a current expenditure even though it has long term benefits.

Problems

Hypos

- Pay \$100k for building → not deductible
 - what if your people \$5000 to find the building? Part of the purchase price, NOT deductible.
- buy building for \$100k, knew ahead of time would need to hire a manager to manager the property? NOT Capital expenditure, doesn't increase the value of the property, just a day to day function
- **if separate, then use §162 to evaluate the non K expense.**

C. ACQUISITION AND DISPOSITION OF ASSESTS

Capitalization – focuses on the timing of deductions, for expenditures that are unquestionably business related (i.e. clearest example is property)

D. REPAIR VS. IMPROVEMENTS

Reg. § 1.162.4 Repairs

- The cost of incidental repairs which neither materially add to the property nor appreciably extend but merely keep the property functioning efficiently ARE DEDUCTIBLE

- 1) Can't add to the value of the property (*if it does, then it is a capital expenditure and you add that cost to the basis*)
- 2) Can't prolong the life

Midland Empire Packing Company v. Commissioner

Facts

Meat packing company had oil seep into the basement from a nearby refinery. They packed cured hams, the oil would make them worthless. To stay in business, lined the walls with concrete.

Issue: Does this make the facility more valuable?

Holding: Not a capital expenditure, did not improve the facilities ability to salt hams. It was an ordinary and necessary business expense.

Rule

Test – Does it materially add value?

- did not improve structure for what it was designed to do (cure hams), thus it is repair.

- even though this significantly increased the value of the property it was ok because it only restored the property to its value before the oil spill.

Timeline starts when operating normally.

Morris Drive-In Theatre v. Commissioner

Facts

Drive in owner needed to add a drain to his property so the farm next to his property could continue to function.

Holding: Court said it was a obvious and foreseeable startup cost, thus it was a capitalization cost, and not deductible.

Repair vs. Improvement (factually dependant)

- 1) How much benefit?
- 2) Part of capital acquisition?
- 3) Add value or keep existing value?

Problems (p. 263)

Hypo

- Own tractor trailer, which needs fuel injection to run. Won't move without it, to replace it will cost \$500, cost of truck = \$50,000.

This is a repair. Returns it to its existing value

- **Does it “materially add value”?** Would an ordinary investor think it was important in making an investment.

1) J makes following expenditures to her restaurant, are they deductible or are they capitol expenditures:

a) \$10,000 to repaint exterior → deductible, O&N business expense. Does NOT materially increase the value of the property.

b) \$12,000 to fix extensive roof damage from a storm? Deductible, a repair.

c) \$30,000 to rewire electricity and plumbing and to remodel the interior at the same time the work was done for a) and b). Capital Expenditure, materially adds value. If many repairs done at once, they might all be seen as renovation and they all become capitol.

f) \$3,000 for insurance premium to cover for fire insurance. Deductible, doesn't add value beyond the end of the year.

g) \$2,000 for 2 years worth of cleaning supplies? Capitol Expenditure, it produces a value that extends materially beyond one year (2 years worth).

E. EXPENSES WITH RESPECT TO A NEW BUSINESS

Startup Costs – there are many expenses incurred that look like ordinary and necessary expenditures, but those expenses when aggregated together are treated as capitol

§195 Start-Up Expenditures

Except as otherwise provided, NO startup costs are deductible

However, can deduct over the 1st 5 years of operation if it falls within (c)(1)(a)(i-iii)

VI. RECOVERY OF CAPITOL EXPENSES

A. DEPRECIATION AND THE ACCELERATED COST RECOVERY SYSTEM

§195 Startup Expenditures

- Except as otherwise provided, NO DEDUCTION is allowed for start-up expenses.

(definition of startup in (c)(1)(A)(i-iii)

Generally – Capitalization is only half of the story, they can't deduct capitol costs, but to treat fairly allow deductions over a period of time

→ Depreciation

Depreciation – Deduction allowed over the period of time that represents the amount of capital used up in a given year.

Examples:

- 1) The cost of property over a short amount of time can be deducted immediately
- 2) TP purchases land and then builds something on it, buildings depreciated but **NOT allowed for land (can deduct when sold)**
- 3) Properties whose values tend to decline while in the use of business

Insert notes for graph and factors of depreciation

§167 Depreciation

- **Deduction ONLY allowed if it is included under the statute**

- Deduction **ALLOWED** for exhaustion, wear, and tear for:

- 1) Property used for *trade or business* **OR**
- 2) Property held for the production of income
(does this include personal property?)

§168 Accelerated Cost Recovery System

- 1) Applicable Depreciation Method (several)
- 2) Applicable Recovery Method
- 3) Applicable Convention = $\frac{1}{2}$ **year convention** (the same as in the handout)

(b) Applicable Depreciation Method

- Certain property is done by a straight line method (non-residential real, residential real, etc.)
- For property other than structures, use 200% declining balance method switching to straight line method when it is better to do so

(c) Useful Life

- Residential Rental = 27.5 years
 - Nonresidential = 39 years
 - **For things other than real property, their use life is classified in (e)**
- p. 332 in the case book has the recovery periods of other property
- This allows for accelerated deductions, thus can decrease income (???)

(k) There is a more generous property deduction for properties acquired between the years of 9/10/01 and 1/1/05.

Simon v. Commissioner

Facts

Violinist sought a deduction for her violin for wear and tear even though it had appreciated in value. She did not buy it as an investment, bought it for sound quality.

Rule

Does NOT matter that the property increase in value, can still deduct for depreciation for wear and tear.

Can NOT depreciate for works of art.

Factors to determine wear and tear (§168(e)):

- 1) Tangible Property
- 2) Used in Trade or Business
- 3) Salvage Value
- 4) Rate of Depreciation
- 5) Useful Life

Hypo:

Hanging a very old and valuable rug on the wall, deductible as a depreciation? If it is on the floor it is subject to wear and tear and is deductible, if it is on the wall it will be a work of art.

Policy

- Depreciation is the favorite deduction of corporations. Considered a way to encourage investments.

B. OTHER DEPRECIATION MATTERS

§179 Election to Expense Certain Depreciable Assets

- Taxpayers (notwithstanding capitol requirements) can deduct the cost of certain depreciable assets for:

- Tangible Property and Computers
- Targeted to the Manufacturing Sector
- Cost must be <\$25,000 (in 2005 it increases to \$100,000)

*******This is a express override of §263*******

§197 Amortization of Goodwill and Certain other Intangibles

(ex. Brandnames that make things more valuable)

- IF Self- Created, then NOT a capitol expenditure and the cost of creating the intangible asset is deductible

- BUT if the business **purchases** the intangible, it becomes a capital expenditure and can NOT depreciate (i.e. buying a trademark)

- purchased goodwill not deductible

Rule: Can deduct *Straight Line* Intangibles

(d) Examples of intangible p.204

C. LOSSES

- When the Taxpayer sells the asset for a loss

§165 Losses

4 Requirements to Deduct a Loss:

- 1) Loss Must be Realized
- 2) Loss Must be Recognized
- 3) *Must be expressly stated in the statute that it allows such a deduction*
- 4) *Can NOT be statutory provision that disallows deduction*
 - For 3) and 4) → **rule:** if the loss was incurred for trade or business or the purpose was to make a profit, you CAN deduct the loss.
 - If for personal use, loss NOT deductible.

§267

- if you have a loss when you sell capitol to FAMILY, there is NO Deduction.
(another rule, probably not important, that if that family member then sells it, no gain is recognized unless the gain is greater then the original capitol loss)

Problem (Syllabus)

Purchases classic Rolls for \$200,000. Sell it for only \$180,000.

- 1) Deduction is allowed if his intention was to sell it for profit.
- 2) If he uses it for transport, then not deductible because it was not his intention to sell for profit.

D. BAD DEBTS

- a debt which is owned to a taxpayer, is from his viewpoint a asset
- Being repaid a loan is not income, only getting back to where he was
- If taxpayer is not repaid, it becomes *bad debt*

§166 Bad Debt

2 types:

- 1) Business Bad Debt – done expecting economic return → Can Deduct in Full
- 2) Nonbusiness Bad Debt – in connection from taxpayer's trade of business → NO DEDUCTION, treated as capitol loss

Generes

Rule

Test: Look to the what the dominant motivation of the taxpayer was when the money was loaned to determine what kind of bad debt it is.

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

- Taxpayers always want to deduct personal expenses (duh!)

A. TRAVEL EXPENSES

§262 Personal, Living, and Family Expenses

- Except as otherwise provided, there are NO deductions for personal, living, or family expenses unless otherwise provided.

Rule: NO commuting expenses are deductible (EVER!!)

- doesn't apply to staying overnight for business, that is ok under the ordinary and necessary §162

To avoid being labeled as a traveling expense under §262, must show that you are "away from home". There are 4 factors to show this:

- 1) Did it require you to sleep outside of home
- 2) Duplicate expenses (i.e. housing costs 2x)
- 3) Incurred in the pursuit of business
- 4) Reasonable

Flowers

Guy lived in Jackson Miss. And had to commute to Mobile Ala. To work (I think he had homes in both places or something).

The court said that it was NOT in pursuit of business, because there is no business benefit derived from living in both places.

Look to 2 things:

Flower's Test: Must be in pursuit of business

Federal Test: Must be overnight

Problems (Syllabus)

- Marketing Executive lives in NYC. As part of job, she must hold conventions at her employers hotels. Employer pays for her traveling costs.

- 1) What happens to her airfare? §162 applies
- 2) What about the cost of the working suite at a fancy hotel? §132(d) working condition fringe benefit, excludeable.
- 3) \$100 a day for miscellaneous expenses? Also under &132 (d)

B. ENTERTAINMENT AND BUSINESS MEALS

Moss v. Commissioner

Facts

Most convenient time for lawyers to meet was during lunch at a restaurant.

Issue: Can they deduct this as a business expense?

Holding: NOT Deductible, look to §262. Meal provided no business purpose.

- There was no special need to eat together (i.e. taking clients out to dinner or a large meal to foster relationships).

Rule

Ask if the meal serve a purpose

Ask if there is any other way

Look to §162 to see if it is ordinary and necessary.

Even if it passes §162, it must ALSO pass §274

§274 Disallowance of certain entertainment, etc., expenses

(This does not allow deductions, it is a LIMITATION)

- To get to §274, must first pass §162, and then to deduct it cannot be under one of §274's limitations

(a) Activities that contain “entertainment, amusement, recreation”

IF, a expenditure is related to these, it is ONLY deductible **IF**:

- 1) TP establishes that the expenditure was *directly related* to the tax payer's trade or business
- 2) During entertainment period, some discussion must be business related to increase business (either *immediately* before or after entertainment)
- 3) Principal character was for business

(d) To substantiate (look to factors p. 248

(k) NO Deduction allowed for *food or beverages* **UNLESS**:

- 1) NOT lavish AND
- 2) The taxpayer or one of his Employees is present

(n) Only **50%** of meal and entertainment expenses are allowed as deductions (so at least half the cost will be a personal expense)

Problems (Syllabus)

- Exective of clothing firm spends \$400 to buy tickets to a popular play. Hopes to sell goods to a department store and will attend with a potential client. Is sarah's employer entitled to a deduction with respect to the tickets if the PURPOSE was:

- 1) To nurture good personal relationships with potential customers? NOT deductible, not “directly related” to the business §274
- 2) follow the day that sarah had just showed the new clothing line? I don't understand this one, just look to see if it falls under §274 exceptions to see if deductible

C. EDUCATION

Reg. §1.162- 5 Education

-Educational Expenses are deductible **IF**:

- 1) They maintain or improve skills in employment, trade, or business
AND
- 2) Meet requirement of employer as a condition of maintaining a job requirement

Then “presumably” deductible

-The expenses are **NOT** deductible IF:

- 1) Inseparable aggregate of personal and capital expenditures.
- 2) Only meet the minimum conditions to keep job
- 3) ?????

Problems (p. 411)

Hypos

- Girls studies engineering in college? Not deductible, only minimum education received.

- Law Students? Not deductible, same reason.

Not deductible if it qualifies for a new trade or business (i.e. paralegal studying to become a lawyer)

5,250 deductible IF employer pays money directly to education (rest is income) → §127

§25A (tax credits, are a subsidy have nothing to do with income)

2 Credits:

1) Hope Scholarship – allows federal government to pick up the first 2 years of community college cost. 100% of the first \$1,000 and 50% of the next \$1,000.

- this is dollar for dollar savings, the deduction is a reduction in income before taxes

2) Lifetime Learning Credit – Tax credit for the first \$10,000 on **“tuition and related expenses”**

- reduced if income > \$40,000

§222 Qualified Tuition and Related Expenses

- Allows for a TP deduction (not available if TP income >65k or married income >130k)

- Deduction allowed depends on the year (p.225)

§529

Interest on tuition related expenses is NOT taxable

- if withdrawn for tuition not taxable, if withdrawn for something else becomes taxable

HANDOUT

D. CHILDCARE EXPENSES

§21

- NOT limited by income, but there is more help for the poor

(b)(2)(c) **outside daycare** – only applies if it meets the requirements of the statute.

(c) NO deduction if it is paid to a dependant or a child of the taxpayer

- IS OK for other family members

- only eligible for kids **under 13**

- also covers **dependants and spouses** if they are **unable to take care of themselves**

Policy

Should they be deductible, choice between a nanny and a decrease in hours/income. Public sentiment thinks so, thinks it increases the lifestyle of kids.

HANDOUT

E. LEGAL EXPENSES

- most legal expenses are treated as ordinary and necessary

Gilmore

Rule – Can only deduct for legal expenses that *arise from a business origin* and **NOT** a personal original

F. CLOTHING

Pevsner v. Commissioner

Facts

Woman required to buy the clothing of her store (expensive boutique). She does not wear the clothes at home, only at work. In her “subjective” view they were not suitable for home use. Court used reasonable test.

Rule

Test (obj): What reasonable person would wear.

Clothing Test:

- 1) Type Specifically Required as a condition of employment.
- 2) Not adaptable for General Usage.
- 3) Not worn for General Usage.

Policy

Use objective test for Administrative purposes.

VIII. PERSONAL DEDUCTIONS

Policy

Vertical Equity – people of modest income really pay no tax, higher income people pay most of the tax burden

People of modest means avoid most tax liability through 2 deductions:

- 1) Personal Exemptions (\$3,050)
- 2) Standard Deduction
 - The combined effect exempts THE ENTIRE INCOME of people who's income is at or below the poverty level

Alternative to Standard Deduction: the tax code allows a deduction for *itemized deductions*

- *itemized deductions* used to achieve “horizontal equity” (so that 2 taxpayers of comparable resources should pay comparable taxes)

Taxpayer gets the choice between:

- 1) Standard Deduction
- 2) Itemized Deduction

A. PERSONAL DEDUCTIONS AND PERSONAL EXEMPTION

§151 Allowance of deductions for personal exemptions

(just says that you can deduct an exemption if allowed in another provision, and can increase that deduction for every spouse and dependant)

- Allowed for EVERY INDIVIDUAL (unless you income is too high, look to (d) on p. 138 to see if you qualify)
- TP can deduct for his spouse if it is not a joint return
- TP can deduct for dependants (look to requirements; p.137)

Dependant (§152) when you provide for more then ½ of support and they are *related*

- Married Joint Deduction = \$7950
- Unmarried = \$4,750
- Personal Exemption = \$3,050

§24

Allows a \$1,000 Tax Credit for Dependant child under 17.

Tax Income Rates on p. 1828 of the syllabus

Problem (Syllabus)

- D is a law student, P the parent claims that D is a dependant. Is P attempting to rip off the system?

In order to qualify as a Dependand under §151, you must be 1)over 24 and pay for ½ of their expenses. The allowable exemption would be \$3050.

IMPORTANT PROBLEM

-R and S are married to each other and have 2 dependant kids. Their combined gross income was \$20,150. What is their taxable income?

Taxable Income = AGI – (SD +Personal Exemptions)

[Note - 2 personal exemptions for each spouse and 2 for each dependant (their kids in this case)]

$$= 20,150 - \{7,950 + [(3,050 + 3,050) + (3,050 + 3,050)]\}$$
$$= 0$$

- What is the tax rate of a married family with 2 kids with a AGI of \$40,150?

$$TI = AGI - (SD+PE) = 40,150 - [7,590 + (3,050) \times (4)] = 20,000$$

$$\text{Tax Liability} = 10\% \text{ for first } 14,000 = 1,400$$

$$15\% \text{ for the remaining } 6,000 = 900$$

$$= 2,300$$

$$- (1000) \times (2) \rightarrow \$24$$

$$= 300$$

*******To Determine If you should Itemize*******

- Compute Taxable Income under §63

§63

(b) Taxable income when NOT Itemizing

Taxable Income = Adjusted Gross Income – (The Standard Deduction + Deduction for Personal Exemption <under§151>)

B. REDUCTION OF ITEMIZED DEDUCTION FOR HIGH INCOME TAXPAYERS

§68 Overall Limitations on Itemized Deductions

(FILL IN THE BLANKS)

C. THE EARNED INCOME TAX CREDIT

32 Earned Income

-Refundable credit – if credit > liability, then IRS will pay the different (negative income tax)

People who are eligible:

1) Person who has a qualifying child

- 2) Unmarried person between 25 and 65 with a modest income
so if you have one kid your credit is 34% ---→learn how to use this

Policy

Why? This is calculated with reference to the taxpayer's income, so in order to qualify you need a job (rewards those who work). Designed to reduce the tax burden on the working poor because poor people still pay taxes other than the income tax (i.e. social security) and this helps to alleviate that.

This is the only income provision that encourages people to lie claiming they have more income than they actually have to claim more tax credits. The earned income credit is eliminated as income increases.

Sections A-C of outline eliminate personal income taxes for ½ of the population.

D. PERSONAL ITEMIZED DEDUCTIONS

1. The Interest Deduction

§163 Interest

- Allows a deduction for interest that is “*paid or accrued*” on indebtedness
- Interest – the amount paid for the use of money

Requirements:

- 1) Must be a true loan
- 2) Is the payment made by the person REQUIRED to make it?
- 3) Has the interest been “paid or accrued”?
- 4) Any limitations which prevent Taxpayer from Deducting

(h) NO deduction for personal interest

(h)(1) Personal interest is **allowed** or corporations

(h)(2) 4 Things that are NOT personal interest (and are thus ok):

- 1) Interest that is indebtedness
- 2) Investment Interest
- 3) Passive Activity Interest
- 4) Qualified Residence Interest

- Qualified Residence Interest – Interest that is either “acquisition indebtedness” or “home equity indebtedness” with respect to “Qualified Residences”

- Qualified Residences – The principal residence of the Taxpayer OR another residence chosen by the taxpayer that is used as a residence (this includes vacation homes)

- Acquisition Indebtedness – Indebtedness that is acquired from “acquiring, constructing, or substantially improving”

- Home Equity Indebtedness – Indebtedness that is secured by a qualified residence can NOT exceed the equity in the property

MAX LIMIT – can't deduct more than the \$1 million of the value of the home.

§221 Interest on Education Loans

- Allows Deductions on education loan interest paid by taxpayer.
- Education Loan – indebtedness incurred by the taxpayer **solely to pay for qualified higher education**

-Must be:

- 1) On behalf of the taxpayer, his spouse, or a dependant AND
- 2) Paid or incurred within a reasonable time after the indebtedness is incurred AND
- 3) Which is attributable to education during a period where the recipient was an eligible student

Davison v. Commissioner

Facts

Corporation owed Hancock \$1.5 million in interest. Hancock was an insurance company which lent the money to the corporation.

Issue: Is the 1.5 million deductible?

Holding: No, there was no real payment, the loan was used to pay off the interest owed from an earlier loan.

- sidenote – if they had borrowed the money to pay off the interest from a 3rd party, then the interest would be deductible. Because the parties are not in the same economic position afterwards it is ok → **“Substance v. Form”** Doctrine

Rule

In situations where payment is made by parties, if person gets funds for the lender for the sold purpose of paying off interest then it is not deductible.

Problems (Syllabus; p.493)

Daughter lends \$30,000 to father at 90% interest (27,000). Is this deductible for the father?

- Not really interest, more like a gift or repayment of a loan.
 - If dealing with relations, check to see if the interest rate makes sense.
- 1) To what extent can K deduct the following payments?
 - a) \$3,000 interest on a bank loan use to pay operating expenses at his business. Deductible, it is interest that is indebtedness
 - b) \$500 interest on a loan to purchase a car and \$1000 in interest on credit cards used to make personal purchase. NOT deductible, were for personal purposes.
 - c) \$1,200 interest on a loan for kid’s tuition. Deductible, under the §221 exception.

HYPO FROM NOTES (HOME INTEREST PROBLEM)

Policy

Congress is concerned over:

- 1) Is it really interest?
- 2) Does all of the interest need to be deductible?
- 3) Whether or not it is “paid” or “accrued”?

Congress makes an exception to personal interest for the home so as not to lower the values of homes if interest was not deductible (allows the people to charge a higher rate because you can deduct the interest, makes owners and realtors happy when it is time to sell a house. Problem is that home equity puts your home at risk, and by making the interest deductible, at the same time you are making it more attractive and increasing the risk.

2. Taxes

- he didn't cover, I think you can deduct non federal income taxes, but not sure.

3. Casualty and Theft Losses

§165 Losses

- There is a deduction for ANY loss *not compensated for*.

- In the case of a business, the amount of the deduction is equal to the **basis**.

(c) Deductions for Individuals

- losses allowed if incurred in a “trade or business” or if for “profit” or even if it was not for trade or profit can still deduct for *fire, theft, shipwreck, or natural disaster*.

(h) Limitation on claims:

Only if the loss **exceeds 10% of AGI** and \$100

Problems (p.521)

Hypo

- Buy a property in 2002 for \$10,000. Deduct \$2,000 in 2002 for depreciation. It is stolen in 2003, basis was \$8,000. Taxpayer can deduct \$8,000.

4. Medical Expenses

-notes

5. Charitable Contributions

-notes

IX. LIMITATIONS ON DEDUCTIONS AND LOSSES