

TAX OUTLINE

I. INTRODUCTION

- Functions of the Tax System: Raise revenues, Allocate cost of goods and services through progressive pay system, tool of social policy (Sections 163, 121, 170), economic policy (168)
- Steps of the Taxation Process:
 - What items of income or gain are included in gross income?
 - What items of expenses are allowed as deductions?
 - When is an amount included in income and when is TP entitled to claim a deduction?
 - Who is the TP that is going to be taxed?
 - What is the character of the items of income/deductions?
- Definitions:
 - **Gross Income (61)**: All income from whatever source derived.
 - The form of compensation does not matter.
 - Services for services are calculated based on the FMV of the services.
 - Assignment of income does not allow TP to shift income received to someone else.
 - Consider whether TP is cash or accrual method.
 - Think about interest, dividends and other gains.
 - **Adjusted Gross Income (62)**: This is gross income minus deductions.
 - Deductions:
 - Above the line: Used to determine AGI – business expenses (listed in 62).
 - Below the line: Used after AGI is determined – other expenses. If this is greater than standard deduction, then itemize and don't take the standard deduction.
 - Note that whether or not the standard deduction is used, TP can still deduct trade/business expenses. So itemize trade/business expenses – this is AGI. Then itemize the other expenses or take the standard deduction. The end result is taxable income.
 - Definitions of itemized deductions (63).
 - **Deductions (161)**: These are narrowly construed.
 - Business Expenses (162)
 - Expenses for the production of income (212).
 - Personal expenses typically don't count (262).
 - Commuting, etc.
 - But some personal expenses are deductible (164) – real property taxes, state taxes paid.
 - Also student loans.
 - Capital Expenditures (263).

- Depreciation (**167/168**)
- Interest (**163**)
- Charitable Contributions (**170**).
 - Note that AGI must be computed to take this deduction.
- **Taxable Income:** This is the income after standard deductions or itemized deductions are taken from AGI.
 - Section **67** limits some deductions unless they exceed 2% of AGI. If not, no deduction. This does not apply to home mortgage interest, state income tax, real property tax, or charitable contributions.
 - Section **68**: If AGI exceeds a certain amount, then itemized deductions are reduced by 3% of the amount that AGI exceeds the certain amount.
 - This is applied after section 67.
 - Personal Exemptions: These may be reduced if AGI exceeds a certain amount.
 - These may be claimed whether or not TP itemizes (so in addition to standard deduction).
- Credit vs. Deduction: A credit reduces tax liability dollar for dollar and the deduction reduces the taxable income in relation to tax bracket.

II. GROSS INCOME

A. INTRODUCTION

- **Section 61:** This is a broad definition that is inclusive and elastic, but there are exceptions
 - Income is obviously included. Year-end bonuses are included.
 - Gifts are excluded
 - When property is compensation, it doesn't matter. If TP pays for property, to the extent the payer gets something that exceeds what they pay, there is no income if there is an arm's length transaction.
 - If ER to EE without ad in paper it is not arm's length and therefore taxable.
 - Note that **FMV** is the price at which property would change hands between a willing buyer and seller
- **Glenshaw Test for What is Income:**
 - (1) Undeniable accession to wealth, (2) that is clearly realized, and (3) the taxpayer has complete dominion over it.
 - This typically means that which adds to net worth is income.
 - This can be through payments of property or services.
 - This case involved punitive damages.

Also

- **Cesarini: The clearly Realized requirement:** Treasure Trove is income.
 - **Realization:** This is when the increase or decrease in value is realized. Typically the benefit of the bargain does not result in income until realized, but the treasure trove here was income because of the Glenshaw test.

- There must be an express exemption to exclude something from GI.
- **Old Colony Trust:** Payment of another's debt is income (such as when ER pays taxes of EE as opposed to withholding EE's taxes for payment to IRS).

B. FORM OF RECEIPT

- If Services are paid for other than in money, the FMV of the property/services taken in payment must be included in GI.
 - If there is a stipulated price, it will be presumed to be FMV in absence of E to the contrary.
- Trip Expenses paid by a company-employer as a reward to an employee for meeting certain levels of performance (*services rendered*) is a form of compensation that falls under gross income – look at FMV. **McCann**.

C. TAX FREE FRINGE BENEFITS

1. Introduction

- GI includes Fringe Benefits as economic benefits conferred on EE as form of compensation in whatever form or mode under Section **61**.
- However there are exceptions to this rule (**119, 132**).
- **ANALYSIS**: Start with 61. Then look for exceptions to see if fringe benefit puts the additional income into GI of TP.

2. Meals and Lodging

- **Section 119** may provide an exception for meals/lodging provided to EE.
- **Requirements:**
 - (1) Is the meal/lodging provided for the convenience of ER?
 - So EE can be called for emergencies, not enough time for EE to eat short meal or get a meal nearby in reasonable time, to promote good will or attract prospective EE.
 - (2) Is the meal/lodging on the business premise?
 - If not, then the meal/lodging is GI.
 - (3) Is the lodging accepted as a condition of employment?
 - It is excluded if the employee is required to be available for duty at all times – it is not necessary to show that duties are impossible to perform without lodging. *So if presence is necessary for employment and duty is continuous.* **Benglia**.
 - (4) Is the meal/lodging provided by or on behalf of ER?
 - (5) Is the meal/lodging provided to EE, spouse, or dependents?
- If EE has to pay for the meal but does not have to accept it, then the cost can be excluded from GI. But it is if the payment is taken regardless if EE accepts the meal and it is for the convenience of ER.
- See notes regarding the regulation.

3. Work Related Fringe Benefits

- **Section 132**: Provides 7 fringe benefits that are excluded from GI

- (1) **No-Additional Cost Service**
 - This is a service provided by Er to an ee for use by ee, if:
 - (1) Service is offered for sale to customers in the ordinary course of business in which ee is providing services, and
 - **Line of Business:** Note that EE of airline biz of ER may not exclude the value of free hotel rooms provided by hotel biz of same ER. ***POLICY:*** This favors small biz. However, if EE provides substantial services to both (e.g., accountant), then the fringe benefit may come from both.
 - (2) Er incurs no substantial additional cost (including forgone revenue) in providing the service to ee without regard to what ee pays.
 - **Discrimination** under (j)(1) applies here.
 - *If this benefit is not allowed because of substantial cost, a portion may be excluded under qualified EE discount.*
 - Note that this does not apply to property – only services.
 - ***Policy:*** This allows ER to give a valuable tax-free benefit to EE who is paid low wages.
 - ***Examples:***
 - Flying standby is OK.
 - But airline EE reserving seat is income but the foregone revenue is calculated in the cost of what is substantial.
 - But if FMV of ticket was 1000 and EE paid 800, it would be OK because under qualified EE discount the service would be discounted by 20% and not greater. Anything over this is included in GI.
- (2) **Qualified EE discount**
 - **Definition:** Qualified property/services are property/services offered for sale to customers in the ordinary course of line of business of ER in which EE is performing services.
 - *Property does not include real property or personal property held for investment.*
 - **Amount Excluded:** Any EE discount for qualified property/services if discount does not exceed
 - (A) *for property*, gross profit percentage of the price at which it is offered by Er to customer, or
 - If Er is not making a profit off of ee then it's ok, but if they are taking a loss then it counts as income. If the discount is greater, then it counts as income to ee
 - Gross % is sales to customer over price to ER divided by sales price (1M – 600K = 400K or 40%).
GPP= aggregate profit of company/aggregate sales price

- EE bought clothes at 100 – cost to ER is 150. Retail is 200. So EE has 50 of GI.
 - (B) *for services*, 20% of the price
 - **Note: Anything over these amounts is included in GI.**
 - **Policy:** This stimulates the sales of the company because EE buys it, and increases sales to general public because of EE education.
 - Discrimination under (j)(1) applies here.
- (3) **Working Condition Fringe**
 - Any property/service provided to EE of ER is EE paid for such property or services and would be a deduction under **162** or **167**.
 - Must be connected to job performance such that if EE paid for them, they would be deductible under 162/167.
 - Cash payments do not count, unless EE must use for pre-arranged activity that qualifies.
- (4) **De Minimis Fringe**
 - Property or service that has so small a value that taking into account the value is impracticable.
 - If it is normally used for business-related purposes, but is sometimes used for personal use, then it most likely falls under de minimis
 - Meals/meal money/transportation is included as de minimis fringe if it is *reasonable* and satisfies (1) occasional and not routine, (2) provided because overtime work necessitates, and (3) in the case of a meal, the money is provided to work overtime. **Reg. 1.132-6(d)(2)**.
 - Also, if transportation is provided for security and because of unusual circumstances, then the excess of 1.50 is excludable. This is based on facts and circumstances.
 - You cannot aggregate a yearly allowance based on what would be otherwise permissible under this rule. Instead, the determination is made based on each occurrence.
 - **Policy:** Administrative convenience.
- (5) **Qualified Transportation Fringe**
 - This applies to commuter vehicle if between residence and employment (only \$100/mo), transit pass (only \$100/mo), or qualified parking (only \$175/mo.)
 - Cash reimbursements are OK (in the case of transit pass, only if voucher is not available for direct distribution).
 - No Constructive Receipt because EE can choose between fringe and compensation.
 - **Qualified parking** must be at or near the biz. premises of ER or on or near where EE commutes to work on commuter vehicle.
- **Employee includes:** former employee by ER in line of business that no longer works because of disability or retirement. This also includes the widow or widower of EE who died while employed.

- **Spouse and Dependent Children:** These two are treated as use of EE. Latter means dependent of EE or if both parents are dead and the child is not 25. Also any use of air transportation by parent of EE is treated as use by EE.
 - This does not include domestic partners – only spouses.
- Note that on-premises athletic facilities are OK if only allowed to be used by EE, spouse, and dependents.
- **No discrimination for No-Additional Cost or Qualified EE discount:** If ER only gives the benefit to highly compensated EE, then the discount is included in GI. The benefit must be given to each EE on substantially the same terms.
 - ER can discriminate with the other kind of fringe benefits.
- **Consequence if not under 132:** If the fringe benefit is not excludable then it is in GI at the amount of the FMV of the benefit.
- **Business Trips (Gotcher):** Look at the primary purpose of the trip. If for business and if primarily for the benefit of the ER then it should not be included. Incidental personal benefit is OK. However, the spouses expenses should be included if the primary benefit to her was pleasure.

4. Other Statutory Fringe Benefits

- This involves limited amount of life insurance, health insurance, contributions to retirement plans.
- **Health Insurance:**
 - **General Rule: 106a** – GI does not include ER-provided health insurance.
 - So ER health care plans as part of compensation package are not included in GI.
 - **For Sickness/Personal Injury:**
 - **Generally: 104a3:** If TP receives payment from accident/injury insurance are not included in GI.
 - **Limitation – If ER provides it:** However, under **105a** – if EE receives amounts through accident/health insurance *for personal injuries/sickness* (like disability insurance), then it is included in GI if:
 - The contributions by ER were not included in GI of EE,
OR
 - Paid by ER directly
 - *So if ER pays the amount directly or pays the premiums, then all amounts received are included in GI. But under 104a3, if TP pays, then it is not included in GI.*
 - **For Medical Care 105b** – The inclusion under 105a does not include payments to TP or to doctors from ER as reimbursement for medical care under 213. So this is an exception to 105a – medical care is not in GI as opposed to personal injury/sickness.
 - **213(d)(1) Medical Care:** This includes (A) diagnosis, cure, mitigation, treatment, prevention of disease, or for the purpose of affecting any structure/function of the body, (B) transportation

primarily for and essential to medical care, (C) qualified long-term care, (D) insurance for A-B or C premiums.

- Note – **213(d)(9) Cosmetic Surgery**: Medical care does not cover Cosmetic Surgery unless it is necessary to ameliorate a deformity arising from congenital abnormality, personal injury resulting from accident/trauma, or disfiguring disease. Cosmetic Surgery is that which is aimed at improving appearance and does not promote function of body or prevent illness disease.
- **Limited to actual medical care expenses incurred**: Note that amounts paid to TP for subsequent use are include in GI – it must be reimbursement or for the actual payment relating to medical care.
 - 104a2 allows exclusion of that which is over this amount when not from ER.
 - If there is a dual plan (ER coverage and Self Coverage) then apply 105a, b, and 104a3 in proportion to the coverage.

Summary: *Under 106, the default is that Er coverage for accident/health plan is not included in gross income. However, under 105, if payments under the plan are used for personal injury or sickness (not medical care) then the amount is included in gross income if it was not in ee gross income and contributed by Er or is paid by Er. However, this is not included in gross income if the Er pays the ee or hospital for reimbursement for actual medical care incurred.*

Note that 105b and c are exceptions to 105a

- **For Payments Unrelated to Absence From Work**: Under **105c**, GI does not include payment if the payment is for (1) permanent loss or loss of member/function of body, permanent disfigurement of TP, spouse, or dependent AND (2) references nature of loss without regard to days missed.
- **ANALYSIS**: Start with 105b. If ER paid for this it's OK if for medical expenses. But if not, look to 105a, and if ER paid for this, then it is included in GI.
- **POLICY**: 105a prevents a tax benefit to TP and treats the ER payment as compensation. The reason is that non-medical care payments that fall under ER insurance allow excessive use by TP and may be abused by EE. In this case, the compensation is disguised and TP really earns more money without being taxed. The solution to this is health savings accounts.

Life Insurance – Section 79: The amount of group life insurance is included in GI if the cost exceeds 50K and any amount paid by EE.

FIND OUT IF YOU CAN DEDUCT HEALTH INSURANCE PREMIUMS AS NORMAL TP.

Deductions and Medical Expenses: If you have previously deducted medical expenses, you can exclude any amount that is attributable to this. But reimbursements for non-deductible medical expenses are excluded from GI.

Lawsuit Awards: Parties allocations are respected as to medical expenses and non-medical aspects unless unreasonable. If no allocation, then presumption exists that it

is attributable to medical expenses first. Future awards may be excluded from income, but the TP may not deduct again when they are incurred in the future.

Workers Compensation – 104a1: This is excluded from income.

Military Disability Pensions: This includes combat related injuries, disability comp under VA, and injuries suffered in terrorist attacks upon EE of US engaged in performance of official duties outside US.

D. GIFTS, INHERITANCES, AND SCHOLARSHIPS.

1. Gift or Compensation

- **General Rule – Section 102(a):** GI does not include the value of property acquired by gift, bequest, devise, or inheritance.
 - **Exception 102(b):** Income that results from the gift is included in GI.
 - 102(b)(1): Incomes that result from the property is included in GI. So interest of money in bank after a transfer is income. Also the appreciation of stock after transfer once it is realized.
 - 102(b)(2): Life estate holder has income and remainder has gift (a trust is set up to incrementally distribute the trust to donee after donor's death and then after donee's death, the remaining amount in trust goes to his kids).
 - **Employee Gifts 102(c):** Transfers from ER to EE or for benefit of EE, it is not a gift and therefore not excludable from GI
 - *For benefit of EE*, this applies to someone EE knows (child, etc.) or paying expenses of EE.
 - **De Minimis Fringe - 132:** This may allow EE to exclude the gift from GI if it is of low value. This can also allow ER to deduct to gift.
 - **Deduction of Gifts – 274(b):** ER cannot deduct under 162 or 212 for gift expenses for gifts during the tax year that, in aggregate, exceed \$25. *Note that this does not allow EE to exclude the amount – it allows ER to deduct the amount.*
 - This does not include something that costs TP \$4 or less on which name of TP is on, and which is one of number of identical items to TP OR sign or promotional material to be used by recipient on business premises.
 - **What is a Gift? - Duberstein:** Look at the intent of the donor – it must be transferred with detached and disinterested generosity. The facts/circumstances (mainsprings of human conduct) must reveal this intent (affection, respect, admiration, charity, etc.).
 - Unlike fringe benefits, a *case-by-case analysis* is used.
 - The further the gift is from the family context, the harder it is to justify as a gift.
 - If something is given out of appreciation for past services, it may be a gift.
- Examples:**
- Tokes to casino dealers and not gifts but income: This is motivated by the hope of winning, not detached generosity. **Olk.**
 - There is regularity, equally divided between EE, etc.

- Donations to Minister that are Structured: Even though there was no policy, Donors did not deduct, etc., the gift was made by the congregation as whole – not individuals – in a structured fashion. This also enabled the church to keep the talented minister.
 - So for both: Regular, sizable payments to whom TP performs services are typically not regarded as gifts.
 - **Policy**: This respects the family unit and does not treat a transfer from one individual to another, but recognizes that the wealth remains in the family. It would also be hard to enforce if otherwise on the administrative level.
- ANALYSIS**: See who gave gift – if ER probably not. If non-ER, apply Duberstein.

2. Treatment of Inherited Property

- This is narrower, but the Duberstein analysis still applies.
 - It excludes a proper devise as well as the settlement of disputes.
 - However, if a devise is for services performed by the devisee to the devisor, then it will not be a gift. **Wolder**.

3. Scholarships

- **General Rule – 117(a)**: GI does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at a qualified institution.
- Is it a Scholarship?
 - **Qualified Scholarship 117(b)**: Amount received, if individual establishes that the amount was used for qualified tuition and related expenses
 - **Qualified Tuition and Related Expenses**: Tuition and fees required for enrollment/attendance AND fees, books, supplies, and equipment *required* for courses or instruction.
 - ***This does not include meals/lodging.***
- **Limitations – 117c**: The exclusion does not apply if the payment is for teaching, research, or other services by student that is required as condition of receiving the scholarship (unless it is a special type of scholarship).

High School Performance and Athletic performance may be valid grounds for scholarship if no strings are attached to the scholarship.

 - If an athletic scholarship is given and it is not revocable due to injury or the decision not to play, then it is excludable to the extent it does not exceed qualified tuition expenses. **Rev. Rul. 77-263**. So as long as the scholarship does not go to past, present, or future employment or services it may be excluded.
- **Qualified Tuition Reduction – 117d**: Despite the limitation in 117c, an EE of educational institution may get a reduction in the tuition at that institution for courses ***below the graduate level***. This may not discriminate to highly compensated EE.
 - Also, graduate students may get this reduction if engaged in teaching/research and the below the graduate level limitation does not apply.
 - This includes family members

- Note that stipends and remissions together are two separate awards. The former is income in the event that qualified expenses are 0.
- **Gifts:** If the scholarship does not qualify it is not a gift under 102. Although a tuition payment from grandmother to son could be a gift.
- **Educational Assistance Programs (127):** If ER pays for EE education, then the amount is not included in GI.
 - **Definition:** This includes payment of expenses for tuition, fees, books, supplies and similar payments or courses of instruction. This does not include tools/supplies that may be retained after completion, meals, lodging, or transportation. It does not include courses involving sports, games, or hobbies.
 - EE may not claim a deduction/credit for any amount that is excluded from income.
 - **Scope:** This does not have to be job related or part of degree program.
 - **Limitation:** *This only applies up to the first 5,250 paid by ER.*
- **Miscellaneous:**
 - Educational costs that qualify as trade/business expenses may be deductible.

E. GAINS DERIVED FROM DEALINGS IN PROPERTY

1. Introduction to the Realization and Replacement of Capital Purchases

- **Section 61a3** includes gains derived from dealings in property in GI.

DEFINITIONS

- **Gain/Loss (1001a):** - *AMOUNT REALIZED – ADJUSTED BASIS*

Definitions

- **Gain:** From sale or other disposition of property is the excess of the amount realized over the adjusted basis (1011).
- **Loss:** Excess of the adjusted Basis over the amount realized.
Holding something is not a realization.
- **Amount Realized (1001b):** *MONEY RECEIVED*
 - From sale or other disposition of property, sum of the money received plus FMV of the property other than money received.
 - Realization Requirement:
 - Mere appreciation is not taxed. It must be realized through sale or disposition.
 - **POLICY:** Administrative convenience and it would be unfair to tax without realization because TP may not have the money. But this stifles the sale of property.
 - **Examples:**
 - **Exchanges of Interest:** If the exchange is materially different (legally distinct), then the exchange results in realization. Cottage Savings.
- **Recognition of Gain/Loss (1001c):**

- Except otherwise provided, the entire amount of the gain/loss on the sale or exchange shall be **recognized**.
 - There are many exceptions to this. Realization is technical and recognition is different in that that which is realized may or may not be subject to tax.
- **Adjusted Basis for Determining Gain/Loss (1011):**
 - This is the basis (1012) as adjusted under 1016.
 - **1016** – Basis is adjusted for expenditures, receipts, losses, depreciation, capitalization, etc.
 - **Example:** Adding a garage to a house increases the value of the house by the amount of the room. If the garage is destroyed and the insurance proceeds are not applied, then the basis is reduced by that amount. So if TP owns a house, takes out a loan for 50K and applies 40K to improvements, the basis of the house increases by 40K.
 - **Purpose – Recovery of Capital:** This allows TP to recover investment without paying tax on it. This prevents double taxation.
 - **Bargain Sale to Charitable Organization:** If deduction is allowed under 170 from the sale, the adjusted basis is the portion of the adjusted basis that bears the same ratio to the adjusted basis as the amount realized bears to the FMV of the property.
- **Basis of Property – Cost (1012):** This is the cost of the property.
 - This does not include real property taxes under 164.
 - Note that borrowed money does not affect the basis of the property. This doesn't matter if the loan is secured or not (recourse vs. non-recourse).
 - This is beneficial with respect to depreciable assets.

2. Basis of Property

- **Tax Cost Basis – Property in lieu of Compensation:** If TP receives property instead of compensation, then the basis in the property is not 0, but the FMV of the property. This amount is reported as income and should be the basis. This is the **tax cost basis**. This is practical when TP sells the property and doesn't get screwed just because he didn't use cash income to pay for the property.
- **Assuming Liability and Impact on Amount Realized:**
 - Liabilities that are assumed by the purchaser are included in the amount realized of seller. (If A sells to B, and B assumes the existing mortgage).
- **Basis of Property Acquired in Taxable Exchange:**
 - **General Rule:** the basis of property received in a taxable exchange is the FMV of the property *received* in the exchange
 - After you exchange, you calculate the adjusted basis of the property given in relation to the FMV of the property received (*this is like the amount realized*) to determine a gain/loss. **Philly Park Amusement**.
 - **POLICY:** If it were otherwise, there would be double taxation if the FMV of the property received is more than the FMV of the property given. It

also prevents an untaxed stepped-up basis if the FMV of the property received was more than property given.

- Note that arm's length transactions create a presumption that the FMV of the two properties are equal.
- **Example:**
 - (1) A has X worth 100K with basis of 75K. B has Y worth 100K with basis of 40K. They trade. A has a gain of 25K and B has a gain of 60K. This is just from the exchange. Upon disposition look at the FMV as the basis and calculate the gain based on the amount realized.
 - (2) Same, but A then sells Y after the exchange for 120K. Because the basis is 100K now and the 25K has already been included in GI, the sale results in 20K gain.

3. Basis of Appreciated Property Acquired by Gift (Transferred Basis Rule)

- This is a modification to the normal basis rules under 1012 and 1011.
- While gifts under 102 are not included in GI, subsequent transactions involving the gift are included in GI.
- **General Rule: 1015a:** A valid gift results in the transfer of the donor's basis to the donee.
 - **Donor Basis:** This is the basis of the donor or the last preceding owner by whom it was not acquired by gift (like in the case of heirlooms).
 - **Exception:** If the basis is more than the FMV at the time of the sale, then the basis is the FMV of the property – donee can't take the loss.
 - Note that if the basis cannot be determined because of lack of information pertaining to last owner who did not acquire it by gift, then the basis is approximated to the FMV of the last donor ascertainable.
- **POLICY:** If this was not the case, the basis would be 0 and the entire gain would be taxed if disposed of by donee after the transfer. So this prevents realization of income that would be more than that realized by the family keeping in line with the policy of gifts. This also prevents over-taxation (no tax on the appreciation in the hands of the donor). Any loss upon donee's disposition is not allowed to be realized if FMV exceeds basis.
 - This allows TP in higher bracket to shift gain to someone in a lower bracket and the property will not be taxed as high. But it does not allow for the shift of losses (giving someone in a higher bracket a loss so they can claim a larger deduction).
- **ANALYSIS:** If there a gift under 102. If so, then there is no realization upon the transfer. Does the donee sell or dispose of the property? If yes, under 1015, look at the basis in the hands of the donor and the amount of the sale. Is it a gain – if so, the amount realized over the acquired basis. Is it a loss – too bad.
- **Example:**
 - **Gain:** F pays 4K for stock and gives it to S while worth 10K. S does not realize any gain. S sells stock for 18K. Because S took basis of 4K, the gain is 14K.

- **Loss:** F pays 4K and gives it to S at 2K. S sells it. There is no loss realized because the basis exceeds FMV and the basis is thus determined to be 2K.
- **Note on Gift Tax 1015d1:** The basis of the gift is increased by any gift tax paid on the property. (1) If acquired after 9/2/58, the basis is increased by amount paid but not more than FMV at time of gift. (2) If acquired before 9/2/58 and is not sold before the date, the basis is increased on this date by tax paid, but it shall not exceed the amount equal to FMV over the basis of the donor at the time of the gift.

4. Property Acquired from Decedent -- Stepped-Up Basis

- A devise is not taxable under 102 when devisee takes it.
- **General Rule: 1014a1:** The devisee's basis in the property acquired from decedent or to whom the property passed from the decedent is the FMV of the property at the date of the decedent's death.
 - *Unlike 1015*, the appreciation while in the hands of the decedent disappears upon devise and is not subject to tax when the devisee disposes of it. Only the appreciation while in the hands of the devisee is taken into account when determining gain/loss.
 - Any loss (basis exceeds FMV) will be negated. So devisee cannot claim a loss.
 - **1014b1:** This includes property that is acquired from bequest, devise, inheritance, or from estate.
- **Preventing Abuse from gift to devise – 1014e:**
 - **Rule:** If a donor or the donor's spouse gifts the property one year before someone dies, and that decedent devises the property to the donor, the basis of the property upon devise to the donor is the adjusted basis of the property immediately before the decedent's death.
 - **Note:** this applies only to the donor or the donor's spouse and only applies to appreciated property (if FMV exceeds adjusted basis the day it was transferred to decedent).
 - It also applies if the donor is entitled to the proceeds of the sales from decedent's estate/trust.
 - **Example:** A has something with basis of 100K and worth 1M. Gifts to B. B has a basis of 100K under 1015a (takes the donor's basis). B dies 6 months later and devises it to A. If the rule was not in place, then A would have a basis of 1M and circumvent 900K in appreciated gain. Instead the rule says that the basis is 100K under 1014a1 (FMV).

F. TREATMENT OF THE OWNER OF ANNUITY AND LIFE INSURANCE CONTRACTS

1. Life Insurance

- **General Rule: 101a:** Life insurance proceeds that are paid out because of the death of the insured are not included in GI.

Types of Insurance:

Whole and ordinary are basically the same

- **Term life insurance:** Pay a premium of \$900 and beneficiary receives \$500K if you die during the term. If you survive until the end of the term you get nothing. This is like a bet.
 - Mortality gains are tax free (amount of policy minus amount of premium).
- **Whole life insurance:** An extreme example is single premium life insurance. You pay \$225,000 and don't have to pay anything else. If you die, then the recipient gets 500,000. Instead of forfeiting everything at the end of the year, after the end of the year, you could surrender the contract and receive 225,000 back plus the investment return minus 900/year. ??
- **Ordinary Life:** Pay premiums every year at higher level than term for what could be same policy amount. But the excess is put in savings – this increases the amount of the policy.

Examples of 101a exclusion:

- Beneficiary gets the amount of the policy tax free if it is paid because of the insured's death.
- So this would not include life insurance taken out by seller on the buyer of property on an installment basis – this would be paid out because of unpaid debt.
- However certain provisions allow for the exclusion of accelerated death benefit paid out or assigned to a third person before death in the case of terminally ill or chronically ill people.
- The insured does not have to be the owner of the policy. The owner can be the recipient of the policy and 101 would apply.

Surrendering the Policy under 72e:

- With ordinary insurance, if you surrender you are taxed on the proceeds that exceed the payment of premiums.
 - So if you paid 9K and get 10K after you surrender, you are taxed on 1K even though 4K may have been actuarial cost and 5K may have been savings paid into the insurance.
 - This is better than term because you would only get the one time payment and if you had saved in a bank account what would have otherwise been saved in an ordinary life insurance plan, that amount is taxed.

Payout to Beneficiary:

- 101 applies to lump sums and installments. For the latter, any interest that accrues after the insured's death is taxed (but not the policy amount).
- The payout has no bearing on how much premiums are paid into the policy.

Transfer for Value: 101a2:

- The exclusion from GI if A transfer the policy to B is the amount of valuable consideration paid for the transfer in addition to any premiums or subsequent amounts (interests paid on indebtedness) paid from A to B.
 - This does not apply if the transfer is to the insured or a related partner. It does not apply if the contract of transfer has a mechanism to gauge the gain/loss of the transfer.

- This applies to arm's length and family transfers.
- **Deductibility?:** Note that insurance policies are non-deductible under 262 unless ER pays it as form of compensation to EE – then ER can deduct it.

2. Individual Retirement Accounts

Mechanics:

- **General Rule: 219a:** You can deduct qualified retirement contributions.
 - **Max Amount of Deduction: 219b:** The deduction cannot exceed the lesser of 3K or the amount equal to compensation includible in GI for the year.
- **POLICY:** This encouraged retirement.

Types of IRAs

- **Non-deductible:**
 - IRA payment is taxed before it is put in.
 - Under this account the interest is not taxed, unlike a bank account. Rather it is only taxed when taken out.
 - There is no income limitation here, so people with loot can use this.
 - **Rules:** 3K cap, Limit increases for 50 and older, no contribution after 70.5, contributions are not deductible but there is a tax-deferral, 10% penalty
- **Roth:**
 - This is taxed before investment. But here, the interest is tax-exempt and not just tax-deferred.
 - Rules: 3K cap, limit increases if over 50, based on AGI and phased out, nondeductible, but qualified distributions (5 year holding period taken out after 59.5, dies, or disabled; also for qualified first-time homebuyer expenses) are completely tax free, can contribute after 70.5
- **Deductible:**
 - Amounts are deductible from GI.
 - Everything withdrawn is subject to tax, but in an IRA as opposed to a bank account, the tax is deferred because the IRA is deductible.
 - The distributions are included in GI (72).
 - **Rules: 219:** Up to 3K/yr. This is phased out if TP makes too much or has certain pension plans. No deductions after 70½ yr. old, but amount that can be contributed is increased by 500 after age 50. 10% penalty on early distributions (before 59½ or retiring after 55).
- **Roth or Deductible?:** In a **Roth**, if your tax rate is lower now then it will be in the future, you are better off putting the money here. You lock in the lower rate. In a **Deductible**, if your tax rate is higher now not then it is better here.
- **Penalties and Qualified Distributions 72:**
 - There is a 10% tax if you take out money from the plan (72t1) unless the distribution is made after you are 59.5 (72t2Ai), or part of a series of substantially equal periodic payments (no less than annually) for the life of EE or joint lives of EE and beneficiary (72t2Aiv)

- **Higher Education Expenses:** Distribution from plan to person for qualified higher education expenses are not penalized 10% as long as the distribution does not exceed the cost of the education expenses.
- **First Home Purchase:** Distributions to this are not taxed 10%.

3. Annuities

- Series of payments over time at regular intervals over more than a year as long as the time period or total payment is determinable on the date payments are deemed to begin. (X buys annuity for 10K to receive 1K payments each yr. for 25 yrs.).
- **Section 72a-b2:** GI includes these payments.
 - **Exclusion Ratio is the tax consequence:** GI does not include this (the amount of investment/expected return).
 - So 10K investment over 25 payments = 40%. This portion is not taxed and the rest is (60%).
 - In the case that the payments are open-ended (for rest of life) then look at the actuarial expected return. If TP outlives this, then the payments are fully taxable. If TP dies before that time, then the unrecovered investment is deductible (take exclusion ratio and multiple it by how many years of expected were paid; then subtract this from the investment to determine what the deduction is).
- You pay premiums before the payments start. The interest that accrues is not taxed. But if you withdraw before the payments start, then it is included in GI and assessed a 10% penalty (**72e1-3; q1**).

G. TRANSACTIONS INVOLVING INDEBTEDNESS

1. Loans: Legal and Illegal

- A loan is an obligation to repay – it is not included in GI.
- **General Rule:** Debts are not included in GI under 61 – there is no accession to wealth because there is an obligation to repay. The repayment of a loan does not reduce income – it is not deductible.
 - **Repayment by Third Party:** This is income to debtor. **Old Colony Trust.**
 - **Exception:** If it is a gift under 102.
- **Illegal Income:**
 - The general rule is that this is taxed. Embezzlement and extortion are taxed as well even though there may be obligation to repay. However, the repayment of illegal income entitles person to deduction since it is previously taxed (even if the promise to repay occurs in the same year it was embezzled).
 - What sucks is that after tax, the chances of V getting money back are low.
 - **Rule:** There must be a consensual recognition, expressed or implied that there is an obligation to repay for something to be characterized a loan and not included in GI. **James.**
 - **Exception to GI:** if TP intended to pay it back, had reasonable certainty to pay it back, believed that the illegal withdraw would

have been otherwise approved and made prompt assignment of assets to secure the amount owed.

- Basically, there must be an intent and an obligation to repay.
- **Deposits:** Deposits as a security for damages or to ensure performance are not includible in GI as long as there is an unconditional obligation to pay. **Power & Light Comp.**
 - **Analysis:** Look at the rights/obligations of the parties with respect to the amount paid/transferred.
 - **Factors:** Lack of complete dominion over money, lender can get back at any time without commitment, no guarantee that TP could keep the \$ – this shows that something is a loan. Fact that interest accrues and that it is not in an escrow is not big deal.)
 - Note: Advanced payments are income (rent paid in advance) and included in GI the year it was received, a loan is not.

2. Cancellation of Indebtedness

- **General Rule: 61a12:** Discharge for indebtedness is includes in income.
 - **Freeing of Assets Theory:** While a loan is not income, TP has accession to wealth if the loan is canceled and therefore has income (after discharge there are fewer liabilities to offset assets).
 - The repayment of a corporate debt at less than it's face is income.
- Here there is a debt and the creditor reduces it, and it is not a gift.
- **Timing:** The income is determined at the time TP is enriched – not a the time the loan/debt was taken.
- **Exceptions: 108:**
 - **Status of TP:** GI does not include discharges that occur in bankruptcy or when TP is insolvent. The amount excluded is applied to reduce the tax attributes (basis).
 - **Qualified real property business indebtedness:** This is debt that is incurred/assumed by TP in connection with real property used in a trade/business and secured by this property. In this case, the discharge will reduce the basis of depreciable property that TP has. This also includes debt that was incurred/assumed to acquire, construct, reconstruct, or substantially improve such property. But the amount excluded from GI shall not exceed the excess of outstanding principle over the FMV reduced by the principle.
 - **Loan secured by land – Deed in lieu of foreclosure:** If this is the case, and TP deeds some of the land over to the creditor and also receives cancellation of indebtedness, any debt reduction as a result of the transfer is separate and is not excluded from income. 1001, 63a3. The amount realized through the deed includes the liabilities that are knocked off. **Gehl.**
 - **Gifts:** Remember that gifts may include discharges of indebtedness and are therefore not included in income under 102.

See Example
on P. 164

- **Settlement:** If there is a disputed debt and the amount is settled for a different amount, the difference is not income (it is unenforceable).
- **ANALYSIS:** You must determine whether the discharge is income (either compensation, discharge, etc.) or if it is an excludable discharge. Look at the nature of the discharge/payment. Then look at the status of D and who cancelled the debt. Is it a purchase price adjustment?
 - **Characterization: Compensation vs. discharge:** TP is insolvent and paid 10K for service. This is income. TP is insolvent and performs service to creditor and creditor erases 10K of debt. This is income and 108 does not apply. If the FMV of the service is 10K – income; if 2K, then 8K is discharge and it is not in GI if TP is insolvent.
 - If the discharge of debt is a medium of payment then 61 applies – not 108.
 - Also, an amount owed by TP (buyer) to seller that is forgiven by seller in return for a release of contract (or counterclaim) is not income from discharge of indebtedness. Rather it is payment for lost profits and not a discharge of debt.

Definitions **108d1-3:**

- **Indebtedness of TP:** debt for which TP is liable or indebtedness subject to which TP hold property.
- **Insolvent:** Excess of liabilities over the FMV of assets. This is determined immediately before the discharge.
 - Note that the amount excluded in this case is limited to that amount that TP is insolvent. So the cancelled debt over insolvency is included in GI.
 - Also TP must show by preponderance of the E that he will more probably than not be called on to pay obligation.

Purchase Price Adjustment – **108e5**

- If the seller reduces the debt owed by purchaser that arose out of the purchase of a particular property, then the reduction is not income, but a purchase price adjustment (retroactive reduction in the purchase price).
 - The reduction must not occur because of bankruptcy or insolvency and the amount would otherwise have qualified as income.
 - *This is a rebate.* It could also occur because of a product defect.
 - **Effect on basis:** The purchase price adjustment reduces the basis by that amount. TP has no gain/loss when sold at the adjusted basis here.
 - **Limitation:** If there is a third party involved (A financed from B to buy from C and B reduces the amount owed to B) then this provision does not work.

Student Loans – **108f**

- **General Rule:** If the discharge of a student loan was pursuant to a loan provision that would allow for the discharge if the student worked for a certain amount of time in a certain profession for any of a broad class of ERs, then the debt is excluded from GI.

Effect on Basis – 1017a; 108b1; 108b2E - When there is an exception to income then the basis is reduced.

- **Timing:** If an amount is excluded from income under 108a and involves the reduction as applied to basis for qualified real property (108c1) or 108b5 (depreciable property) then the reduction of basis in property shall apply the following year.
 - **Depreciable Property Election:** Under **180b5**: TP may elect to apply any portion of the reduction to basis of depreciable property. But this amount shall not exceed the aggregate adjusted bases of the depreciable property held by TP at the beginning of the year following the deduction.
 - *So a reduction in basis of depreciable property is OK as long as the reduction does not exceed the total bases of all depreciable property that next year.*
 - **Effect:** This reduces the depreciation deductions allowed.
 - **The good and the bad:** Reduction is good because TP does not have income, but it is bad because the basis is reduced (this increases the gain realized and decreases the loss that is allowed).
- POLICY:** This protects people to get out of tough situations and is not harsh. This gives the opportunity to succeed. The inability to pay the tax would undercut the bankruptcy policy if it demanded tax payment.

H. TREATMENT OF DAMAGE RECOVERIES

1. Damages to Property or to Business Interests

- **Test to determine whether the damage award counts as Income:** In lieu of what were the damages awarded. **Raytheon**.
 - **Lost Profits:** Damages for lost profits are taxable.
 - Example: Lost rental cost because someone damage the car that you rent. This award is taxable.
 - **Property damage:** Tax is measured against the basis of the property to determine gain/loss.
 - Barn worth 100K, basis is 20K. Someone burns it down. You get 100K, 80K of which is taxable.
 - **Loss of Good Will:** This is like the purchase of the product under 1012 and is not taxed. However, anything in excess of this (amount realized over adjusted basis) is subject to tax.
 - Same barn but worth 100K and basis is 100K. You get 100K, not taxable income because no gain realized.
- **POLICY:** The substitute for what would otherwise be taxable, should be taxed.

2. Damages for Personal Injuries

- **General Rule: 104a2:** GI does not include any damages received (by suit or settlement), as lump or periodic payment on account of personal injury or sickness.
 - *This involves tort rights.*
 - This does not include punitive damages
 - **Lost Wages:** Under 104a2, lost wages, unlike in property damage in Raytheon, are not taxes.

- **Emotional Distress:** Look at the *origin of the claim*, if emotional distress arises from physical injury/illness, then it may be excluded from GI (loss of husband due to injury, depression because of bed-ridden sickness). If not, no exclusion (depression because of employment discrimination).
- There must be a physical injury.
- **Settlements:** In a settlement, you want the agreement to specify damages and have as much as you can put in the non-taxable allocations. This can be reviewed for abuse.
- Deductions for atty. fees is subject to 2% floor or alternative minimum tax.
- **POLICY:** Congressional compassion for those that suffer physical injury or illness – make the victim whole. Also there is no accession of wealth to TP.
 - TP is encouraged to structure the payout to exclude interest payment of periodic payment.
- **See also: “Other Statutory Fringe Benefits” – 104-105.**

ANALYSIS FOR DAMAGES: To what was the damage caused? If it is property, then apply Raytheon. If it is for personal injury or sickness then apply 104a2.

I. TAX-EXEMPT INTEREST

- Interest on state and local bonds is excludable under 103(a) because of federalism issues.
- Whether or not to invest in these hinges on the tax bracket and the rate of return in other taxable investments. It depends whether the after-tax return of the taxable investment exceeds the return of the tax-exempt investment. So those in a higher bracket have more of an incentive to get the tax-exempt bonds.
- Impact of Provision:
 - In the example of a taxable bond, the interest rate is 10%. If principle amount of bond were 10K, each year you would make 1000. Assume tax is 35%. Result is 350 tax on interest. After tax profit is 650.
 - If you were to invest in a state bond you would want more than 6.5% interest (to offset the taxes lost in other investment vehicles)
 - If the state bond was 7.5%, this is a better choice because you would make 750 (as opposed to 650). The interest is less but the after-tax profit is more (as long as the interest rate is over 6.5%).
- **POLICY:** This benefits the states because the interest rate is lower and it costs less to borrow. It’s cheaper for the states.

J. SOCIAL SECURITY PROCEEDS

Section 86

Gross income may include a portion of SS benefits. If you work through the provision:

- If <25K (32K) then SS benefits are not included.
- If >55K then up to 85% will be taxed

The value of medicare benefits is never tax

III. PROPERTY TRANSACTIONS: REALIZATION, RECOGNITION, ETC.

A. Introduction

- **General Principle:** Before there is a gain, there must be a **realization** (under 1001) and a **recognition**.
 - **Realization:** Sale or other disposition of property.
 - **Cottage Savings and Hair-Trigger Realization:** Any change in rights/obligations under assets may cause realization.
 - Something legally distinct is materially different and thus even upon an exchanged there is a realization.
 - This is a matter of timing.
 - **Recognition:** The gain/loss has been realized and will be taxed currently.

B. Realization When Property Transferred as Compensation

Section 61 requires that property given as compensation be included in GI.

*This involves the **timing** when the property will be included in GI.*

- **General Rule 83a:** If property is given to someone then the FMV of the property over the amount (if any) paid for the property is included in GI.
 - **Qualification – Vesting Requirement:** The property must be transferable and not subject to substantial risk of forfeiture before the property is included in income. *So the property may not have strings attached.*
 - **Substantial Risk of Forfeiture:** Rights to full enjoyment are conditioned upon future performance of substantial services.
 - **Transferability of Property:** Rights in the property are not subject to a substantial risk of forfeiture.
 - **Exception:** The amount is included in GI, if TP sells/disposes the property in an arm's length transaction before it is transferable or not subject to substantial risk of forfeiture.
- **Election Notwithstanding General Rule 83b:** TP may elect to include the property in GI despite strings that are attached (FMV over amount paid). This must be made within 30 days.
 - **Impact:** If this is done, TP cannot claim a deduction if the property is forfeited.
 - **Rationale:** This is good for TP if the property is going to appreciate substantially before TP would otherwise realize it.
 - So can realize then gain now and then take the hit on appreciation later at a lower rate (long-term capital gain).
 - Also if TP dies then the gain is stepped-up and the devisee will take the adjusted basis at the time of TP's death.
- **ER Deduction 83h:** ER can deduct the same amount of GI that the person who performed the services included in GI (162). This is allowed when the property is includable in the GI of the person who performed the services.
- **Basis 1.83-4(b):** If section 83 property is acquired by someone while it is non-vested, the basis reflects any amount paid for the property AND any amount

includible in the person's GI who performed the services through the performance or the disposition of the property.

- However, if the property is acquired by arm's length, the basis is determined under 1012.
- **ANALYSIS:**
 - Four Questions Apply:
 - (1) Does section 83 apply? Property for services.
 - (2) If so, who has income? Person performing services or if TP transfers the property to someone else.
 - (3) When does TP have income? When it vests or if an election is made.
 - (4) How much income? The FMV minus any price paid for it.

C. Example

- **NOTES:**
 - Transfer to third party creditor of TP who performs services (to pay of school loans) is the same as if it were transferred to TP. It doesn't matter where the property goes.
 - The amount in GI is offset by any amount paid by TP to get the property.

D. Non-recognition

- **Purpose:** Exception to 1001 gain in cases when the gain is not significant enough to include in GI.
- **FOR THESE RECOGNITION IS DEFERRED – EXCEPTION INVOLVES RESIDENCES (121)**

1. Property Settlements in the Context of a Marital Dissolution

- **General Rule 1041:** No gain/loss is recognized on transfer of property from TP to spouse or former spouse **IF** the transfer is incident to divorce.
 - If incident to divorce, then the transfer is treated as a gift (**102**) to spouse and the basis of the spouse is the adjusted basis of the transferor (**1012**).
 - If not incident to divorce, then it is a normal gain/loss.
 - **Incident to divorce:** The transfer occurs within one year of the divorce OR is related to the end of the marriage (for the latter the trigger is the end of the marriage – kids get something when they are 18, etc.).
- **Example:** W has barn with basis of 100K. Six months after divorce sells it to H for 150K (FMV). H takes a 100K basis. W does not recognize gain from sale.
 - **Tax Consequence:** Allow there is no gain recognized here, the recipient must pay for the appreciation that occurs after the transfer in the event of sale or disposition.
 - Even though there is a sale here, 1 year puts in under 1041.
- **Limits:** Does not apply to transfer of services. Transferor is also held for the interest that has accrued on tax-deferred bonds if transferred.
- **Third Parties:** 1041 applies to *qualifying* transfers to third parties when (1) the transfer is required to be made to the 3rd party by divorce instrument or (2) made pursuant to written request of non-transferring spouse.

- This is treated as (1) a 1041 transfer from the transferring spouse to non-transferring and followed by (2) a non-1041 transfer from the receiving spouse to the third party.

POLICY: 1041 makes sure that inter-spousal or incident to divorce transfers does not result in a gain/loss recognition. It also treats the two as an economic unit.

2. Like-Kind Exchanges

- ***Purpose:*** *A change in ownership is a realization under Cottage Savings – typically this is recognized as a gain/loss. But 1031 prevents the recognition of the realization as a gain/loss if certain requirements are met. The recognition is deferred. Start with 1001.*
- **General Rule: 1031a:** No gain or loss is recognized on the exchange of property held for productive use in a trade/business or for investment if the property is exchanged solely for property of like kind which is to be held either for productive use in trade/business/investment.
 - **Exceptions: 1031b:** stock in trade or other property held primarily for sale, stocks/bonds, other securities/indebtedness/interest, etc.
 - **If not Solely in Like Kind 1031c:** This is the case when the exchange includes money and other non-like property. The gain to the recipient shall be recognized, but no more than the amount of the money or the FMV of the other non-like property.
 - **Basis: 1031d:**
 - Basis in New Property = Basis in old property – (money received + gain/loss that was recognized on the exchange).
- **Requirements:**
 - (1): **Held and to be Held:** Applies only to property that was held for certain purposes (trade, business, investment) and will be held for certain purposes
 - **Holding Requirement:** There must be an intent to hold it for that purpose (prearranged charitable contributions, etc. don't count).
 - This requirement is imputed to the particular TP and the use of the other TP is irrelevant. A's rental house for B's personal house could still work for A – just not B.
 - This does not include personal use.
 - For related persons, there is a 2 year time limit for which the property may be held.
 - (2) **Properties must be like-kind.**
 - **Real Estate:** broad definition. It doesn't matter if you are trading unimproved for improved or office for farmland, etc. So 30-year leasehold for real estate is ok too. This also includes trading mineral rights, baseball contracts, gold bars for gold coins, etc.
 - **Non-Real Property: Depreciable Tangible Property:** Here there are different classes of property and deal with depreciation (trucks for trucks, cars for cars, baseball contracts, etc.). Both properties must be in the same **General Asset Class** or **Product Class** (codes

are given out for this). Some must be in the same kind or product class. Not US currency for foreign currency.

- If personal property that is non-depreciable is the case or is intangible (like copyrights – stocks are not covered here), then they must be like kind – look at the facts/circumstances – not a formal as tangible property.
- (3) Solely of Like Kind: To have complete non-recognition, it must be solely an exchange of like-kind problems. This is modified under (b)
 - **Boot** is non-like kind property that A gives to B to even out the trade. The *giver* of boot is not affected, but the *recipient* has a gain not covered by 1031.
 - This includes liabilities assumed – if someone assumes a mortgage, the other person recognizes a gain as if it was cash.
 - Gain/Loss of non-like kind property is treated under 1001 (realized over basis). If A trade non-like kind and the FMV is less than the basis, then A can realize the loss and vice versa for the gain.

ANALYSIS:

- Gain Realized (1001 – amt. realized over adjusted basis)?
- Like Kind?
- Amount Received that is not like kind?
- Amount of gain recognized?
 - Lesser of either the total gain realized or (amount of cash plus gain of non-like property).
- Basis: The basis is computed by a formula (Basis in new property = Basis in old property - amount of cash received + amount of gain *recognized*).
- Then see if you've messed up (Gain Realized – Gain recognized = Gain preserved):
 - **Gain preserved**: how much gain would TP realize and recognize if TP sold the newly acquired property for FMV.
- **Example**: Suppose A has 60 basis in lot with 100 FMV. Trades with B. A trades B for another lot. The gain that *would be* realized is 40. But 1031 prevents recognition of anything. This gives A the gain preserved of 40. So gain realized (40) – gain recognized (0) = 40. This equals and makes sense.
 - The gain not recognized will be later upon sale or disposition of the exchanged property. So the gain is not forgiven, it is deferred.
- **Example when Exchange is with Cash (Boot)**: A exchanges 60 basis property, FMV 100 for property + \$15.
 - Assume that FMV (*of received*) is 85 (because 15 paid in addition for property traded that had FMV of 100). The \$15 results in gain realized of 40 ($85+15=100 - 60 = 40$).
 - Since \$15 is not like kind that is the amount **recognized**.
 - Basis: $60 - (15, \textit{received} + 15, \textit{realized}) = 60$.
 - Gain Preserved: $40 + 15 = 25$. The property received is worth 85 so upon sale, the gain realized/recognized is 25 ($85 \text{ FMV} - 60 \text{ basis} = 25$).

- **Example when non-like exceeds gain realized:** Basis of 90, FMV of 100 gets \$15 and property.
 - Gain realized = 10 (100, amount realized over 90, basis). This shows that property received is 85 (85 + 15 = 100, equal cost of that traded).
 - Gain recognized = 10. Because the amount of gain recognized is the lesser of the gain realized or the amount of non-like kind property, the gain recognized is 10. The gain was less than the 15 received.
 - Basis (90 – 15 + 10 = 85).
 - Gain preserved: 10 – 10 = 0.
- In the above examples, if other non-like property had been given instead of cash, under 1031, the basis is allocated between the properties. The amount received from the non-like property is the amount equivalent to the FMV of the property at the date of the exchange.
- **Liabilities:** Note that assuming a debt is considered money received under 1031d. If both have existing mortgages, the net liability constitutes money received.
 - Rules: (1) Cash received always counts as “money received”, AND (2) net liability relief, reduced by any cash paid, also constitutes money received (the person receiving the net liability may reduce the amount received by any money paid to equalize the exchange).
- Two Party Buyer: If A sells to B who is financed by C and C sells A the same product that B bought from A – this is an exchange if the transaction is complementary or mutually dependent – this prevents abuse. But if the sales are not, and are independent (A did not know about C’s involvement with B), then it is a sale. **Bell Lines.**

POLICY: Promotes efficient allocation of resources; hard to compute the gain on the administrative level when dealing with exchanges. No justification of taxation here because it is considered as a continuation in investment.

3. Involuntary Conversions

General Rule 1033a

- **(1) Converted Property and Similar Property Received:** No gain is recognized if property (as a result of its destruction in whole or in part, theft, seizure, condemnation or threat/imminence thereof) is compulsorily/involuntarily converted then TP gets new property that is similar/related in service or use.
 - In this case **1031** applies (mandatory). This is rare.
 - So no gain will be recognized if it is solely like-kind for like-kind and if TP gets money, it gets complicated. Also the basis issues apply
- **(2) The Election: Converted Property and Money/Un-similar Property Received:** But if TP gets money or non-similar property, then gain **is** recognized. **But TP can make an election with the \$ for converted property as to whether 1033 applies to what TP receives after the property is converted with the money.**
 - **Limitation on Gain:** If TP uses money to buy similar property (*qualified replacement property*) or stock in control in company that owns similar property, TP recognizes gain if the amount received exceeds the cost of

the replacement property (*gain is recognized to the extent that money received exceeds the expenditure for the replacement of property*)

- Example: If 50K money for replacement that cost 40K and the basis in the old is 10K then 10K is gain
- Note that if the basis of the old exceeds the cost of the replacement, then the gain is offset. 50K money for replacement. 45K basis in old. 40K cost of new. Then 5K or 10K is gain.
- *This limits the gain that TP would otherwise recognized from the conversion money.*
- **Time limit:** From the date of conversion or earliest date of threat (whichever is earlier) until either 2 years after the close of that year when the gain is realized. This ensures continuity of investment.
- **Purchase:**
 - Note that property bought before the disposition of the converted property will not be deemed to be replacement unless it is held at the point the converted property is disposed.
 - Also the basis must be the cost under 1012, not anything like 1015 (gift), etc.
- **Basis:**
 - **A1 Conversions: If property is acquired 1033b1:** The basis of the converted property – money received not expended for similar property + amount of gain/loss that TP recognizes.
 - **Example:** A owns 600K FMV, Basis 350K. Upon conversion she gets new property for 525K and 100K cash.
 - Basis: $350K (\text{old basis}) - 100K(\text{money}) + 25K (100K \text{ gain} - 75K\text{loss}) = 275K.$
 - This makes sense because the gain for original sale would have been 250K (600-350). Now the gain of $525 - 275 = 250.$
 - **If money is acquired and used for similar property 1033b2:** Basis = cost of replacement – gain not recognized
 - **Example:** A owns 600K FMV, Basis 350K. Upon conversion she gets 600K and buys new property for 525K.
 - **Gain** realized is 250K (1001). Because 75K money not put toward 525K, 75K of 250K was recognized and 175K was not recognized.
 - **Basis:** Not recognized is 175. So $525-175 = 350$ (Basis).
 - If replacement cost is more than the cost of the converted then the basis will still be the cost of the new and the amount not recognized.

ANALYSIS:

- (1) When only a portion of the property is destroyed/condemned. In this case can TP sell the entire property?
 - **Test:** If what is sold is part of an economic unit with property that is condemned or destroyed then 1033 will apply.

- Example: Building when one out of six floors is damaged, then 1033 could apply.
- (2) Is the conversion involuntary?
 - This applies when G condemns or when there is a threat of condemnation.
 - **Factual question:** *Whether there is a bona fide possibility of condemnation*
 - A conversion that is attributable to the threat of condemnation from contamination is eligible. The conversion for public use includes that which promotes public health and safety (must distinguish between sale as condemnation and sale as destruction here).
- (3) Is the replacement property similar in service or use to the original property?
 - **Test:** Compare the similarities of services or uses of the original and replacement properties to the TP. This results in a difference between TP-owner (look at physical service) and TP-investor (look at TP-lessor's relationship to land).
 - **Factors for Investor:** extent and type of management activity, amount/kind of services rendered by tenants, nature of business risks.
 - The property does not have to be identical. If someone is a landlord and has commercial tenants and then switch to residential – it's OK. **Liant Record, Inc.** But an autoshop to a grocery store if TP was proprietor would not be OK.
 - What does not qualify: unimproved for improved real estate, proceeds applied to reduction of indebtedness, tug for barges.

Involuntary Conversion Events: it does not have to be sudden

Difference between 1031 and 1033:

- Under 1033, the replacement property must be substantially similar, but under 1031, at least for real property, it just has to be similar.

POLICY

- Recognition could create severe hardship. The policy is that the replacement of what was involuntarily condemned could be frustrated if the gain was recognized. This avoids forced recognition.

4. Transactions Involving Residential Property

- **General Rule: 121:** GI does not include gain from the sale/exchange of property that has been owned and used by TP as principle residence for 2 aggregate years out of 5.
 - Because there are no special basis rules, the gain will never be taxed.
 - At the time of sale the residence does not have to be the principle residence. The use does not have to be continuous. Short periods of absence (vacations) count as use.
- **Requirements:**
 - **Threshold:** Must own/use for 2 or 5 years.

- **Amounts:** If single, only 250K may be excluded. If joint 500K is excluded.
 - **Special Rules for Joint:** (1) either spouse may meet the ownership requirements, (2) both must meet the joint use, (3) neither has used it in the last 2 years.
 - Note that the use requirement can be running before the couple is married if they are living together.
 - If the couple has 2 residences and the special rules aren't met, if they meet the requirements for individual return for the house respectively then they can each reduce gain by 250K.
 - If the rules are not met, then 250K limit applies to the couple.
 - This can only be taken advantage of once every two years.
- **Exception for not Meeting the Requirements:** In the case of a sale/exchange because of a change in employment, health or unforeseen circumstances (in regulations) and TP does not meet the requirements, the dollar limitation is applied to a ratio that equals the shorter of (1) aggregate period of use/ownership over 5 years or (2) period after most recent sale. In relation to 2 years.
- **Other Rules**
 - **Widow/Widower:** The period of use/ownership by TP includes dead spouse's use/ownership if dead on date of sale.
 - **Joint Returns:** Get the benefits if either spouse meets the ownership/use requirements (but to get 500K must meet the special rules).
 - **Property Owned by Spouse Former Spouse:** If there is a **1041** transfer then the transferee takes the transferor's period of use/ownership. Also if TP cannot live there because of a divorce decree, he can be deemed to have used the house while he can't live there during the time the spouse does.
 - **Involuntary Conversions:** Conversion is treated as a sale. Apply 1033 to find the amount realized. Then apply 121 to reduce the gain. Also the ownership/use of the former property carries over to the replacement if the basis of the new was calculated under 1033.
 - **Out-of-residence Care:** If physically/mentally incapable of caring for yourself, and have owned/used for 1 out of 5 years, then the time during 5 years at nursing facility count toward use/ownership requirements.
 - **Depreciation:** Exclusion does not apply to the gain realized on the sale if TP claimed depreciation deduction under 1250 after 5.6.97.
- Factors for principle residence: location of residence to business, time spent there, involvement in community. Time factor is given the greatest weight. Also surrounding land may be including as used as the principle residence if not used for anything else.

IV. DEDUCTIONS AND CREDITS

- **Requirements for deductions** (1) The loss must be realized, (2) the loss must be recognized, (3) the loss must be allowed (there must be a statutory provision that allows TP to deduct a certain amount, and (4) the loss must not be disallowed.
- Note: Under **262**, personal deductions are typically not allowed.

A. Business Expenses:

1. Overview and General Principles

- **General Principle:** Deductions allow TP to take into account business expenditures and provide an economic benefit to TP. Factual determination.
 - **Rule:**
 - **Section 162 – Business Expenses:** Deductions are allowed – this does not include personal deductions or capital expenditures.
 - (1) **Ordinary and necessary expenses - Welch**
 - Necessary: This is appropriate and helpful and goes to sensible business practice.
 - Ordinary: Something that is normally done – reasonableness standard – customary and in the line of business.
 - **Considerations:** Look at any relationship between the parties (Dad/CEO paying son/VP big bonus when other VPs don't get it) – relationships are scrutinized more, any contract provisions, etc. Look at the normal practices in other industries to see the ordinary requirement and whether it is appropriate and helpful.
 - (2) **Paid/Incurred in that tax year**
 - (3) **Carrying on**
 - Expenses incurred in an effort to create a new trade/business do not count. The expenses must be related to the same trade/business. This relates to seeking employment.
 - (4) **Any trade/business**
 - Where TP engages in activity regularly, continuously with the objective of making a profit, then it is a trade or business. Groetzinger.
 - The primary purpose must be to make profit. This is fact dependent.
 - Investor is not; trader is.
 - **Examples:** rents, wages, supplies, etc.
 - **Section 212 – Profit Seeking:** This allows for non-business deductions if not deductible under 162.
 - (1) Ordinary/Necessary
 - (2) For the production/collection of income, management, maintenance of property held for the production of income of in connection with the collection/refund of tax.

- This applies to the production of income that already exists, not the search for a new interest.
 - **Examples:** secretarial assistance, advisors, etc.
- **Mechanics:** Take gross income under 61 and subtract the deductions to arrive at adjusted gross income. 62. There must be an express provision to take a deduction. 162, 212.
 - **Result:** This reduces the income that is subject to tax.
- **162 deductions:** This includes, reasonable allowances for salaries, traveling expenses including meals/lodging that are not extravagant while away from home in pursuit of trade/business (cannot exceed 1 year), and rentals that are required for continued possession when TP needs it for business and does not have the title.
 - If against public policy, it is not deductible (bribes, kickbacks, etc.). Lobbying expenditures are excluded unless on the local level.
 - **Clothing:** This is deductible if ee is required to wear a distinctive type of uniform.

2. Reasonable Compensation

- **Salaries:** Publicly held companies cannot deduct salaries paid to the four highest officers that exceed 1M. **162m. Harold's Club.**

3. Employee Business Expenses

- TP may have two businesses – this is OK. *But one may be offset by 183 (hobby loss depending on if it is an actual trade/business).*
- Deductions are determined on the basis if EE is carrying on in an existing trade/business. There must be sufficient continuity between the old job and the new one in the case of seeking employment in the same trade/business. If so, then it is deductible.

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

A. Introduction

- These produce benefits over an extended period of time. These are distinct from capital gains and capital assets.
- **Rule re Capital Expenditures: Section 263:** There is no deduction allowed for expenses paid out for new buildings or for permanent improvements made to increase the value of property. No deduction is allowed for amount paid in restoring property.
 - This does not include incidental repairs and maintenance – but only applies to that which adds value or substantially prolongs the useful life of the building or adapts the property to a new/different use.
 - This is a qualification of **162.**
- **Purpose/Policy:** Matches the current expenditures with future benefits. This also prevents sheltering taxable income for a year if TP could deduct the entire expense when the amount is paid.

- **Basis:** The basis of property increases if the capital expenditure is an improvement. **1016**. In the case of a purchase, then the basis is calculated under 1012.

B. Defining Capital Expenditures

- If something has long-term, significant benefits that extend substantially beyond the end of the tax year, then it is a capital expenditure.
 - This includes tangible and intangible assets.
- **Examples:** Payment of atty. fees incurred in a friendly takeover (for both selling and buying parties); paying two years of rent at the beginning of one year, prepaid insurance (majority rule). **INDOPCO**
 - **Maintenance**, costs incurred because of heavy maintenance are deductible as ordinary and necessary. However, costs incurred in conjunction with a heavy maintenance must be capitalized to the extent they materially add to the value of substantially prolong the useful life of, or adapt the airframe to a new or different use. Any costs to rehabilitate, modernize, or improve must be capitalized as well.
 - **Advertising** costs are not capital expenditures.

C. Acquisition and Disposition of Assets

- Acquisition Costs are capital expenditures (buildings, machines, copyrights, patents, etc.).
- **Analysis:** look at the origin of the claim to determine if the cost of litigation is a capital expense – it is if you bring a claim to acquire something. Look to see whether the fees are attributable to the acquisition, a combination, or the management. You may split this among acquisition and management if it is that ambiguous. **Woodward**.
 - If something is part of acquisition costs, like fees, wages, etc., then the cost may be a capital expenditure. If the fee is paid in relation to the acquisition of property then it is a capital expense.
 - **Section 263A:** The costs are directly related to the cost of real or tangible personal property and the indirect costs must be capitalized. Note that inventory in the hands of TP is inventory costs.
- **Examples:** defending/perfecting title, commission fees to real estate agent;

D. Repair vs. Improvements – Reg. 1.162-4 (facts and circumstances)

- **Repair** – these are deductible:
 - Expenditure that does NOT materially add value
 - Does not appreciably prolong the useful life
 - Note that environmental cleanups and employee training are treated as repairs.
- **Improvement** – these are capital expenditures:
 - Materially add value and prolongs the useful life of
 - Something that stands by itself – like an oven in a restaurant – and is replaced is a capital expenditure.

- This increases the basis.
- Notes: you cannot convert a capital expenditure into a repair by breaking it up into small components. **Mt. Morris Drive-In** (repair should have been capitalized because it was really part of the acquisition).
- To be deductible, repairs should not change the property, increase the capacity, but should retain the same use and result in the same life span. The repair should keep it in the ordinary operating condition and may be deducted. **Midland Empire Packing**.

E. Expenses with Respect to a New Business

- **General Rule: 195:** No deductions are allowed for start up expenditures.
 - **Election:** TP may elect to defer the expenses and deduct over a 60 month period starting the month that the business begins. If the business closes before then, then the remainder can be deducted under 165.
 - **Requirements:** (1) Expense must be paid in connection with creating, investigating, the creation of business *entered into by TP*. (2) Must be allowable as deduction for taxable year in which is it paid/incurred in connection with expansion of existing business in same field as that TP entered in.
 - So if TP has an existing business, startup expenses regarding the expansive of the biz are deductible.
 - This limit on deduction includes expenses that are paid/incurred in connection with investigating the creation/acquisition of trade/business, creating the trade/business, or activity engaged in for profit before the active trade/business begins.
 - However, this could be deducted as a loss if it failed.
- **Policy:** This prevents deducting personal expenses. The expenses here are also long-term and not limited to the year of the expenditure.

VI. RECOVERY OF CAPITAL EXPENDITURES

A. Depreciation and the Accelerated Cost Recovery System

- **Definition:** Depreciation involves the deduction of capital expenditures over time.
 - Ordinary expenses are deducted under 162, land is dealt with under 1001 and capital expenditures are dealt with through depreciation under 167-8.
- **Questions for Depreciation:**
 - (1) What rate of decline for value
 - (2) How long will asset last
 - (3) At end of life, how much is it worth.
- **Rules:**
 - **Applicability of Depreciation: Section 167:**
 - Depreciation is allowed for the exhaustion, wear and tear of property used in the trade/business or property held for the production of income. This also includes obsolescence.
 - This does not include inventories (held primarily for sale to customers). The property must be used in the business.

- It does not include land – asset must be terminable.
- **Mechanics: Section 168:** This involves the depreciation deduction.
 - **Factors:**
 - Applicable depreciation method
 - Applicable recovery period
 - **Section 168e:** Figure out the class life, then find the property classification and then look under **168c** to find the applicable recovery period.
 - Applicable convention.
- **Effect on Basis:** The depreciation deductions lower the basis of the property. 1016. This affects the gain that may be realized if the property is disposed (1001).

Elements:

- **Useful Life: 168c, e:**
 - Assume that the property has a 5 year class life.
 - Note that works of art are not entitled to a depreciation deduction because there is no determinable useful life. However, instruments used for professional reasons can get deductions.
- **Methods of Depreciation Deductions:**
 - **Straight Line:** Change in value over time in straight line – divide the amount of the assets by the number of years (class life) to find the amount you can deduct each year. For 5 years, it would be 100% divided by 5 = 20% of price as a deduction.
 - *Note that this must be used for residential rental and nonresidential real property.*
 - **Accelerated Depreciation:** Declines rapidly at first and then slows down. This is more like computers and cars. **See page 334 of casebook.**
 - % applied to cost minus the deductions taken in previous years.
- **Convention:**
 - Assume that it is the half-year convention.
- **Special Provisions:**
 - In the case the recovery period is 20 years or less, TP can deduct 30% of the basis before the deductions are applied if there is a purchase after 9/10/01 and before 5/5/03, then TP gets – **30%** of cost plus whatever else is allowed. From 5/5/03 to 12/31/04 – the deduction is **50%** of the cost.

B. Other Depreciation Matters

- **General Rule for Special Tangible Property: Section 179:** Certain property (179 tangible property, 1245 property and property acquired by purchase for use in active conduct of trade/business) can be deducted. This applies to property that is tangible personal property acquired by purchase for use in active conduct of trade/business.
 - **Amount:** For year 2002-06, 100K. For other years, 25K.
 - **Limit on Amount - Costs:** If costs placed in service for a year exceeds 200K or 400K in 2002-06, then the amount of the deduction is reduced..

basis, FMV 10K. B sells to friend C at 12K – no gain. If B sold to C at 16K, then 1K gain).

- Family members include brothers, sisters, spouses, ancestors or lineal descendants.
 - Hostility in family relations does not overcome this.
- **Miller.**
- This also includes individual and corporation if more than 50% of outstanding stock is owned by individual; and if two corporations are members of the same controlled group.

D. Bad Debts

- **General Rule: Section 166:** Any business debt that becomes worthless in a tax year is deductible. The amount is the adjusted basis under 1011.
 - **Bad Debts:** (1) Debt created/acquired in connection with trade/business; (2) the loss of the debt is incurred in TP's trade/business.
 - **Requirements:**
 - Must be a bona fide debt (valid enforceable)
 - Look at the terms.
 - Must be worthless (not canceled)
 - Cannot have a lien and debtor cannot pay back
 - Must have a dominant business motive
 - Like 162, an investment is not a business related debt. However trying to preserve a source of ordinary income (preserve employment) with a loan could result in a debt. The business motive must be dominant – not just significant. **Whipple; Generes**
 - If a relationship is involved a gift will be presumed.
 - Unlike 267a1, there is not a bar on bad debts involving related parties so look at the circumstances and the terms of the debt.
 - **Limitation – Personal Bad Debts:** This does not apply to nonbusiness debts. Non-Business debts are treated as capital losses and only when they are *completely worthless*.
- **In relation to 165:** 165 does not allow personal deductions unless casualty/loss – 166 allows capital loss. Investment losses are not subject to capital losses under 165, but are under 166.
- **ANALYSIS:** (1) Is it a debt? (2) Is it worthless? (3) Is it business or non-business?

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

A. Travel Expenses

POLICY: The deduction of this adds resources to TP and G picks up some of the tab because it is deducted before tax.

Requirements: (1) must be reasonable/necessary, (2) incurred away from home, and (3) incurred in the pursuit of business.

1. Local Travel and Commuting

- **General Rule: 162a2**: If business-related travel falls under this you can deduct.
- **Daily Commuting**: This relates to 262 and prohibition on personal deductions
 - **Permissible deductions**: (1) EE works in 2 places and can deduct the travel between the two locations if it does not exceed the cost home, (2) working in two places with two different employers in same city, (3) cop on duty and must use unmarked car from home, (4) going to temporary workplace outside metro area, (5) TP has more than one worksite and can deduct the expenses going from home to a temporary worksite if in same trade/business, (6) If TP's residence is the principle place of business, then going to another work location in the same T/B is deductible.
 - Look at TP's realistic expectation regarding whether the employment will last under a year to determine if the work is temporary.
- **Alternative Methods to deduct**:
 - 132f – qualified parking
 - 125 – cafeteria plans

2. Food and Lodging: Away From Home?

- **General Rule: Section 162a2**: These are deductible while away from home in the pursuit of a trade/business.
 - Note: This includes meals as long as they are not lavish.
 - The entire amounts of the lodging and meals are deductible.
- **Business-Pleasure**: If the primary purpose is business, then the travel expenses are deductible. If not, then only the expenses incurred once at the destination that relate to trade/business are deductible.
 - Look at primary purpose.
- **Away From Home** – this requires that TP have the need for sleep/rest. **Correll**. In this case, TP may deduct the entire cost of meals.
 - **If more than one residence**: Find the **principle residence** to determine the tax consequences (must incur substantial continuing living expenses, where TP conducts most important activity).
 - **Temporary Job**: This applies to temporary jobs if under one year away from home. Note that if TP has two jobs (one is seasonal) then the EE may only deduct the cost of the meals and lodging at the minor place of employment while away from the principal post.
 - **Spouse: 274m3**: Spouse expenses can only be deducted if (1) bona fide EE of TP, (2) travel is for bona fide purpose, (3) spouse could not otherwise deduct the expense.
- **Employee-Employer**:

- For ER: Use section 162:
- For EE: Use Section 132d – if something would otherwise be deductible, then it is not included in GI of EE. It is deductible under 132 – so no GI for EE.
 - **Per Diems:** If used for meals, etc. while away then not in GI. If kept, then it is compensation.
 - **Reimbursement plans** are not included in GI of EE for travel expenses.
 - **Requirements:** Must be for deductible expenses, properly substantiated, and EE must return any excess.

B. Entertainment and Business Meals

- **Flashback** – Rule 119 allows for the deductibility of meals on the ER premises for convenience of ER.
- **Co-Workers:** 162 allows for the deduction of business expenses. For meals not on the ER premises, 262 trumps 162 if the personal reason for the meal trumps the 162 business reason. **Moss**. Once a month is OK – daily is not.
 - **POLICY:** Prevents abuse of deductions.
- **General Rule: Section 274a:** Entertainment activities must be:
 - (1) Directly related to a bona fide business discussion, or
 - **Requirements:**
 - More than a general expectation that business will be generated in the future – goodwill is not enough. **Walliser**.
 - Discussion must take place but does not have to be successful
 - Principle character of the outing must relate to the active trade/conduct. But more time does not need to be spent on business discussion.
 - (2) Associated with a *substantial* and *bona fide* business discussion.
 - The discussion must directly precede or follow the entertainment.
 - Goodwill is OK. There must be a clear/concrete business purpose. More time does not need to be spent on business discussion.
- **Substantiation Requirement: 274d:**
 - TP must report amount, time/place, business purpose, business relationship.
- **Limit on Deduction – 50% Rule: 274n:** TP can only deduct 50% of the meal.
 - This does not apply to reimbursement (EE does not take 50% hit, ER does), travel as compensation, recreation for EE, items available to public, entertainment sold to public, or expenses includible in the income of others who are not EE.
 - Note: 274 does not apply to this in addition to meals on the premises for ER convenience.
- **Special Rules for Meals: 274k:**
 - Deduction is allowed only for meals if there are not lavish/extravagant under the circumstances, and TP must be present at the furnishing of the meals

- If lavish, subtract that amount before applying 50% rule.
- **Other Limits:**
 - There is no deduction for the amount paid for a facility (unless primarily in furtherance of trade/business and only that which is directly related to active conduct of trade/business can be deducted), for dues, or memberships.
 - There is no deduction for foreign travel expenses not related to trade/business, unless the foreign travel is less than a week or the non-business expenses is less than 25% of total time.
 - Special rules for conventions outside US or on cruise ships or for 212 conventions – 274h.
 - Regulations: If TP is not present or there are substantial distractions, then it is not deductible.
- EE-ER 132/162 applies here in terms of GI to EE.

ANALYSIS: There must be a deduction allowed under 162 or 212. If it is entertainment, look under 274. The primary purpose must be business. Then look for substantiation, then apply the 50% rule.

C. Education Expenses

- **General Rule: Reg 1.162-5:** Education expense is deductible as an ordinary and necessary expense if:
 - (1) **Maintains or improves skills** required by the individual in their employment, trade or business, or
 - Refresher courses, current issues in the field, etc.
 - There must be a sufficient relationship between the education and required job skills. It must be relevant. **Takahashi**.
 - TP must be established in a trade/business (although leaving a job for a year is a temporary absence and TP retains trade/business). **Furner**.
 - (2) **Meets the minimum necessary requirements** of the employer or applicable laws and regulations in order to retain an existing job or status or rate of compensation.
 - Requirements must be bona fide business purposes.
- **Limits:** Expenses are **not deductible** under §162 if it constitutes an inseparable aggregate of capital expenditures even if it improves a skill to maintain one's existing jobs. *The following are nondeductible:*
 - (1) Education that is required to meet the minimum education requirements for qualification in taxpayer's employment.
 - Once hired and education requirements change, to meet these, it is deductible.
 - (2) Qualifies the taxpayers for a new trade or business.
 - This does not include a change of duties.
- **ER Payment: Section 127:** ER can deduct under 127 (up to 5250). Use this if EE cannot otherwise deduct the expense (in that case it would not be a working fringe under 132 because 127 allows this). Anything above 5250 is included in GI.

- **EE Payment:** It is deductible like any other TP if it maintains or improves. In this case, if EE paid for it, then it would be a working fringe under 132.

ANALYSIS: See if 127 or 132 applies. If 127, then 5250. If anything above that see if 132 applies.

POLICY: Encourages ER to pay for education.

- **Travel Expenses: 274m:**
 - Travel is not a form of education
 - Deductible Expenses: If you travel somewhere to get an education, if the primary purpose is education, then the travel expenses, meals and lodging are deductible. The personal expenditures (sightseeing, etc.) are not deductible.

Education Tax Incentives

- **Hope Scholarship Credit: Section 25A:** This applies to first 2 years of post-HS education. The max credit is 1500 (100% credit of first 1K and then 50% excess up to 1K). The credit is phased out for 40-50K single and 80-100K joint. Must be enrolled at least halftime. This is on per student basis.
- **Lifetime Learning Credit: Section 25A:** 20% of qualified tuition expenses – the max is 2K. Same phase out. This is on a per TP basis.
- **Coverdell Education Savings Account:** Can contribute up to 2K per year until child is 18 for qualified expenses. Contributions are nondeductible and tax free unless the payout exceeds the amount of qualified tuition expenses.
- **Qualified Tuition Plans: Section 529:** Amounts paid into, accrued interests, and payments to school from qualified trusts are tax exempt and the beneficiary nor the contributor are taxed on the earnings.
- **Qualified Higher Education Expenses: Section 222:** This is a deduction and not a credit. This expires in 2005 and the deduction is 4K. Capped at 65K single, 130K joint for 4K and 80K, 160K for 2K deduction.

D. Child Care Expenses

- **General Rule: Section 21:** This allows a credit for employment related expenses.
 - **Formula:** Such cost cannot exceed \$6000 (or \$3000 if only one person involved).
 - Tax credit allowed is 35% of this amt if TP's adjusted gross income is \$15K or less
 - Credit declines to 20% as adjusted gross income increases. For each 2K over 15K, the percentage is reduced by 1 point (if over 40K, then only get 20% of 6K or 3K).
 - The amount cannot exceed earned income – so this provision is not refundable.

- **Qualified Individual:** Applies only to kids under 13 or retarded or adult incapable of caring for himself.
- The employment-related expenses involving qualified individuals and are incurred to enable TP to work: expenses for household services and expenses for care of qualifying individual. This does not include amount paid at camp where individual stays overnight.
- **In Conjunction with 129 Deduction:** GI does not include amount paid by ER for dependant care assistance to EE if the assistance is for the exclusive benefit of EE. The exclusion is up to 5K (2.5K in separate return).
 - This shows that the credit is better for the poor.

E. Legal Expenses

- **Origin of the Claim Test:** If the origin is personal, then the expense is not deductible. **Gilmore.** The economic consequences are not considered. If it is business-related, then it may be deductible under 162.
- Problem with test is that the application to similar circumstances is not uniform.
- **Regulation 1.262b7:** atty. fees in divorce proceeding are not deductible. However, the part of the fee which are attributable to the production of income or collection of amounts includible in GI under 212 are deductible *by the wife* under section 212.

F. Clothing Expenses

- **Requirements to deduct clothing – Objective Test:** (1) clothing is a type specifically required as a condition of employment, (2) it is not adaptable to general usage as ordinary clothing, and (3) it is not so worn – for personal use. **Pevsner.** Here 262 trumps 162.
- TP can deduct clothing if required to wear distinctive uniforms not suitable for ordinary wear.
- **POLICY:** Administrative convenience and fairness.

VIII. PERSONAL DEDUCTIONS

A. Standard Deduction and the Personal Exemption

- **General Rule: Section 63:** Taxable income is the GI minus deductions. If you don't itemize, take GI and subtract standard deduction and personal exemptions in 151.
- **Standard Deduction: 63c:** Individual 4750 and joint 9500. You must not itemize to get this.
- **Personal Exemption: 151:** Each person gets 3050. This includes TP's dependents (under 19 or full-time student under 24, or makes less than the exemption). This is allowed even if you itemize.
 - TP must provide half support for dependents.
- **Additional Child Credit: 24:** For each child under 17, TP may take an additional 1K.
 - After the deductions, a family of two making below 40K does not have taxable income.

POLICY: Vertical equity. People with different amounts of income should pay different amounts.

B. Reduction of Itemized Deduction for High Income TPs

- **General Rule: Section 68**: Even if TP itemizes deductions, there is a reduction on the amount that TP can deduct if he makes over 100K. It is reduced by 3% of the excess over the amount or 80% of the itemized deductions – whichever is less.
 - This does not include 213 medical, 163 investment, or 165 casualty/loss.

C. The Earned-Income Tax Credit: An Implicit Deduction for Miscellaneous Expenses of Low and moderate Income Employees

- **General Rule: Section 32**: In cases of eligible individuals, there is a refundable credit available
- This is a refund and if you have more credit than taxable income, you get a check. **See supp. p. 37.**
- Definitions:
 - Qualified individual: (1) someone with a qualified child, (2) someone with primary place of abode in US of ½ of year, is not a dependent and is between 25 and 65.
 - Qualifying Child: Relationship to TP (son, daughter, step, brother, sister, step, eligible foster child, etc.), has same place of abode for more than ½ year, and is not 19, or is student under 24, or permanently and totally disabled.

POLICY: Encouraging parents to work and reducing the welfare incentives, and reducing the tax burden of FICA. This shows social engineering.

D. Personalized Itemized Deductions

- This includes the deduction for interest, state and local taxes, and charitable contributions.

1. The Interest Deductions

- **General Rule: Section 163a**: TP can take a deduction on all interest paid or accrued within the taxable year on indebtedness.
 - You can only deduct what was paid – this is cash basis accounting, not accrual.
 - **Definition**: Interest is the amount paid for the use of money. It must be compensation for the use/forbearance of money per se and not a payment for specific services which the lender performs in connection with the borrower's account.
 - This includes points (1% of the loan) attributable to risk on a loan that is charged to debtor upon taking a loan (exception to prepaid insurance as capital expenditure).
 - TP cannot borrow money from the creditor to pay the interest owed to the creditor and deduct the payment – TP must have unfettered control over funds that are used to pay back. **Davidson**. *Look at form not substance.*

Deductible Interest - Requirements

- **TRUE LOAN:** There must be a **true loan** in existence with respect to which the interest is being paid – *legally enforceable obligation*.
 - **MADE BY PAYOR WITH OBLIGATION TO PAY:** The repayment of the loan must be the obligation of the party making the payment
 - **PAID/ACCRUED:** The interest claimed to be paid or accrued must be properly allocable to the current year, rather than a future year.
 - **NO LIMITATIONS:** There cannot be any limitations which prevent the TP from deducting the interest.
- **Requirements:**
 - The Expenditure must be for interest
 - The interest must be paid or accrued
 - That limitations on the deductibility of investment interest (163d) or personal interest (163h) must not apply
 - **Limitation on Interest: 163h:**
 - Personal Interest is not deductible. So the interest must be connected to trade/business, investment, qualified residence interest, or educational loans (debt to pay qualified educational expenses – 221).
 - **221, the max deduction for interest is 2500.** It must be for the cost of attendance at a qualified institution.
 - It must be a qualified education loan (incurred on behalf of TP, spouse or dependent; paid within reasonable time; and furnished during period when individual was student.
 - You cannot take this deduction for any amount that is otherwise deductible.
 - There is a phase out.
 - **Qualified Residence Interest: 163h**
 - **(1) Acquisition Indebtedness:**
 - Debt that is incurred in acquiring, construction, or substantially improving a residence AND is secured by the residence.
 - This includes refinancing debt as long as the amount does not exceed the amount of debt that was refinanced.
 - Dollar Limit: 1M.
 - **(2) Home Equity Indebtedness:**
 - Any amount that debt other than acquisition which is secured by the residence. This is secured by the home but does not have to put into the home.
 - **Example:** If 600K taken out to pay of a 400K loan, 140K improvements and 60K car. The 60K for the car is home equity and it's cool as long as it does not exceed the formula below. Note that the interest on the 540K would be acquisition indebtedness.

- The amount of debt treated as home equity indebtedness is limited to the lesser of: (1) equity in the home (i.e., FMV – acquisition indebtedness), or 100K (even if the loan is larger).
 - **Example:** Above example: If FMV is 800 and 540 is acquisition, then 140K is home equity and since it is more than 100K only interest relating to 100K can be deducted.
- **Qualified Residence:** Principle residence of TP and 1 other residence used by TP pursuant to **280Ad1**. TP does not have to rent the second residence.

ANALYSIS: Is it personal interest? If so, it is not deductible. If not, it is probably deductible.

- Is it qualified residence interest? If so, the focus is on the debt.
 - Underlying Debt: Is it acquisition indebtedness? Is it home equity indebtedness?

POLICY: Prevent personal deductions to disallow TP from splurging and hurting the economy. If there was no deduction for housing interest it would hurt the market. Borrowing against you house allows TP to do things without having to sell house (send kids to school, etc.).

2. Taxes:

- **General Rule: Section 164:** TP can deduct state and local real property taxes and personal property taxes.
 - This does not include taxes against local benefit that increase the value of property. It must be paid on whom it is imposed (exception is that one tenant in common can pay for the others).
- This allows for the deduction of taxes outside of 162 and 212. It trumps 262.

3. Casualty and Theft Losses

- **General Rule: Section 165c3:** Losses of property not connected with a trade/business (162) or activity producing profit (212) is deductible if it arises from fire, storm, shipwreck, or other casualty, or theft.
- **Limitations: 165h:** (1) The amount of each loss must exceed \$100, (2) the loss is deductible only to the extent that the loss exceeds 10% of TP's income, and (3) if TP has insurance, a timely claim must be filed.
- **Basis:** The amount of the loss is the adjusted basis of the item – this includes depreciation deductions.
- **Nature of other Casualty:** Must be sudden and relate to physical damage.

Chamales.

- **Definitions: Casualty:** complete or partial destruction of property resulting from an identifiable event of a sudden, unexpected and unusual nature – includes the accidental loss. **Sudden:** the event is swift and precipitous – not gradual or progressive. **Unexpected** means that the event is ordinarily unanticipated that occurs without the intent of one who

suffers the loss. **Unusual** means the event that is extraordinary and nonrecurring, one that does not commonly occur during the activity in which TP was engaged when the destruction or damage occurred, and one that does not commonly occur in the ordinary course of day-to-day living of TP.

- Vietnam example: **Popa**
- OJ example: **Chamales**.
- If the loss is willful, then 165 does not apply. If you file a lawsuit and succeed then there is no loss (like insurance).
- **Timing:** For theft, the year it was discovered and for damage, the year it occurred.
- **Calculations:**
 - **For casualty:** The amount before casualty and the amount afterwards is the loss.
 - **For Theft:** The amount afterwards is 0 – so typically you get what you paid for it.
 - **Limitations:** This is offset by any insurance received, the 100 deductible, and 10% of income.
 - If gains exceed losses, both are treated as capital gains and losses.

4. Medical Expenses

- **General Rule: Section 213:** TP can deduct medical expenses that are actually paid for TP, spouse, and dependants in a year to the extent that the payments are more than 7.5% of GI. It also applies to prescribed drugs and insulin. So you can only deduct that which exceeds 7.5%.
- Medical Care includes diagnosis, prevention, cure, mitigation, treatment, or to affect any structure of the body. Is also applies to transportation that is essential to medical care and qualified long term service. It does not apply to cosmetic surgery.
 - TP may deduct food and lodging while traveling to a critical point of medical treatment. **Montgomery**.
 - The care of child in the course of a parent's treatment is not deductible because it is not close enough (essential) to the medical expense.
- **Self-Employed TP: 162(L):** If TP is self-employed, TP can deduct 100% of the medical expenses.
- **Cafeteria Plans:** These allow TP to pay into ER account and be reimbursed for medical expenses. 213 does not apply to this.
- Expenditures for general health are not included.

5. Charitable Contributions

- **General Rule: Section 170:** TP can deduct charitable contributions.
 - **Qualifications:** For a company on accrual basis, if board authorizes the payment and it is paid before the 15th of the 3rd month of the next tax year, it can be deducted in the prior year. In the case of future interests of tangible personal property, a contribution is made when all the intervening interests have expired.

- **Requirements:** (1) Made to qualified charity, (2) no expectation of return benefit, (3) actually paid to charity, (4) cannot exceed a certain limit
 - **Actually Paid:** This is effective upon delivery and includes credit card charges.
 - **Excluded:** Contribution ensures admission of child, earmarking for particular person, etc.
- **Amounts:** TP can deduct the amount contributed or the FMV of an item that is contributed.
 - You must itemize to get this deduction.
- **Definition of Charity:** (1) company, trust fund, foundation, (2) created in US, (3) organized exclusively for religious, charitable, scientific, literary, educational, foster sports (but not equipment), or prevention of cruelty, (4) no part of net earnings can go to private SH or individual (so amounts to individuals are not deductible here), (5) not disqualified for tax exemption under 501c3 because of lobbying and does not support candidate for office.
- **Substantiation:** No deduction is allowed for 250 or more without a receipt from donee organization that lists (1) the amount contributed, (2) any goods/services given in return, (3) good faith estimate of any goods/services given in return or if the return was intangible religious benefit.
- **Quid pro Quo Contribution:** If a contribution is made and something is given in return, (1) TP must pay over the FMV of the item and (2) the contribution deduction is limited to the amount of the payment that exceeds the FMV.
 - This does not include inconsequential items.
 - But for other items, if there is no price and TP “buys” something that is characterized for charity, it does not count because it is presumed the purchase price was the FMV.
 - This applies even if TP does not accept the ticket, service, item, etc.
 - Raffles are not contributions.
- **Tickets:** 170L: TP that contributes to higher education for the right to purchase tickets at school’s sporting event only get 80%. If tickets given, then that amount is subtracted from contribution, then 80% applies.
- **Services:** You cannot deduct the value of services to a charitable organization. But TP can deduct unreimbursed expenses in the course of providing the service.
- **Property:** The contribution of property is typically FMV, but for appreciated property:
 - For a short-term capital gain – not capital assets: In this case, TP cannot deduct the appreciation. TP deduction is limited to basis.
 - Inventory, services performed, etc.
 - **Note:** Long-term capital gains are included in the deduction – just not short term gains.
 - For tangible personal property – capital assets: If the use by the donee is unrelated to the ground that gives rise to a valid contribution, then TP’s deduction is reduced to the basis.

- *So: (1) For appreciated property that would produce income if sold like a short term capital gain, the deduction is reduced by the appreciation – like a work of art produced by the donor. (2) For tangible personal property, if the use is unrelated to the purpose of the exemption, then it is reduced by the appreciated amount (giving something of value when the charity will sell it).*

POLICY: Support the growth of social goals. Allows TP to make the decision. Like deductible expenses, this is pre-tax and G assumes some of the tax burden in that it is not taxed.

IX. LIMITATIONS ON DEDUCTIONS, LOSSES, AND EXPENSES

A. Requirement of a Profit-Seeking Activity (Hobby Loss Provision)

- **General Rule: Section 183a**: If an activity is not engaged in for profit, then a deduction is not allowed. However, there are exceptions under 183.
 - **NOTE**: If engaged in for profit – look to 162 or 212 and 183 does not apply. If not, apply 183 to the losses.
 - **NOTE**: This section only applies when there are losses - 165. Then look to whether an activity is engaged in for profit. Each activity is analyzed separately.
- **Factors to Determine if Activity is Engaged in for Profit:**

TP must have the objective to engage in for profit – not reasonable expectation of profit – apply the factors - Dreicer

 - (1) Manner in which TP carries on the activity, (2) Expertise of TP or advisors, (3) Time and effort expended by TP in carrying on the activity, (4) Expectation that assets used in the activity may appreciate in value, (5) Success of TP in carrying on other similar or dissimilar activities, (6) TP’s history or income or losses with respect to the activity, (7) Amount of occasional profits which are earned, (8) Financial status of TP, (9) Elements of personal pleasure/recreation.
- **Mechanics: Personal Deductions Allowed under 183:**
 - **b1**: Deductions under 163 (qualified residence) and 164 (real estate taxes).
 - **b2**: Also, any deduction that would be allowed if engaged in for profit, but only *if GI derived from that activity* exceeds the deductions under b1. So after 163 and 164 are taken, if GI from the activity exceeds the deductions, then further deductions can be taken.
- **Presumption of activity engaged in for profit**: If GI from an activity exceeds the deductions under b1 for 3 out of 5 years, then the activity is presumed to be engaged in for profit. If horse breeding, training, showing, racing is involved it is 2 out of 7 years.
- **This does not apply to 280A.**

POLICY: This prevents TP for engaging in loss producing activities to offset GI.

B. Home Office Expenditures and Vacation Homes

- **General Rule: Section 280Aa**: No deduction is allowed for use of dwelling unit that TP uses during the year as a residence.
 - **Dwelling Unit: 280Af1**: house, apt., condo, boat, etc. This does not include hotel, motel, inn, etc.
 - **Use as a Residence: 280Ad**:
 - **Rule**: If TP uses it for the greater of 14 days or 10% of the days which the unit is rented at FMV.
 - Personal Use includes use by TP or family member, if rent allows TP to use another unit, if the rent is not at FMV.
 - If rented at FMV as renters principal residence it is not used by TP – this includes rent to family member.
 - **NOTE**: This mainly applies to vacation homes. If over the limit then 280A applies. If not, then 162 applies.
 - **Exceptions to General Rule**:
 - **b**: TP can take the deductions under 163 (qualified residence) and 164 (real estate taxes).
 - **c**:
 - (1) For business use: The bar on deduction does not apply if:
 - A portion of residence is *exclusively* used on a regular basis as
 - (1) Principle place of business for trade/business
 - Importance of activities and time spent there
 - Principle place of business includes that which is used by TP for the administrative/management activities if there is no other location where TP could perform the substantial activities.
 - (2) Place used by clients/customers in meeting/dealing with TP in the normal course of business, **or**
 - (3) Is a separate structure not attached to the dwelling
 - For EE, it must be for the convenience of ER
 - (3) If TP rents a portion of it
 - (4) A portion is used for day care – special qualifications.
 - **(c)(5) Limitations on Deduction**: Deductions cannot exceed the GI from the use after the deductions of 163, 164 and other deductions allocable to the trade/business. **Same as 183 basically.**

- But the excess can be carried over.
- Note: Expenses must be allocable to business (depreciation, rent, utilities, etc.) – so lawn care would not count.
- **Applicability and Analysis:** Is the deduction not related to activity engaged in for profit? If not, apply 280A. Consider whether the home is used as an office and then deduct the portion that is used as an office if it qualifies. If vacation home is rented then make sure TP has not used it too often to qualify for deduction.

POLICY: Provide objective criteria.

X. WHEN IS IT INCOME? TAX ACCOUNTING: WHEN IS IT INCOME OR DEDUCTIBLE?

A. The Cash Method of Accounting

1. Income under the Cash Method

- **General Rule:** TP has income when it is received. So you can accelerate deductions if you pay before the end of the year.
- **Constructive Receipt:** If TP can get the money and the money is not subject to limitations, then TP has received it for purposes of that tax year. When TP has it credited to account, set aside for him, or otherwise made available if notice of intention to withdrawal is given
 - **Requirements:** (1) Must be made available and (2) control must not be subject to limitations, (3) cannot turn back on income.
 - For #1, bonus stock that is not available to be exercised for TP,
 - For #2, distance and knowledge (lack thereof) may prevent TP from constructively receiving the payment. Also contractual arrangements
- **Non-qualified deferred compensation:** This involves payment received at a later time for services already rendered.
 - Examples: Monthly payments after retirement, a subsequent bona fide agreement can defer payments that should have been made and avoid constructive receipt, etc. Note that ER cannot deduct it until EE includes it in income.
 - Problems: The payer may go bankrupt and you may not get the payment because creditors have rights to the payer's assets. This could be transferred to a third party (rabbi trust) but the threat of bankruptcy is still there, but it still prevents constructive receipt.
- **Exceptions:** (1) refusal to claim a prize is not included in GI, (2) cafeteria plans avoid constructive receipt.

2. Deduction under the Cash Method

- **General Rule:** TP can deduct when the payment is actually paid. Mailing a check is the same as delivery. Credit card payments count.
- There is no constructive doctrine here.
- Payment into escrow does not count. Promissory notes do not count.
- Payment can be with borrowed funds as long as not borrowed from creditor.

B. The Accrual Method of Accounting

- **General Rule for Income:** When TP has a right to the money, it is included in GI.
 - An item of income is includable in GI when all events have occurred which fix the right to such income and the amount thereof can be determined with reasonable accuracy
- **General Rule for Deduction:** When TP has a legal obligation to make a payment then it is deductible.
 - An expense is deductible when all the events occur which establish the fact of liability, the amount can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability
- **Example re Loans:** If TP (business) gave a loan and is due 8K interest and someone pays 2K – the income is 8K under accrual. If the remaining 6K is not paid then TP can claim a bad debt to offset what is included in income. If the 6K was received it would not be taxed again since it has been accounted for.
 - Equity Kickers: You take out 100K to buy something and an agreement to pay bank 8% plus 40% of the proceeds upon disposition. You cannot deduct the 40% given to the bank until the disposition takes place.
- **Contested Liabilities:**
 - Cannot be deducted by an accrual method TP because the contest renders the liability not fixed. The payment of the contested liability accrues the liability and provides a current deduction in the year of the payment.
 - Requirements: TP must contest liability, transfer money to satisfy it, and be entitled to a deduction but for the contest. If not paid, it will not accrue. There must be a bona fide dispute.
 - The transfer must put the money beyond the control of TP.
 - This typically only applies to accrual method because cash method may deduct a liability even if it is contested.
- **Inventory accounting:** gross profits or loss from sales in a given period is determined by subtracting the cost of goods – adding cost of opening inventory at the beginning of the period and costs of goods purchased during the period, and subtracting from the total the cost of closing inventory at the end of the period – from the sale proceeds

XI. INTRODUCTION TO CAPITAL ASSET TRANSACTIONS

A. Capital Gains and Losses

1. Statutory History and Policy

- Preferential treatment for capital assets held longer than one year – the tax is lower.
- The policy in 1986 of lowering the tax rate and the time to hold assets went to simplification and to increase investment.

2. Current Statutory Provisions

- **General Rule:** A gain of stock is treated as a gain under **1001**. In determining this, subtract out the capital gains from the rest of income and apply the tax rates in 1(h).
- **Tax Rates:** The max rate on long-term capital gains is 15% (5% for low earners). Short term gains are taxed at normal individual tax rate.
- **Net Capital Gain:** 1222: $NLTCG - NSTCG = NCG$
 - The excess of net long term capital gain (long term capital gains over the long term capital losses) over the net short term capital losses (short term capital gains over short term capital losses).
 - If there are both LTCG and STCG then they are each subjected to different rates.
- **Different Tax for Different Types of Assets:**
 - **28% Rate Gain:** This applies to collectibles if TP is in bracket higher than 28%. If not, then whatever lower rate TP is in applies to these assets.
 - Rugs, coins, antiques, metal, art, etc. and certain stocks under 1202.
 - **1250 Unrecaptured Gain:** Max rate of 25%. This applies to depreciation allowed with respect to real estate held for more than one year – see below.
 - **Adjusted Net Capital Gain** (gain after 28% and recapture is taken out): This is a 15% tax for most, and 5% tax for those in 15% bracket.
 - If TP has income in 15% bracket and gains that put the income over 15%, the gains up to the 15% threshold are taxed at 5% and every gain after that is taxed at 15%.
- **Qualified Small Business Stock:** 1202: TP can exclude 50% of these gains if held for more than 5 years. This is limited to 10 times TP's basis in stock or 10M gain from disposition of the stock. It must be in a C corporation and acquired at original issuance after 8.10.93.

3. Limitation on the Deduction of Capital Losses

- To calculate losses, use section **1211 and 1212**. This is in **165f**.
- **Mechanics:** **1211:** To deduct losses, TP can do so if the losses exceed the gains from the sale of capital assets (the amount of loss equal to gains) plus up to 3K (the amount of loss over the gains, but cannot exceed 3K). **1212** provides that the loss that cannot be included this year, can be rolled over the following year.
 - **Example:** If you have 20K loss and 9K gain, you can deduct 9K loss plus 3K. The other 8K rolls over.
 - Note: Companies do not get the additional 3K.

4. Definition of Capital Assets

- **General Rule:** 1221: All property is a capital asset unless there is an exception under rule 1221.
 - Exceptions:
 - (1) Stock in trade of TP or other property that would properly be included in inventory of TP, or property held by TP primarily for sale to customers in the ordinary course of trade/business.

- For latter: Must be held primarily for sale to customers or it is a capital asset. Holding it for appreciation is not enough. If it is held for investment then it is a capital asset.
 - For land development and finding the primary purpose: Courts look at frequency and substantiality of sales.
- (2) Property used in trade/business of character which is subject to the allowance for depreciation provided in 167 or real property used in trade/business.
- (3) Copyright, composition or letters held by (A) TP whose personal efforts created it, (B) if letter, TP for whom such property was produced, or (C) TP in whose hand the basis is determined by reference to TP in A or B.
- (4) Accounts or notes receivable acquired in ordinary course of trade/business for services rendered or from the sale of property
- (5) Publication of the US received from US G or agency *other than by purchase at price at which offered to sale to public* and held by (A) TP who received it, or (B) TP in whose hands the basis is determined from sale or exchange by TP in A.
- (6) Commodities derivative
- (7) Hedging transaction
- (8) Supplies of a type regularly used/consumed by TP in ordinary course of trade/business

i. Inventory and Property Held for Sale to Customers

- Note: capital assets are preferential treatment because it is taxed at a lower rate – so this is the exception to the rule despite the broad definition.
- **Section 1221a1**: Property held by TP primarily for sale to customers in the ordinary course of trade/business.
 - Must be held ***primarily*** for sale to customers or it is a capital asset. This is more than substantially.
 - Holding it for appreciation may render it a capital asset. If it is held for investment then it is a capital asset.
 - For land development and finding the primary purpose: Courts look at frequency and substantiality of sales.
 - **Biedenharm Factors**: frequency/substantiality of sales; improvements made to land, TP's solicitation and advertising efforts, utilization of real estate brokers and agents
 - **Bynum Factors**: Look at the purpose at the time of sale, not the historical purpose or why it was acquired to determine what it is held for. Also look at improvements, gain of any appreciation, motivations to sell, etc.

ii. Other Assets Excluded from Capital Asset Treatment

- **Depreciable or Real Property: 1221a2**: If held for more than a year then look at 1231 – there is special treatment.

- **Copyrights, etc.: 1221a3:** Not capital asset if held by creator or who took the thing with basis in reference to the creator. If basis is the FMV (buy something from someone at arm's length, then it is a capital asset). This also prevents excessive charitable deductions if someone donates papers, art, etc.
- **Accounts Receivable: 1221a4:** This assures any gain/loss by accrual type TP will not be capital in the event that TP sells the account at a gain/loss (the account is already included in income). This is better since losses are more favorable to TP is deducted under other provisions.
- **Publications of the US G: 1221a5:** This limits charitable deductions. It must be purchased at price offered to sale to public. 170e1 denies a charitable deduction. This is not a capital asset if TP who received it or TP whose basis is determined by reference to the basis of the TP who received it.

B. Quasi-Capital Assets

- General Rule for 1231 Property: Section 1231a:
 - If the gains of 1231 property exceeds such losses then they are treated as LTCG or LTCL
 - If the 1231 losses exceed such gains then it is not treated as gains/losses from sales/exchange of capital assets – it is treated as loss under 165a.
- 1231 Property:
 - It must be property used in trade/business that is subject to depreciation under 167, held for more than a year or real property held for more than a year and is **NOT**:
 - Property that would be in the inventory of TP
 - Property held by TP primarily for sale to customers in the ordinary course of trade/business
 - Copyright, composition, etc.
 - Publication of the US if not purchased at the price sold to public.
 - This includes involuntary conversions if depreciable and held for 1 year.
 - Note: The gain/loss must be recognized.
- **Example**: Buy X for 1K. Claim 520 in depreciation and the basis is 480 now. If you sell for 600, then treat as capital gain if you meet the requirements. If you sell for 300, then it is an ordinary loss.
 - If TP suffered casualty to X worth 1000 and received 1500 insurance, then the 500 would be a capital gain. If TP received, 500, then it would be an ordinary loss.
- Although this is pro-TP, the recapture provision takes some of the benefit out of it.
 - Land worth 25K with 15K basis. Truck worth 5K with 10K basis. If TP sells both the same year, then 10K profit would be offset by 5K loss both treated as capital losses. But if land sold one year and truck the next, then 10K LTCG and 5K ordinary loss – this is better for TP.
 - **Rule**: If in any of the next 5 years, TP has a gain, 5K of it is ordinary income to offset the ordinary loss.
 - Note that this is not retroactive so TP can avoid it by giving up losses later and not recognizing a gain for 5 years.

C. Recapture of Prior Depreciation Deductions

- This applies when TP makes a gain from taking depreciation deductions.
- **General Rule: Section 1245:** Notwithstanding any other provision, gain realized is treated as ordinary income to the extent the lesser of (1) total depreciation deductions allowed or (2) gain realized.
 - So if the gain realized is less than the depreciation deductions, 1245 turns this into ordinary income and if the depreciation deduction is less than gain realized then this is ordinary income. SEE HANDOUT.
- This trumps 1231.
- **1250 Property:** If the asset was property, this is 1250 gain. The anaBut the unrecaptured gain is subject to 25% rate instead of ordinary income tax rate. 1245 applies to depreciable personal property.
 - Under 1(h)(7) – unrecaptured gain is the LTCG from 1250 attributable to depreciation allowed to TP and not characterized as ordinary income.
- **POLICY:** The logic of 1245 is that when the depreciation deductions are too big the ordinary income is too small and TP received excessive deductions. Section 1245 recaptures the deductions. So this is offset by ordinary income later realized when the property is sold. If TP was not subject to recapture, then TP would get big deductions in the early years that would leave income to be taxed at higher rate and the later income would be taxed at a lower capital rate – so TP would receive a tax profit. The recapture evens the tax treatment

D. Transactions Involving Liabilities and Property Subject to Liabilities

- **Non-Recourse Debt:**
 - **Crane Rule:** (1) assumed liabilities whether recourse or not, taken subject to or otherwise incurred in the acquisition of property are included in TP's basis and (2) liabilities of a seller, recourse or not, assumed or taken subject to by a purchaser are included in the seller's amount realized.
 - So liabilities are in the buyer's basis and the liabilities are in the seller's amount realized.
 - **Tufts Rule:** The Crane rule applies even if the liabilities exceed the FMV of the property.
- **POLICY:** Crane and particularly Tufts can be viewed as a judicially created recapture scheme. Ct said TP got too many deductions through period of ownership and we're going to require them to reverse that and include it in their income upon disposition. Then we can prove that their economic injury was much less than TP's deduction. Here, ct determines amt of income and it reflects excessive depreciation deductions. Under §1(h), recapture provision tells us at what rate of tax that income will be subject. Absent that statutory provision, this gain would be taxed at low cap gains rate.

XII. Tax Consequences of Divorce

A. Alimony and Child Support Payments

- Requirements for alimony under section 71:
 - Must be in cash – property and services do not count.

- Must be received by or on behalf of spouse.
- Must be pursuant to divorce or separation instrument.
- Payor and payee cannot be in the same household.
- There cannot be an obligation to pay after the other's death – this prevents property settlements from being called alimony.
- Cannot be designated as excludable from GI or non-deductible.
- 71a requires that alimony be included in GI 215 allows for a deduction of alimony payments.
 - Result: This allows for a shift in income.

Property settlements and child support are not treated as alimony – you do not want it disguised as alimony.

- Property settlements fall under 1041: Treated as a gift and recipient takes the transferor's basis.
- Child support: This is not included in GI or deductible.
 - Note that the parent living with the child gets the deduction for kid under 152 unless they give a written waiver.
 - **Anti-abuse:** If there is a contingency relating to child such as attaining age, marrying, etc., then and the payment is reduced, then an equal amount as the amount of the reduction will be treated as child support.

B. Marriage Penalty Concerns

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Two rules of tax conduct: (1) TP prefer to include things in their income later so they pay taxes later, and (2) prefer to deduct an expense earlier because it reduces the income today and might increase it later.