**BOGDANSKI, FALL 2016**

Federal Income Tax Outline

# **Sources of Federal Income Tax**

## **Constitution**

**Corporations:** “No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.” **Article I, Section 9, Clause 4.**

1. Early tax of 1894 was found unconstitutional because it was a “direct” tax on individuals. *Pollock v. Farmers’ Loan & Trust Co. (1895).*
2. However, the corporate income tax has been found to not be a direct tax.

**Individuals:** “The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment, among the several states, and without regard to any census or enumeration.” **16th Amendment.**

## **Legislation -** Internal Revenue Code, 26 U.S.C.

1. Codifies income tax laws on books for decades (individual income tax since 1913)
2. Codifications: 1939, 1954, 1986
3. We now use IRC of 1986, as amended

## **Administrative Law –** Internal Revenue Service

**Rulemaking**

1. Regulations (26 C.F.R.): go through notice and comment and are given *Chevron* deference by a court.
2. Revenue rulings and revenue procedures: do not go through notice and comment. A positive point is that if it is favorable to taxpayers, the IRS must follow it until revoked. Given less than *Chevron* deference.
3. Lesser types of rulings: private letter rulings that only apply to specific individuals or entities. Only binding on that party, but are available to view with FOIA.

**Adjudication**

1. [Withholding or quarterly estimated tax (with interest liability for failure to pay quarterly) & annual return (self-assessment) by taxpayer] – the end for 99% of people
2. IRS examination (“audit”) of return
3. Notice of proposed deficiency (“30-day letter”)
4. Taxpayer protest, administration appeal
5. **Notice of deficiency (“90-day letter”)** – discussed in the IRC
   1. Three judicial review options: (1) don’t pay tax and go to U.S. Tax Court, appealable to taxpayer’s home Circuit and Supreme; (2) pay tax and sue for refund in District Court, appealable to taxpayer’s home Circuit and Supreme; or (3) pay tax and sue for refund in Federal Claims, appealable to Federal Circuit and Supreme. Bankruptcy court is also a choice.
6. IRS assessment and collection after 90 day period (unless stayed by taxpayer filing petition in court). Could seek due process hearing if 90 days passes, but damage is probably done.

# **IRC § 1 - Tax Rates**

**Gross income (§ 63):** deductions = taxable income x rates = tax – credits = tax liability

**§ 1(a) to 1(e):** has not been changed since Clinton, but the other sections have changed.

**§ 1(i):** 2001, 2003 tax cuts

1. Carved 10% bracket out of the 15% bracket.
2. 25%, 28%, and 33% now instead of 28%, 31%, and 36%. See current tables on pg. 1843-1849.

**§ 1(f):** inflation to deal with the problem of bracket creep, where you are pushed into the next bracket but only as a result of a cost of living increase.

1. Revenue Procedure 2015-53 (West Code and Regs., page 1843-1849)

**§ 1(h):** preference for capital gain(top rate generally 20%, rather than top rate of 39.6% for ordinary income).

**§ 1411:** shadowy additional tax if gross income exceeds a certain threshold. Net investment income taxed at normal rates and this additional tax of 3.8%. Came in with affordable healthcare act, loosely tied to Medicare (wealthy people don’t always pay Medicare tax, but it doesn’t go to Medicare fund anyways).

## **Compliance**

1. There is no SOL on when civil penalties must be sought and a 6 year SOL for criminal penalties. Penalties in § 6662.
2. Information given by taxpayer to tax preparer is not privileged, so attorneys do not often do taxes.

# **Gross Income**

## **Defined**

**§ 61 Definition:** “all income from whatever source derived.” Income has some meaning beyond that which Congress has expressly given it b/c of this broad definition.

**Reg. § 1.61-21:** Income unless there is an exclusion. Fringe benefits are included, unless excepted.

**Judicial definition:** at first defined as “the gain derived from capital, from labor, or from both combined.” ***Eisner v. Macomber (1920).*** Later stated “Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature.” ***Commissioner v. Glenshaw Glass (1955)*** *(punitive damages considered income b/c it was an instance of “****undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion****”).*

1. Now, income includes all “gains” that are “clearly realized” regardless of “source.”

**Haig-Simons (economic) Definition:** not applied, but some push for it. “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question.”

## **Value of Deferral**

1. So long as interest rates are positive, taxpayers generally find it advantageous to find ways to defer their liability to future years. And this value increases with interest rates.
2. The process of calculating present value of a future amount is called discounting to present value.
   1. Future value: FV = PV (1 + r)n
   2. Present value: PV = FV / (1 + r)n
   3. r = interest rate
   4. n = number of years
3. Rule of 72: an amount doubles within the number of years determined by dividing 72 by the interest rate. Thus, at 12 percent, compounded annually, $1 will be worth $2 in six years (72/12).
4. The present value of a series of amounts is called the capital value of the future receipts. Capital value is the current price of the rights to the stream (series) of receipts.

# **Noncash Benefits**

What matters is not the form that one’s income takes but rather the fact that the taxpayer has received an economic benefit.“Gross income includes income realized in any form, whether in money, property, or services.” **Regs. § 1.61-2(d)(1).**

## **Annuities & Retirement Plans – common law**

***Drescher v. U.S. (2ndCir. 1950)* –** where corporate employer (Bausch and Lamb optical) bought non-assignable retirement annuity contracts during 1939 and 1940 payable and deliverable when annuitant should reach age of 65 in 1958, and compensation was not reduced during years annuities were bought and annuitant had no election to receive in cash the amount paid, value of annuities were taxable as part of annuitant’s gross income for such.

1. The court found that the taxable amount may be less than the premium paid b/c although there were present economic benefits (right to receive income payment later and possible benefit from 3rd party contract), there was a decrease in value b/c the employer held the annuity.
2. The tax should be the value of the benefit received, not the premium paid.
3. **Take Away:**
   1. Does not have to be cash to be income, FMV of property received must be reported.
   2. Everyone admitted Drescher was going to have income. This case wasn’t really about whether he had income or not, it was about when he had income.
   3. Problems: liquidity, valuation (Clark’s dissent)
   4. Now the rules have changed to allow Drescher’s goal to be met:
      1. Qualified pension plans [NOT COVERING] – money invested, not income until taken out.
         1. Must comply with ERISA
         2. Must take out a certain amount at 70
      2. § 83 codifies *Drescher* and provides for non-qualified plans
      3. Individual Plans (IRAs, etc.)

## **§ 83. Property transferred in connection with performance of services (Non-Qualified Pension Plans)**

**(a)** States if you are performing services and property is being transferred to you, you must include in your income:

1. The fair market value **MINUS**
   1. “Determined without regard to any restriction other than a restriction which by its terms will never lapse” – ignore restrictions like how *Drescher* could not access the policy (so value will end up being value, in a way codifies the dissent).
   2. A non-lapse restriction would be if you leave employment you have to sell the stock (or property) back at a certain price. This restriction will be taken into account.
   3. Becomes income only when such property is transferable or is ***not subject to a substantial risk of forfeiture***, whichever occurs earlier.
      1. Not taxed until vested.
2. The amount (if any) paid for such property [BY THE EMPLOYEE].

**(b)** Allows the person to elect to either be taxed as above or without the “transferable or is not subject to a substantial risk of forfeiture requirement.

1. Only have 30 days after date of the transfer to make the election with the IRS.

**(h)** Requires the employer to deduct the amount equal to the amount included in the above sections in the same year the employee records it.

1. DOES NOT APPLY TO QUALIFIED PLANS

## **§ 119. Meals or Lodging**

Meals or lodging furnished for the convenience of the employer excluded from income of employee. Excluded from income if for the need or convenience of the employer, the value of meals and lodging is not income to the employee, even though it may relieve him of an expense which he would otherwise bear. It is the taxpayer contesting the inclusion in income that has the burden to prove that it is not income. ***Benaglia v. Commissioner (1937)*** *(hotel manager in HI lived in hotel and both the employee and employer did not record it as taxable income b/c it was “merely as a convenience to the hotels” of the employer).*

1. The court compared *Jones v. United States,* where the amount received as commutation of quarters by an Army officer is not included in income. And *Tennant v. Smith* (English case), where a bank employee was required to live in the bank and this value could not be taxed.
2. **Dissent:** presents a contract of employment which clearly shows that the living quarters, meals, etc., furnished were understood to be compensation in addition to the cash salary. He believes the tax law is concerned with whether or not the taxpayer was financially benefitted.
3. **§ 119 was created after this in 1954.**

**§ 119 Requirements:** must be furnished on the business premises of the employer. Lodging must be REQUIRED.

1. Specifically addresses meals and lodging furnished by educational institutions.

**Reg. § 1.119-1(a)(2):** “Meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if such meals are furnished for a ***substantial non-compensatory business reason*** of the employer.” Cannot be solely for a compensatory reason (pay them less but give them food). But having a compensatory reason alone is not enough to take away the exclusion.

1. **(ii)(a)-(f):** lists examples. On emergency call; only allowed short meal period with no options to get food quickly; employee cannot otherwise secure proper meals – oil drilling rig; food service employee before, during, or after shift; employees such as non-nurses b/c most of the nurses are on call – more than half now

**Judicial interpretation regarding the following:**

1. **Meals:** 9th circuit states groceries is not included in “meals” while the 3rd circuit states it is included (also toilet tissue, soap, and other nonfood items).
2. **Furnished:** must be provided in-kind. The Supreme Court held meal allowance payments to state highway patrol troopers were not excludable under § 119 due to failure to satisfy the furnished requirement. The whole state was the business premises, so this requirement was met. *Commissioner v. Kowalski (1977).*
3. **Business Premises of the Employer:** circuits are split on what this constitutes for state police. For other businesses it depends on how close to the business. Exclusion for the “white house” and residences of the governors of states.
4. **Employee:** rules out self-employed persons, but a person can create a corporation to buy their own company including the asset of his house and require himself to live it in as manager of the farm. ***J. Grant Farms, Inc. v. Commissioner, T.C.M (1985).***

## **§ § 105, 106. Health Insurance Benefits**

**§ 105:** Amounts received under accident and health insurance for personal injuries or sickness included in gross income, with exceptions.

**§ 106:** Contributions through employer-provided coverage under an accident or health plan is not included in gross income of employee. Gross income does include employer-provided coverage for qualified long-term care services like flexible spending arrangements.

1. Employers are allowed to deduct the cost of medical insurance they buy for their employees and the benefits received by employees are excluded from their gross income. A similar rule excludes the value of medical services reimbursed directly by the employer under qualifying plans. The tax system essentially subsidizes (hugely) the health insurance industry by providing a subsidy that rises with tax rates (encourages people to “trade up” on health insurance).

## **§ 107. Religious Housing**

If a religious minister and the church pays for your housing, it is tax free. Does not include rental value of home or rental allowance as long as it does not exceed the fair market value.

## **§ 132. Fringe Benefits**

**(a)** Gross income shall not include any fringe benefit which qualifies as a:

1. **No-additional-cost service** – such as free seating for airline employees on flights that would have not otherwise sold out
2. **Qualified employee discount** – such as discounts for department store employees
   1. For first two, the employee must work in the line of business. **Reg. § 1.132-4**. And these do not apply to highly compensated employees if discriminated in favor of.
   2. If given discount more than profit, only taxed on amount greater than the limit.
3. **Working condition fringe** – things that would otherwise be a business deduction such as business use of company car, or a free magazine subscription related to work
4. ***De minimis* fringe** – such as sufficiently low value to make accounting for them “unreasonable or administratively impractical”
   1. Take into account the frequency with which similar fringes are provided to other employees.
   2. Reg. – at least 85% of the use of the copy machine is for business purposes, any personal use of the copying machine by particular employees is *de minimis*.
      1. Occasional cab fare, meal money, Christmas gifts, etc.
5. **Qualified transportation fringe** – such as employer-provided parking or mass transit passes
   1. Indexed for inflation.
6. **Qualified moving expense reimbursement,**
   1. If you would have obtained a deduction and your employer pays for it, you can ignore it and not report it as income. Must be moving to new work location a certain distance or more from your current location.
7. **Qualified retirement planning services.**
   1. If retirement planning counselors come in to the employer and offer services to employees.

**(j)(4)** **On-premises gym** – on premises, operated by employee, covers family.

**(h)** **“Family” coverage** – certain members of family are included as employees for purposes of (a)(1) & (2).

1. No-additional cost service & qualified employee discount.
2. Special interest legislation includes parents for air transportation.

**(i)** **Reciprocal agreements** – for purposes of no-additional cost services only, agreements can be made with similar companies (allowing an employee to fly on other airlines).

**(j)** **Non-discrimination rules** – for purposes of only no-additional cost service & qualified employee discount, an employer cannot discriminate on pay grade basis.

**(l) Section not to apply to fringe benefits expressly provided for elsewhere**.

**Employer gets deduction, employee ignores** (same as with other excluded fringe benefits)

**Notes:**

1. **Valuation (regulations):** describes rules for valuation of certain fringe benefits not excluded. Usually “fair market value” rather than the taxpayer’s lower subjective valuation. **Regs. §§ 1.61-21 & 1.132-1 to -8.**
2. **Frequent flyer credits:** a problem arose when people would use frequent flyer programs in business and use the credits for personal use (avoiding tax). However, the IRS “will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer’s business or official travel.” You do have to pay tax if you sell your miles though.
3. **Benefits from other than employer:** In the 7th circuit, if a person received sample books for a newspaper and then sold them for charity, they would have to pay tax on that income if they claimed a deduction for the donation. You would include it in income the year donated and claim the deduction.

## **§ 117. Tuition Reduction**

**(d).** Gross income does not include any qualified tuition reduction.

1. Should probably be in section 132, maybe Congress wanted to hide it.
2. Typically happens where a professor’s child gets to go to a college or university (undergrad) at the cost of the employer.
3. Reciprocal agreement allowed, discrimination rules apply, and includes “family.”

## **Other Exclusions**

**§ 129**: child/elder care

1. Shall not exceed $5,000 in a year (not indexed for inflation), excess shall be included in gross income in the year in which the dependent care services were provided, amount excluded shall not exceed earned income for employee or the lesser income of an individual who is married.
2. Eligibility Requirements: (1) separate written plan for exclusive benefit of the employee, (2) shall not discriminate, (3) eligibility determined by non-discriminatory classification system, (4) not more than 25% can be spent on principal shareholders or owners, (5) not required to be funded, (6) reasonable notification, and (7) amount paid/expenses incurred must be provided to employee.

**§ 127**: tuition assistance; $5,250 limit; does not have to relate to work; does not apply to family members.

1. Eligibility Requirements: (1) separate written plan for the exclusive benefit of the employee, (2) cannot be discriminatory, not including collective bargaining agreements, (3) not more than 5% can be spent on principal shareholders or owners, (4) cannot provide a monetary benefit as an alternative, (5) not required to be funded, and (6) reasonable notification to employees.

**§ 79** – group term life insurance; life insurance for benefit of family; only on premiums up to $50,000 per year.

**§ 137** – adoption assistance; if income gets too high, the exclusion falls away.

# **Tax Accounting**

## **Cash v. Accrual Method**

**Reg. § 1.451-1 General rule for taxable year of inclusion –** cash method v. accrual method.

1. Cash receipts and disbursements method: amount is includible in gross income when actually or constructively received.
2. Accrual method: amount is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.

**Reg. § 1.451-2 Constructive receipt of income –** income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. **Treas. Reg. § 1.451-2(a).**

1. A cash basis taxpayer cannot be deemed to have realized income at the time a promise to pay in the future is made (a check not cashable until the following year in return for wheat). The court found the contract was a bona fide arm’s-length transaction and petitioner did not have the right to demand the money for his wheat until the following year, even though he delivered it early. ***Amend v. Commissioner, T.C. (1949).***
   1. Difficult to square with *Pulsifer* and *Drescher* b/c in this case, Amend could actual sell the check (it is marketable).
   2. The IRS has aqcuised in this case.
2. Now, this sale of wheat would be an installment sale under section 453(b)(1), which only applies to sales of property. A party could opt out and be required to report the fair market value of the obligation to the buyer in the year received.
3. An accrual method taxpayer who opts out of the installment method is required to report the total amount payable rather than the fair market value.
4. Income is also not realized when an employee earns a large amount of commission in a year but enters an agreement with their employer so they will be paid fixed sums each year. They can include the fixed sum amount in each year separately. ***Commissioner v. Oates (7th Cir. 1953).***

**Economic-Benefit Theory:** an individual on the cash receipts and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the creditors. ***Pulsifer v. Commissioner, T.C. (1975) (citing E.T. Sproull, T.C. (1951).***

1. In this case, sweepstakes winnings submitted to an Irish court to be held for minors until they were 21 or a legal representative applied for the funds, was required to be recorded in that tax year under the economic-benefit theory.
2. The children were the taxpayers, but they did not constructively receive the money b/c they could not technically force their parents to do anything to make the money accessible.
3. Even if you have not received money, you may still be taxed.

**Capital Expenditures:** amounts spent for assets that have a useful life of more than a year. For example, if you buy something for $50,000, you record an annual deduction of an amount for each year the item is used.

**Annual Accounting:** the proper accounting for tax purposes is to deduct all expenses in year incurred and report all income in the year received. So you may end up deducting in a year where there is no income and receive no tax benefit and then have to pay taxes on the income in the subsequent year. Provisions of the code provide some relief.

## **§ 125. Cafeteria Plans**

A plan under which an employee may choose among a variety of noncash nontaxable benefits or may choose to take cash, which is taxable. This section expressly authorizes this, but limits the fringe benefits that can be included in a cafeteria plan and imposes a nondiscrimination rule. There is also a use-it-or-lose-it-rule. Alleviated constructive receipt problem.

**(d)** Cafeteria plan defined as “a written plan under which all participants are employees and the employees may choose between two or more benefits which may be cash or qualified benefits.”

**(f)** Qualified benefits means benefits other than 106(b), 117, 127, or 132, which leaves medical, childcare, adoption, group term life insurance.

1. But under 132(f)(4), a little separate cafeteria type plan can be had for transportation benefits.

# **Stock Options & Other Restricted Property**

**“Compensatory” or “Employee” Stock Options**

**Stock Options = Compensation:** Options that are granted in consideration of services to the employer, with the option of entitling the employee to buy a specified number of shares of the employer’s common stock at a specified price during or at the end of some defined period of time. The Supreme Court found this is “compensation for personal service” within the meaning of section 61 and therefore it is not excludable and must be taxed. ***Commissioner v. LoBue (1956).***

1. LoBue argued the company was just giving him a proprietary interest in the Corporation. The Supreme Court stated the only way this could be exempted is if it was a gift and the “company was not giving something away for nothing.”
2. Taxable gain realized when LoBue purchased the stock.
3. Taxable gain measured as of the time the options were exercised and not the time they were granted and valued by the difference between the option price and the market value of the shares.

## **Three Approaches of Taxation**

**Income upon receipt of the option:** a person is treated as if he received cash in year 1 in the amount of the option’s FMV and used this cash to buy the option. The employer can make a deduction of the same FMV price.

**[NOW THE LAW] Income upon exercise of the option:** no tax in year 1 and treated as receiving cash in year 5 when he exercises the option, in the amount of the difference between the stock price and the option exercise price at that time. The employer can make a deduction of this same amount.

**Gain recognized upon sale of the stock:** events of both year 1 and 5 are not taxable. Only when he sells the stock in year 10 does he have a taxable gain. However, the employer would never claim any deduction.

**Statutory Rules**

The *LoBue* court chose option two above, but this has largely been superseded by IRC §§ 422 and 83.

**§ 422** covers incentive stock options (ISOs) or qualified stock option. It applies the third approach above (capital gain upon sale of stock) to taxpayers that meet the statutory requirements.

1. Must retain the stock for at least two years after the grant and one year after receiving the stock under the option. 422(a)(1).
2. Option price cannot be less than the fair market value at the time the option is granted. 422(b)(4).
3. Must be pursuant to a plan that stockholders of the granting corporation approve. 422(b)(1).
4. Limit on value of stock covered by ISOs ($100K per employee per exercise year). 422(d).
5. Potential problems with alternative minimum tax (AMT). 56(b)(3).
   1. If you have an employee subject to this, they do not get the benefits of the ISO for purposes of the AMT. Sometimes exercising an ISO can make an employee subject to the AMT b/c it is required to be recorded for AMT but not regular tax purposes.
   2. So people subject to AMT cannot defer their tax as would be allowed under section 422.
6. No tax deduction for employer.
7. Essentially makes this elective and useless for really high-paid employees.

**§ 83** covers non-statutory stock options (already covered).

1. **(e)(3)** This section does not apply to “the transfer of an option without a readily ascertainable fair market value.” So section 83 does not apply to these employee stock options.
2. **Reg. 1.83-7** – no ascertainable value unless the option itself is actively traded on a market (most options state they cannot be traded)
3. **Reg**. **1.61-2** – basis (market value stock is trading for when purchased, not what they paid with the cheaper stock option) is subtracted when the stock is eventually sold.
4. **Employee moment & investor moment**

**Notes:** some may still argue for immediate inclusion of a stock option when granted, but claim it has zero value b/c the company is a long shot. This would allow them to essentially have a § 422 benefit of not being taxed until the stock is sold. However, Reg. § 1.83-87 provides that in many situations, an option’s fair market value will be treated as unascertainable and income will be included when the option is exercised.

**§ 409A:** enacted in 2004, if the exercise price is less than the fair market value of the underlying stock at the time the option is GRANTED, then in most cases, the employee will have to report ordinary income (and pay a penalty tax in addition to regular income tax) in the year in which the option is granted; and if the underlying stock’s value continues to increase, every year until the option is exercised or expires.

# **Imputed Income – Not Taxed**

**Definition:** when people use their own property or their own services to provide benefits directly to themselves or to members of their household.

**Property Other than Cash (horizontal equity):** rental value from an owner-occupied home.

1. A person who rents gets no deduction, but a person who owns receives a nontaxable return (until taxed upon sale). An incentive is created to own homes, but as more people own homes, the nontaxable rate of return will decrease.
2. There is even a tax advantage to borrow to buy a house b/c the interest on the loan is deductible. Property tax is deductible. And imputed income is nontaxable.
3. However, there is also an incentive for landlords, which could be argued to bring the rent price down and benefit renters.

**Services (vertical equity – one better off by doing things themselves, one worse off for purchasing):** the benefit of services that one performs for oneself (painting house yourself rather than working more hours to earn income to pay someone to do it) is imputed income and the failure to tax this benefit results in the same types of problems as above.

1. Principals of fairness and economic rationality are offended. This encourages a person to perform their own services, when performing their own job is more valued by society. There would be a $ per hour deadweight loss.
2. Problems arise when one parent stays home as a homemaker. There is an incentive for one parent to stay home even though their services may be more valuable to society by taking a job.
3. § 21 allows a credit for child and household care. § 129 allows a tax-free employer reimbursement for childcare expenses. § 125 allows employers to offer employees a choice between tax-free benefits and cash.

**Psychic Income & Leisure:** psychic income is managing to enjoy life at a certain degree. Two people may have the same psychic income but the cost of achieving similar happiness is greater for one than the other. Tax system taxes earnings but not the benefit of the leisure that one “buys” not working.

**Consumption Tax**

1. Unrealized gain is not taxable b/c in a way, it has been reinvested in the same property. If this was included in taxation, it would be a tax on consumption: Y = C + S (Haig-Simons) where Y is income, C is consumption, and S is saving (investment).
2. C = Y – S
3. The goal is to tax “ability to pay,” and wealth may seem the most appropriate measure. However, taxing wealth penalizes saving, which is why the income tax is an intermediate between a wealth tax and a consumption tax.

**Imputed Income – Barter Exchange**

1. **Rev. Rul. 79-24**
2. **Regs. § 1.61-2(d)(1)** provides that if services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income.
3. **IRC § 6045** requires information reporting by any “barter exchange,” which does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.” **Regs. § 1.6045-1(a)(4).** Ex. babysitting exchange.
4. Credits earned in a barter club are also taxable.

# **Windfalls**

**Punitive Damages**

Punitive damages are included in “income” b/c “Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature.” “It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury.” ***Commissioner v. Glenshaw Glass Co. (1955).***

1. ***“Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”*** – The closest definition of gross income.
2. This case is significant also b/c the Supreme Court was essentially saying it is up to Congress, not them and the statute is broad. The court found contrary to both the lower courts.

## **Gifts**

**§ 102:** Gifts are excluded from gross income.

1. “Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.”
2. No limit for purposes of income tax.

**In Business:** It becomes a problem in business circumstances. The Supreme Court found “a gift in the statutory sense proceeds from a detached and disinterested generosity out of affection, respect, admiration, charity or like impulses.” “What controls is the intention with which payment, however voluntary, has been made.” And there “must be an objective inquiry as to whether what is called a gift amounts to it in reality.” ***Commissioner v. Duberstein (1960).***

1. **Case 1 Facts:** two businesses, one gave helpful information to the other. In return, the other business gave him a Cadillac. The Tax Ct. found it was not a gift, the 6th Cir. Reversed and the Supreme Ct. reversed the appellate court, deferring to the Tax Ct. NOT a gift.
2. **Case 2 Facts:** a man resigned and was given a money bonus, but the church employer termed it as a gift. The Dist. Ct. found it was a gift, the 2nd Cir. Reversed, the Supreme Ct. remanded b/c the Dist. Ct. did not explain themselves, and then they found it was a gift again.
3. Conclusions on these issues must give primary weight to the trier of fact. The standard of review for jury determinations is whether it cannot be said that reasonable men could reach differing conclusions on the issue. The SOR for appellate courts is that the judge’s determination must stand unless “clearly erroneous.”

**§ 102(c)** was added after and categorically precludes gift treatment in the case of any transfer by an employer to an employee. However, there is a modest and carefully circumscribed exclusion for “employee achievement awards.”

1. **Proposed reg. 1.102-1.** The IRS will not pursue people who are children & employees.

**§** **274(b)** allows businesses to deduct as an ordinary and necessary business expense the first $25 of any business gift.

## **Other Gratuitous Transfers**

**Tips:** tips are includable in income on the theory that they are payments for services rendered. This includes marriage fees and gambling tips. Gambling tips (“tokes”) are taxable income b/c a form of compensation for services, especially where the tips are pooled and divided up each day. ***Olk v. United States (9th Cir. 1976).***

**Prizes:** included in gross income. **§ 74.**

1. **§ 74(b). Exception.** Prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if (1) did not enter themselves, (2) not required to provide future services, and (3) must be transferred by the payor to a governmental unit pursuant to a designation made by the recipient.
2. **§ 74(c).** Connects to **§ 274(j) (employee achievement award).** Gross income does not include tangible personal property, but there is a max dollar amount.

**Awards, Scholarships, and Fellowships:** included in income for individuals who are candidates for a degree, with some exceptions. Only excludes the portion that pays for tuition, fees, books, and supplies and equipment. **§ 117.**

1. This does not apply to individuals who have to perform services to keep the scholarship. **§ 117(c).**

**Welfare:** is not income under **§** **61**. However, unemployment payments are income and includable under **§** **85**.

**Social Security:** **§** **86** excludes it when adjusted gross income is low but phases out the exclusion as gross income increases.

**Alimony:** alimony is deductible by the payor and taxable to the recipient. Child support and property settlement payments are not deductible to the payor and not income to the payee.

# **Appreciation & Realization**

## **Stock Dividends**

**CANNOT Tax:** the court found the Revenue Act of 1916 invalid under the Constitution and the 16th Amendment b/c Congress does not have the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by a Corporation. ***Eisner v. Macomber (1920).***

1. **Facts:** Macomber owned 2,200 shares of stock in Standard Oil Company. The company declared a 50% stock dividend, so she was to receive an extra 1,100. The value of each share fell so overall wealth did not increase.
2. 16th Amendment: “The Congress shall have power to lay and collect taxes on ***incomes, from whatever source derived (should not tax unrealized gain)*** without apportionment among the several States, and without regard to any census or enumeration.” [NOT GOOD LAW].
3. Normal money dividends are taxable.
4. From the company’s standpoint, the new stock has been transferred from surplus to capital, and no longer is available for actual distribution as money.
5. Not taxed until the stock is sold.
6. **The Government Arguments:**
   1. (1) The distribution of the stock dividend increased Macomber’s wealth;
      1. Typically issue stock dividends to reduce the price of shares to facilitate trading or provide shareholders tangible evidence of success.
   2. (2) The company’s accumulation of profits increased Macomber’s wealth and that part of that increase was realized through the distribution of the stock dividend;
   3. (3) The company’s accumulation of profits increased Macomber’s wealth and that the increase in wealth could be taxed at any time.

**§ 305(a):** “gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.”

1. **Limitations:**
   1. Stock dividends are taxable if the shareholder had the option to take cash or other property in lieu of that dividend. **§ 305(b)(1).**
   2. Other rules in this section cover situations in which the distribution results in some change in the nature of the shareholder’s initial investment or proportional interest.
2. **Regs. § 1.307-1(a).** The taxpayer’s total basis of the old shares is allocated between the old and the new shares in accordance with relative fair market values after the distribution of the stock dividend (total basis is allocated equally to all shares).

## **§ 1001(a)**

**Amount realized – adjusted basis = gain (loss).** Defers tax consequences of a gain or loss until the taxpayer “realized the gain or loss.” “The gain or loss from the sale or other disposition of property is the difference between the amount realized from the sale of disposition of the property and its adjusted base.”

1. **(b). Amount realized.** Money received or FMV of property received.
2. **§ 1011(a).** Basis is found in other sections, including § 1012.
3. **§ 1012(a).** Basis is the cost of such property.

***Cottage Savings Ass’n v. Commissioner (1991)*** – Under § 1001(a), an exchange of property gives rise to a realization event as long as the exchanged properties are “materially different.”

1. **Facts:** Cottage Savings owned loans, which suddenly decreased in value. Selling the loans and reporting the loss would put them out of business. The FHLBB issued memo R-49 to allow companies to not report losses associated with mortgages that are exchanged for “substantially identical” mortgages. CS virtually “sold” (exchanged 90%) of their mortgages for tax purposes without “selling” them for accounting purposes. The court found this exchange was a realization event (deductible) b/c the exchanged properties were “materially different.”
2. **“Sale or other disposition of property.**” “Except as otherwise provided . . . the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property ***differing materially*** either in kind or in extent, is treated as income or as loss sustained.” **Reg. § 1.1001-1.**
   1. **Materially Different:** properties are different in the sense that is material to the IRC so long as their respective possessors enjoy legal entitlements that are different in kind or extent.
      1. Different: transactions are realized where parties have shares of stock transferred from one company to another in a different state. *Phellis* and *Marr.*
      2. Same: transactions are not realized where parties have shares of stock transferred from one company to another in the same state. *Weiss.*

## **Transfer of Unrealized Gain by Gift while the Donor is Alive**

**§ 61(a)(3).** Gross income includes “gains from dealings in property.”

**§ 1001.** The amount of the gain is the “excess of the amount realized over the adjusted basis.

**§ 1012.** The adjusted basis is the “cost.”

**§ 1015.** There is an exception for property acquired by gift. The donee’s basis is the same as the donor’s basis. The donee takes a “transferred basis.” **§ 7701(a)(43).**

1. If the donor’s basis is less than the fair market value, the donee’s basis is not the transferred basis but becomes the fair market value at the time of the gift ONLY FOR A LOSS.
   1. Only applies to loss to prevent shifting losses to family members in higher tax brackets.
   2. This different rule for loss does not apply to spouses.
2. **Reg. § 1.1015-1(a)(2)** states there is no gain or loss if the stock is sold below the donor’s basis but above the fair market value at the time of the transfer.
3. The donor does not get a tax deduction when gifting a property that has depreciated.

**Transfer of Basis by Gift:** There is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property. ***Taft v. Bowers (1929).***

1. Where A purchased stock and gifted it to B after it increased in value, A’s basis transferred to B and B was taxed as if it were A who sold the stock.
2. “She accepted the gift with knowledge of the statute and, as to the property received, voluntarily assumed the position of her donor.” When sold, she received the original sum invested, so it should be taxed.
3. The issue here was whether to tax donors or donees essentially.

**Tax the Donor:** the transfer of appreciated property to a political organization is treated as a sale. **§ 84.** Where property is sold by the trust within two years of the transfer to it, it is taxed. **§ 644.**

**Adjustment for Gift Tax:** there is an upward adjustment of the donee’s basis to reflect any federal gift tax paid by the donor. For gifts made prior to 1977, it is for the amount of the entire gift tax. For post-1977 gifts, the adjustment is limited to the gift tax attributable to the net appreciation in the value of the gift property. **§ 1015(d).**

## **Transfers at Death**

**§ 1014.** The basis of property acquired by reason of death is the fair market value on the date of death or, at the election of the executor or administrator under § 2032 (estate tax section), on the optional valuation date (6 months after death).

1. The effect of this is to encourage people to hold onto appreciated property until death.
2. **(a)** Relieves from taxation income or gain that had not been realized at the time of decedent’s death.
3. This section does not apply if what you are getting is income in respect of decedent. For example, income accrued but never received. **§ 1014(c).**
4. People tried to avoid tax on appreciated property by gifting to dying relatives to move the basis to FMV when they died. This is not allowed, unless the dying relative retains the property for a year before death. **§ 1014(e).**

**Regs. § 1.61-2(d)(2):** property transferred to employee or independent contractor as compensation for services for an amount less than FMV, the difference between the amount paid for the property and the FMV is compensation and shall be included in gross income. In computing the gain or loss for the sale of such property the basis shall be what was paid.

1. If you work and get paid in widgets, you will pay tax (“tax cost”) and it will become the basis in that thing going forward.

**Adjusted Basis:** for example, in the *Macomber* case, the cost basis per share was adjusted downward to account for the new stock dividend.

## **Recovery of Capital**

**Easement Sale:** Income does not include returns or recoveries of one’s capital. The full amount of settlement damages/easement price is treated as a return of capital and applied in reduction of petitioner’s cost basis. There are essentially capital gains. ***Inaja Land Co. v. Commissioner (1947), acq.***

1. **Facts:** taxpayer buys land in CA for $61K. City of LA digs a tunnel nearby and began diverting water onto his property, which causes harm. He sues the city and settles for a $50K award, agreeing to free the city of any further liability and to give the city an easement. He pays $1K in legal fees to recoup this $50K.
2. **Easement was a sale:** $49,000 realized – adjusted basis ($49,000). This used basis is then subtracted from the original cost basis.
3. **Options:**
   1. Treat all as income.
   2. Allocate basis. Similar to partial sale (treat the $49K as income, but deduct $49K as his cost basis for the property).
   3. **No gain or loss. Reduce cost basis.**
      1. When later selling the property, his cost basis would be $61K-$49K ($12K).

**Regs. § 1.61-6(a):** “when a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part.”

1. If water property is purchased with no expectation of water rights, none of the original cost of the land is attributable to water rights later acquired.
2. If property is purchased with an expectation of water rights, but none are vested yet, some portion of the cost basis in the land is apportionable to the later sale of water rights b/c a purchaser paid a premium for the land with water rights. The cost basis should be equal to the premium paid (the difference between the premium paid and the cost of comparable land without the expectation of water rights), but the court remanded for this issue. ***Gladden v. Commissioner (9th Cir. 2001).***

## **Holders of Life or Terminable Interests**

***Irvin v. Gavit (1925)*** – decedent had trust, where income would be paid to son in law for 15 years and at the end of the term, the remainder (corpus) would go to granddaughter.

1. Result is codified in **§ 102(b)(2),** where it states only the principal of a gift or bequest is excludable from the income of the donee or heir, not trust income. The trust income to the life-tenant is taxed, but the remainderman is not taxed at all. If there were no trust payments, the trust itself would have been taxed.
2. Goal is to determine who gets the gift exclusion and who gets stuck with the taxable income.
3. Did not allow basis to be used against the trust income b/c there was no sale or transfer.

**§ 273. Holders of life or terminable interest:** No deduction given for holders of life or terminable interest acquired by gift, bequest, or inheritance.

**§ 1001(e):** can still not use basis even if he finds someone to buy his interest in the income.

1. This shall not apply to a sale or transaction where the life-tenant and remainderman both agree to sell the entire interest. Then basis may be used toward the entire thing.

## **Annuities & Pensions**

**Annuities:** vehicles by which individuals can invest their funds and achieve the substantial tax advantage of deferral of tax on their investments. A person pays a certain amount per year in return for being paid a certain larger amount at some later date.

1. Not taxed on the internal investments and increase in cash value of the annuity. Thus, a long term deferred annuity is like a bank account with tax avoidance.

**§ 72. Annuities**

1. **§ 72 (b)(1).** Adopts an “exclusion ratio,” which is applied to each payment received. The ratio is the investment in the contract divided by the expected return. This ratio of the payment is not taxed but the rest is.
2. **§ 72(c)(1).** “Investment in the contract” equals the premium paid minus any money taken out prior to the payments.
3. **§ 72(c)(3).** To determine the expected return (length of life), ask actuaries and see what typical life span would if at certain ages.
   1. **Reg.** **§ 1.72-9.** Actuary table V (age as of annuity starting date).
4. **§ 72(b)(3).** In final income tax return, if the entire amount of the investment is not recovered, she is entitled to a deduction for the portion of the investment not recovered.
5. **§ 72(b)(2).** If the entire amount of investment is recovered and they are still receiving payments, each payment is included in gross income. Only for annuities whose payments began after 1986.
   1. For pre-1986, no deduction if investment is not recovered and exclusion ratio applies as long as payments last.
6. **§ 72(e).** Money in surplus of premium paid taken out before payments begin are treated as income. Cannot pull money out and treat it as a loan, it is still just a withdrawal.
7. **§ 72(q).** Penalty if taking money out before retirement age of 59. Equal to 10 percent.

## **Life Insurance**

**Term Life Insurance –** pure gamble on life

**§ 101(a).** Excludes from income “amounts received . . . under a life insurance contract, if such amounts are paid by reason of the death of the insured.”

**§ 101(g).** Money may be paid before the insured person is dead if terminally ill [(g)(1)(A)] or chronically ill [(g)(1)(B)]. This money is still excluded from gross income.

1. **(g)(2) Viatical Settlements:** selling a life insurance policy of a person who is near death. These companies buy the policy, pay the family something less than the amount of the policy and then makes a profit when the insurance pays. This money is also excluded from gross income.
2. **(a)(2).** The policy buyer/transferee is taxed when the insurance pays.

**§ 101(c).** Any interest paid by the insurance company is taxable as gross income.

**“Whole-Life” Insurance**

Term insurance PLUS investment contract. Essentially just charging higher premiums to make a larger investment outcome upon death.

**Ex.** Pay $3,500/year 🡪 insurance company puts $1,200 towards regular term coverage and $2,300 in another account for investment with a cash value.

1. How to tax cash investment? – not like a bank account; taxed only when money is taken out.
2. If you take money out before the predicted death date, determine amount “invested” (not total premiums paid), then determine amount of the cash value at time of taking out, and basis is withdrawn first.
3. Payments not taxable unless withdrawal is greater than the investment in contract (includes all premiums paid).
4. Near death, you can swap insurance policies and not be taxed on any income above the basis.

## **Gains & Losses from Gambling**

**§ 165(d).** All gains are taxable, but losses are deductible only to the extent of gains from the same taxable year.

1. Record losses for each day to account for at the end of the year.
2. For large transactions, the payor is required to withhold taxes at a rate of 20%. **§ 3402(q).** In general, the payor only has to report to the IRS for amounts over $600 but a taxpayer still has to report amounts under $600 themselves.

# **[Annual] Tax Accounting Problems**

**Net Operating Loss**

If a taxpayer suffers as a result of the fact that losses do not match gains in the same year, it is just tough luck for them. ***Burnet v. Sanford & Brooks Co. (1931)***

1. **Facts:** taxpayer had major losses one year and later tried to state his earnings in a following year (from a lawsuit with interest) were like a return of capital from the losses in the previous year but the court did not allow it. 1913 – net loss; 1914 – net profit; 1915 – net loss; 1916 – net loss; 1920 – lawsuit wins $176,000 recovery of net losses, plus $16,000 interest.

**§ 172.** The harshness of annual accounting is mitigated by this provision, which allows net operating loss carryovers. The period is usually two years back and twenty years forward. You get a deduction in the year of profit by carrying the profit back to years where there was loss (by filing amended return).

1. With carryback, you go two years back and apply as much of the deduction as possible, and then move to next year.
2. 172(b)(3) can make election to only go forward without going back.

## **The Tax Benefit Rule**

Where the taxpayer claims a deduction in an earlier year, and then in a later year the deducted amount is in some sense recovered or regained. For example, where the taxpayer made a deduction for a charitable gift to be used for religious or educational purposes. When she received it back 20 years later, the gain was held to generate taxable income in the amount of the value of the property the year when it was returned (but limited to the amount of the deduction no matter what – whether it gained or lost value) rather than in the amount of the earlier deduction. The basis will probably stay the same also. ***Alice Phelan Sullivan Corp. v. United States (Ct. C. 1967).***

1. The analysis is more difficult where the event that “matches” the earlier deduction is not a “recovery” of property in the most direct and literal sense. ***Hillsboro National Bank v. Commissioner (1983)*** (case #1 – *Hillsboro* – deducted state taxes and then got them back; case #2 – *Bliss Dairy* – deducted cattle feed but then later liquidated it and distributed assets).

**§ 111:** if there was no tax benefit in the first place, nothing needs to be recognized when the property is returned. If a deduction did not reduce the taxpayer’s liability for any year and loss carryovers resulting from it have expired, the recovery of the amount deducted does not have to be included in income.

## **Claim of Right Doctrine**

“If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.” ***North American Oil Consolidated v. Burnet (1932)***.

1. The court viewed the receiver, appointed in 1916, as a custodian of funds and not as a substitute operator of the business so he did not have to file a return for the taxpayer. Thus, the company did not have income until 1917 when the receiver delivered the money, even though they were still in suit with the government. The court rejected the argument that there was income only in 1922 when the litigation finally ended.

**§ 446:** Taxable income shall be computed under the method of accounting which the taxpayer usually uses. **§ 446(a).** There is an exception where the method used by the taxpayer “does not clearly reflect income,” such as in the case above. **§ 446(b).**

**Amended Returns:** may be filed only to correct mistakes about facts that were, or reasonably should have been, known before the end of the year. However, where an employee received a bonus for $22,000 and it was later determined he had to give back $11,000 to his employer, he could not file an amended return. He had to include $22,000 in the year he received it and $11,000 as a deduction when he lost it. ***United States v. Lewis (1951).***

1. **§ 1341.** Congress made this section in response. It takes the same position, but provides that if the deduction exceeds $3,000, the tax is the lesser of the amount determined by claiming a deduction in the ordinary manner or by foregoing the deduction and claiming a credit in the year of repayment for the tax that would have been saved by excluding the item in the earlier year.
   1. This section only applies to amounts that were held under a “semblance” of a right.

**Recovery of Loss:** as long as a taxpayer does not take a deduction in a prior year for a loss, the amount received by him in the taxable year, by way of recompense, is not then included in gross income. ***Clark v. Commissioner, acq. (1939)*** (taxpayer paid too much tax, accountant gave him money as recompense for his mistake, and the taxpayer was not taxed on that repayment).

1. **Reg. § 1-61-14** describes additional items that are included in gross income including when other people pay your taxes for you. However, this case is different b/c it is similar to tax return money.

# **Recoveries for Personal & Business Injuries**

## **Basic Rules**

**What do the damages replace?**

1. If they replace income, it’s income;
2. If they replace gift, then it’s a gift;
3. If they replace property, it’s treated as a sale of property **§ 1001;**
4. if restore damage to property, it’s treated as return of basis – *Inaja Land*;
   1. Taxable to the extent it exceeds the basis of the property. However, a taxpayer may defer taxation provided the amounts are reinvested in similar or related in use. **§ 1033.**
5. If they replace nothing, it’s income *Glenshaw Glass*

## **Personal Injury Exception**

**§ 104(a)(2).** Awards (or settlements or insurance proceeds) are generally tax-free provided the payment is attributable to a personal injury. “Personal physical injuries or physical sickness.”

1. Personal physical injuries or physical sickness.
   1. Includes wrongful death
   2. If no physical injury (emotional distress), no exclusion
      1. Exception: reimbursement for medical expenses (psychiatrist)
   3. If physical injury, damages for resulting emotional distress also excluded
      1. But not damages for harm to property
   4. However, ***punitive damages*** arising from personal physical injuries or sickness are taxed.
2. Excluded as income both as a judgment or settlement.
3. If a deduction was taken under the tax benefit rule under § 213 for ***medical expenses***, it will be included in gross income.
4. **§ 104(a)(1).** Excludes workers’ compensation.
5. This benefit really does benefit insurance companies also.

## **Deferred Payments & Structured Settlements**

**§ 104(a)(2).** Also states “and whether as a lump sum or periodic payments, [it is excluded from income]. This effect of this is that a tort victim may choose to take periodic payments and earn interest and not be taxed on it when they otherwise would have if they took a lump sum and invested it. This is an intentional incentive.

1. A defendant could also buy an annuity plan in case they go bankrupt and cannot pay the payments. These annuity payments would also not be taxed.

## **Medical Expenses & Other Recoveries & Benefits**

**§ 104(a)(3).** Recoveries under an individual’s medical insurance policy are excluded, even if those recoveries exceed the cost of medical care.

**§ 104(a)(3).** Recoveries under disability insurance policies financed by taxpayer are excluded, but the premiums are not deductible.

## **§ 139F – wrongful incarceration**

Not in our books, but a new code section for exclusion of damages. “In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal manner) relating to the incarceration of such individual for the covered offense for which such individual was convicted.”

1. Appears to exclude even punitive damages, if even possible.

# **Debt**

Not income b/c there is an obligation to pay it back. No accession to wealth. When the debt is paid back, it is coming from income. No deduction for principal on the loan, maybe deduction for interest paid.

## **Cancellation of Debt Income**

Corporation issued bonds in return for $12 million, interests went up, they paid back part of the loan so $1 million of the IOU went away, but for less pay back (lenders would want this so they could take some money and make more interest on it loaning it to someone else). However, Congress would have expected them to pay back the $ 1 million, not less. So the difference between the amount paid and the amount they should have paid is income. ***Kirby Lumber.***

**§ 61** expressly includes this as income.

**Many Exceptions:**

1. **Discharge as Gift:** where debt is discharged as a gift to the debtor, it is not income. This would come up more often in family circumstances, but not always.
2. **Seller Financed:** buy with store credit card and pay back over time and promises the product is sold at the lowest price, or a certain quality. If there is then another lower price found, the discharge of that debt to make it the lowest price is not income. **§ 108(e)(5)** creates this exclusion and takes it out of the basis (as if the original sale price was lower).
3. **Bankruptcy:** Gross income does not include discharged debt in title 11 bankruptcy. **§ 108(a)**
4. **Insolvency:** Gross income does not include debt when the taxpayer is insolvent – sum of debts greater than sum of assets. You could go into bankruptcy, but this encourages people to work it out with the creditors and offer them something to discharge the debt. **[§ 108(d)(3)]. § 108(a)(2).**
5. **Student Loans:** if discharged by working in public sector for a certain period of time, the discharge of student loans is not income. **§ 108(f).** No exclusion for other student loans.

**Tax Consequences for Exceptions (assumption of borrowed money used to purchase stuff):** if excluded under bankruptcy or insolvency or farm, tax benefits are lost such as net operating losses – carryovers cannot be used, the basis of the property – left with a car or something and the basis gets reduced by the amount of debt (taxpayer can elect to go straight to this consequence), and others. **§ 108(b).**

**Exception for Disputed Debt:** If a taxpayer in good faith disputes the amount of a gambling debt, then the subsequent settlement of the debt does not amount to a discharge of debt. However, this taxpayer was insolvent, so the exception would have been applied. ***Zarin v. Commissioner.***

1. **Facts:** craps player borrowed $3.4 million from the casino and lost. There was a law that did not allow casinos to lend more than a certain amount. So the debtor argued the casino should not have continued the line of credit, and they settled for $500,000. The court stated chips are not property so it is not really debt. They also say maybe it was not debt b/c it was disputed.

## **Satisfaction of Debt with Property**

If satisfying a $1000 debt with a piece of property that has appreciated from $400 to $1000. The debtor would be taxed on the gain or loss ($600). This is b/c he should be taxed as if he sold the property to get the cash to pay the debt. This is not discharge of indebtedness income.

## **Transfer of Property Subject to Debt**

***Diedrich v. Commissioner (1982)* –** the Sup. Ct. held that a donor who makes a gift of property on condition that the donee pay the resulting gift tax receives taxable income to the extent that the gift tax paid by the donee exceeds the donor’s adjusted basis in the property transferred.

1. Income includes “income from discharge of indebtedness.” § 61. But not really a discharge of indebtedness, it is a part gift part sale. A sale of the gift tax and a gift of the rest.
2. When a gift is made, the gift tax liability falls on the donor. § 2502(c). Therefore, the donor became indebted to the government. If the donee agrees to pay the tax, the donor realizes an immediate economic benefit.
3. Rejected the argument that the donee is gifting back by paying the debt.
4. Gain = amount of the gift tax liability – donor’s adjusted basis.
5. When gift tax is paid, the basis is increased by part of the gift tax that was paid.
6. The donee gets a basis of the amount of the gift tax (the amount paid for the gift) + more b/c gift tax was paid.
7. **Regs. § 1.1001-1(e)** prevents the plaintiff from claiming a loss if the amount realized (gift tax) is less than the adjusted basis.

***Crane v. Commissioner (1947)*** – describes how a taxpayer who acquires depreciable property subject to an unassumed mortgage (not personally liable to pay), holds it for a period, and finally sells it still so encumbered, must compute the taxable gain. If nonrecourse mortgage is included in basis (b/c that is what it cost to purchase the property) it should be included in the amount realized also.

1. The basis is the value of the property, undiminished by mortgages. To adjust the basis, it should be reduced for deductions made for depreciation (allowed if the property is used in trade or business).
   1. FMV on death of husband [$262,000] – depreciation for renting apartment [$28,000] = $234,000.
2. The amount realized is the amount of the (assumable) mortgage upon sale plus cash received.
   1. Mortgage at sale [$255,000] + cash [$2,500] = $257,500
   2. This is not always allowed, most mortgages have a DOS (due on sale) clause.
3. Taxable [capital] Gain = $23,500 (only $21,000 accounted for from taking deductions for depreciation b/c she paid $7,000 on the principal)
   1. If the property is not depreciable, the amount realized – adjusted basis will be zero.
4. Essentially, an investor who purchases real estate on the basis of a nonrecourse mortgage can take depreciation in the same way as if the purchase was self-financed (creates a “tax shelter”).
5. **Recourse Mortgage:** does not change this analysis. The original borrower would only have an action against the party who assumed their mortgage.

***Commissioner v. Tufts (1983)*** – explains how much a person is taxed when they sell a property subject to a nonrecourse mortgage where the property FMV is less than the debt or give it back to the bank. The “amount realized” of property sold, subject to a nonrecourse mortgage, is still the full amount of the debt rather than the lower market value of the property. You get basis right away and can get deductions. There is no “discharge of indebtedness.”

1. **Facts:** partnership invested $40,000 and obtained nonrecourse mortgage for $1.85 million to construct an apartment complex. Over two years it deducted $440,000 for depreciation. The market went down b/c the town had layoffs and when it sold the property, the fair market value was less than the adjusted basis ($1.45 million).
2. The court found a taxable gain of $400,000. The partnership had an obligation to repay the full amount and when the obligation was relieved, they “realized value to that extent within the meaning of section 1001(b).”
3. The buyers cost is only equal to the FMV and not the value of the entire debt.
4. FN 37 (44) in Crane discussed this exact situation but suggested the opposite outcome (amount realized would be the lower fair market value, not the amount of the mortgage). Clearly, this footnote is not right. Barnett attempted to justify this as stating that this is the case, but there is an additional discharge of indebtedness income. This would apply if it was a recourse loan.

**Equity Loans:** you own the property but go get a mortgage against it. Doing this does not affect the basis in the original property, you just get a basis in whatever you use the mortgage money for. If you borrow against your home to improve it, the basis does increase. If the property was then sold, the amount realized still includes the debt.

1. Basis: $20,000 & FMV: $100,000. Equity Loan: $40,000. If the buyer takes over the mortgage, they would pay $60,000 cash and take over the mortgage. But the gain is still $80,000.

## **Illegal Income**

Illegal income is gross income.

**In the Nature of a Loan:** where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does not realize income on the withdrawals. The funds were not “without restriction as to their disposition.” ***Gilbert v. Commissioner (2nd Cir. 1977).***

**Embezzlers:** embezzled funds can constitute taxable income to the embezzler. “Taxed like a thief rather than a borrower.” The money is without restriction as to their disposition until there is an obligation to repay. ***James v. United States (1961).***

# **Statutory Non-Recognition Provisions**

**§ 1001(c):** “***Except as otherwise provided*** in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.”

**Purpose:** should not recognize b/c (1) if no cash is generated to pay the tax; (2) valuation problems; (3) nature of investment does not change; and (4) to avoid discouraging mobility of capital to more valuable uses.

## **Like-Kind Exchanges -** § 1031

**Analysis:** (1) figure out gain or loss, (2) determine whether it would be recognized gain or loss, and (3) determine the basis of the new property.

**§ 1031(a).** Provides that gain or loss will not be recognized if business property (other than inventory) or investment property (other than stocks and bonds) is exchanged for other business or investment property of like kind. Requirements:

1. Taxpayer is giving up property held for use in trade/business or for investment
   1. Not personal-use assets
   2. Not property held for sale (inventory, dealer property)
   3. Not stocks, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership, certificates of trust or beneficial interests, or choses in action (Such as *Cottage Savings*).
2. Taxpayer is receiving property held for use in trade/business or for investment
3. Exchange (not sale, purchase)
4. Properties given up/received are of “like kind”
   1. **Regs. § 1.1031(a)-1(b)&(c)** defines “like kind” to have reference to the “nature or character” and not the “grade or quality.” Broad allowance for things like old car for new or city land for a ranch. Basically all real estate is alike. **Regs. § 1.1031(a)-2(b)(2)** lists general asset classes for other non-real property. There is also a North American Industry Classification System that you could refer to. Not as crazy as real estate (trains are not like planes, etc.).
   2. Both parties do not have to satisfy this, just our taxpayer. One party can use 1031 while the other may not.

**§ 1031(b).** Gain from exchanges not solely in kind (exchange of like kind property & boot).

1. Does not prohibit the receipt of cash “boot” in connection with a like-kind exchange, but gains (not losses) are recognized to the extent of the cash.
2. Taxed on the amount of the boot, while the rest is exchanged without recognition.
3. **If boot is not cash:** must determine the new basis for both the new property and the boot property. New basis for both property & boot = old basis - $ received [ONLY MONEY] + gain recognized [FMV of boot]. Property for just boot = FMV on transfer.
4. **If boot is a taking over a mortgage:** amount realized = FMV (which includes mortgage) – basis. Recognized = amount of mortgage.

**§ 1031(d).** Explains that the basis transfers so that the basis of the new exchanged property takes the basis of the old. If there is boot received, the basis decreased by the FMV received and increased by the gain recognized (sometimes results in cancelling out). A FMV is attributed to boot that is not cash.

1. The gain, IF ANY, will be recognized. But you cannot have less gain than recognized. The recognized gain is the realized gain or the FMV of the boot.
2. Regs. § 1.1032(d)-1(a) states that if boot is paid, the amount of the boot is added to the basis of that person’s new exchanged property.

**3 Way Exchanges:** typically does not happen with just two people, more common with three. One party wants to exchange property without a gain, one party has money and wants the property, and a third party has a property and just wants money.

1. Party with money buys the one property and exchanges it with the first party. Because he just bought it there would be no gain so he does not care about buying and selling quickly.
2. Exchange properties and then party that wants money sells.
3. **Starker Exchange:** Starker had timber property and someone wanted to pay cash for it. Timber company was in a hurry so he conveyed the property in exchange for the promise to have a property of his choice in the future.
   1. **§ 1031(a)(3).** A “deferred exchange” will qualify for non-recognition if the replacement property is identified within 45 days of the date on which the party transfers his own property, and if the replacement property is received within 180 days after the transfer or before the due date of the taxpayer’s return. The money must be kept in escrow, it cannot be received.

## **Involuntary Conversions -** § 1033

**§ 1033.** Provides for non-recognition where property is compulsorily or involuntarily converted by theft, destruction, or condemnation and is replaced with property that is “similar or related in service or use.”

1. “Similar or related” means like-kind if eligible for like-kind exchanges. So if real property is lost, you could purchase a wide variety of real estate to replace it (burned down bowling alley could be exchanged for pool hall).
2. Taxed on amount left over after purchasing replacement property and the basis transfers.
3. Must purchase new property within 2 years (or IRS extension) from date of conversion or threat.

**Sale-and-leaseback:** there is no exchange of like property – a fee interest for a long-term lease – where a party sells property and then leases it from the purchaser. So the seller can take a deduction for the sale of the property. ***Jordan Marsh Co. v. Commissioner*** (the taxpayer sold a department store and real estate for $2.3 million and then entered into a 30 year lease. He could take the deduction but keep using the land).

## **Sale of a Personal Residence -** § 121

**§ 121.** This creates a tax incentive to sell one’s home and purchase a similar replacement home in order to obtain a ***tax-free step-up in the basis***.

1. Taxpayer’s principal residence for 2 out of 5 years preceding sale.
2. $250,000/$500,000 gain limit (two individuals can claim $250,000 each if they both own the house and file separately).
3. No basis consequences, get a step-up.
4. No reinvestment requirement.
5. Two-year waiting period between uses of exclusion.
6. Exclusion reduced if taxpayer owned home before moving into it as principal residence (period of non-qualified use cannot exceed period of proper use).
   1. Non-qualified is when not used as principal residence, but does not include (1) time after done using it as principal residence (renting it out after moving out); (2) time spent away for official duty; or (3) change of employment, health conditions, or other unforeseen circumstances.

## **Transfers Incident to a Divorce or Separation Agreement**

**Separation Settlement:** the transfer of property pursuant to a settlement and separation agreement before marriage was taxable b/c it was a realization event. The property received by the husband was the release of the wife’s marital rights. The value of this is equal to the property it was exchanged for. Therefore the husband is taxed on the FMV of the property (-basis) he gave in return for the rights (he gave stock that had appreciated). The wife is not taxed and the basis of the property becomes the FMV of the property at the time of transfer. ***United States v. Davis (1962) [Separate Property State].***

**§ 1041:** now provides that no gain or loses shall be recognized on transfers of property between spouses **OR** former spouses incident to divorce.

1. The property transferred has a substituted basis in the hands of the transferee.
2. Even applies to sales between spouses.
3. Alimony or child support not covered.

**Prenuptial Agreements:** same as Davis but before the marriage. The taxpayer ex-wife sold certain shares of stock which she had previously received from her husband-to-be pursuant to an ante-nuptial agreement. Under that agreement the taxpayer, in consideration for the shares, had surrendered all marital property rights. The stock had a basis of 15 cents a share, and a FMV of $10 a share when transferred to the wife. The commissioner argued it was a gift so the wife’s basis should be $15 cents. The court found her basis to be $10 b/c this was an exchange of valuable property interests – stock for marital property rights. He should have been taxed when he “sold” the stock. ***Farid-Es-Sultaneh v. Commissioner (2d Cir. 1947).***

1. **§ 1041** may not change this result b/c it applies to “spouses.” Plan the property transfers to occur after the wedding.

# **Timing Issues Continued**

## **Taxing IOUs**

**Three Approaches**

1. Open transaction - basis first rule;
2. Closed (accrual) - present value taxed as if received;
3. Closed (cash) - **§ 1001(b) -** the current rule that if the FMV received in exchange can be ascertained, the FMV must be reported as the amount realized. But not if it is not ascertainable; OR
4. Installment – allocate basis to each payment received.

## **Open Transactions – basis first**

The notion that where the total value of the consideration to be received by a taxpayer is sufficiently uncertain (not “equivalent to cash” b/c of “no ascertainable fair market value”) gain is not recognized until the payments actually received exceed basis. In addition, a mere promise to pay is not income. ***Burnet v. Logan (1931)*** *(the promise to make future payments should be ignored in the year promised and her entire basis could be recovered before reporting any gain. This taxpayer was paid cash for stock and a promise to pay depending on how much ore was taken from a mine).*

1. **Regs. § 1.1001-1(a).** “The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no FMV.” So this case will not happen again really.
2. In ***Warren Jones Co. v. Commissioner (9th Cir. 1975),*** sold building for $20K cash and IOU, but buyer had risky credit so FMV was much lower than the value of the IOU. However, they just valued the IOU at half of its face value. So even this had an ascertainable value.
3. The § 483 and OID rules ensure that the interest element in any deferred payment is treated as ordinary income rather than capital gain. Prior to this in *Burnet v. Logan,* the taxpayer was allowed to treat the income earned after exhaustion of basis as capital gain though.

## **Installments (§§ 453, 453A, and 453B) – Default method**

Permits non-recognition of gain in transactions involving the sale of property. First, the rules relating to unstated interest (§ 483) and OID are applied. The installment method applies to what remains.

**§ 453(b).** Defines “installment” as “a disposition of property where at least 1 payment is to be received after the close of the taxable year.”

1. Does not include dealers (selling to public all the time).
2. **§ 453(k)(2).** Does not include sales of publicly traded stock – treated as closed (accrual for all taxpayers).

**§ 453(c).** The taxpayer computes a ratio of gain to total expected payments and applies this ratio to each payment (allocates basis throughout future years). **GAIN = payment x (gross profit/total contract price).**

**§ 453(d).** The taxpayer is permitted to elect not to use the installment method and pay the tax in the beginning.

1. Regs. § 15a.453-1(c) (stated below) now apply for allocation of basis. A taxpayer could attempt to opt out of § 453 and argue it is an “open transaction,” but it is unlikely the IRS would agree.

**§ 453(e).** Closes a loophole by requiring a person to treat an amount as an amount realized if the property is later sold by a “related person” to prevent someone from selling to a family member for installments and have that family member sell to someone with their new adjusted basis.

1. **§ 267(b).** Defines a “related person.”

**§ 453(f).** Not available where the consideration is thought to be readily convertible into cash, such as demand notes and publicly tradable debt obligations. However, just b/c a promise to pay is guaranteed, does not mean it has to be treated as cash.

**453A.** Interest charge on deferred tax for large transactions.

**453B.** Disposition of note triggers deferred gain. Disposition includes gifting the note or selling it but death is not a disposition (no step up in basis though).

**Regs. § 15a.453-1(c).** Provides three solutions to determine how to allocate basis when the total consideration to be received is uncertain: (1) determine some maximum amount as the selling price, (2) determine some maximum period of time and allocate equally, and (3) basis is recovered in equal annual amounts over a period of 15 years.

## **Nonqualified Deferred Compensation**

Compensation whose receipt is deferred to a future taxable year.

**Qualified plans:** must be made available to all and are limited to amounts to be deferred.

1. Employee pension plans
2. “Keogh” (self-employed, partner) plans
3. IRAs – mostly for people without qualified plans or no other options. Anyone can do number 3 and it is similar to an annuity.

|  |  |  |
| --- | --- | --- |
| No. 1 | No. 2 | No. 3 |
| Contributions deductible | Contributions not deductible | Contributions not deductible |
| No current tax on earnings | No current tax on earnings | No current tax on earnings |
| Withdrawals included in income | Withdrawals excluded from income | Withdrawals partly included (§ 72) |
| “Traditional” IRC §§ 219 (deduction section), 408 | “Roth” § 408A  Education IRA §§ 529, 530 | “Non-deductible” IRC § 408 |

**Nonqualified plans:** do not limit the amount that can be deferred and are generally used for senior executives.

1. Cash basis employees do not have income when they will be paid later for their services. Even if it is placed in a trust, the employee is not taxed if the trust is subject to claims of the employer’s creditors, etc.
2. ***Minor v. United States (9th Cir. 1985)*** – A taxpayer is entitled to deferred tax obligations by participating in a non-qualified deferred compensation plan unless (1) he has constructive receipt or (2) economic benefit – must be capable of valuation, which must be non-forfeitable, fully vested, and secured against the employer’s creditors by a trust agreement.
   1. **Facts:** in this case, the taxpayer employee was allowed to defer taxation. He was a physician and was allowed to put money in a deferred compensation plan. The money was put in a trust, but his employer was the settlor and the beneficiary, and payment was contingent on working until retirement and not competing thereafter. The money was not taxable b/c (1) there was no constructive receipt, the government admitted as much, and (2) there was no economic benefit b/c it was forfeitable if he quit or competed, it was not fully vested until retirement, and it was not secured b/c he was not the beneficiary.
3. **§ 404(a)(5).** Typically, employers don’t want to do this b/c they cannot take a deduction until the employee receives the money. However, it does work where the employer is in a lower tax bracket than the employee (tax-exempt private university, non-profits, or sports teams).
4. **§ 409A.** Provides that amounts payable in the future are taxable when bargained for if the plan allows employees to accelerate benefits or provides that upon a deterioration of the employer’s financial health, assets are shielded from outside creditors. A response to Enron.

## **The Marriage Penalty**

**§ 1(f)(8).** Elimination of marriage penalty in 15 % bracket. Essentially doubling the size of the tax bracket for single people.

1. **Rev. Proc. 2015-53** describes the new tables.

***Poe v. Seaborn*** – the Sup. Ct. held that a married person’s income may be divided with his spouse in a community property state because by operation of state law, the income earned by one spouse is immediately the one half the property of the other spouse. Congress made the tax rates and joint return in response to community property states.

# **Deductions**

**Formula:** Gross Income [§ 61] – ***above the line deductions*** [§ 62(a)] = adjusted gross income [§ 62] – ***below the line deductions*** [either the standard deduction § 63(c), or itemized deductions § 63(d)] AND deductions for personal exemptions [§ 151] = taxable income [§ 63] \* tax rate = tax - credits

1. Divided because many below the line deductions depend on how much AGI they have. Above the line deductions are available regardless of how much income a person has.

**Itemized Deductions:** available only to taxpayers who elect to itemize and file a Schedule A with their Form 1040. Typically elected only when their deductions exceeds the amount of the standard deduction, which varies with filing status. In addition, all taxpayers are entitled to a personal exemption deduction for themselves and for each of their dependents.

**§ 68. Phase-out provision for itemized deductions.** In 2004 required itemized deductions to be reduced by 3 percent of the excess of adjusted gross income over $142,700. For example, if gross income was $192,700, 3% of $50,000 would be $1,500. Effectively creates a marginal tax rate increase. Medical expenses, casualty losses, and investment interest are exempt from this provision.

# **Personal Deductions**

**Types of Personal Deductions:** (1) involuntary and unexpected outlays which are large enough to exhaust a significant proportion of a taxpayer’s annual income, (2) outlays which Congress wishes to encourage and subsidize, and (3) state and local taxes.

## **Personal & Dependency Deductions – BELOW THE LINE**

**§ 151(a).** Grants each taxpayer a deduction for a personal exemption.

**§ 151(b).** Exemption for taxpayer & spouse (if no joint return is filed and the spouse has zero income).

**§ 151(c).** Grants an exemption for each “dependent,” as defined in § 152.

1. **Qualifying Child – does not depend on who is supporting the child:**
   1. (1) A child, child’s descendent, or a sibling (or descendent of them);
   2. (2) Younger than taxpayer and less than 19 or, if a student, less than 24;
   3. (3) Has not provided more than half of his or her own support; AND
   4. (4) “Has the same principal place of abode as the taxpayer for more than one-half of the taxable year” – does not include time away for medical care or education.
   5. If no joint return filed, treated as qualifying child of the parent with whom they resided longer or the parent with the higher AGI if in the same household.
   6. If multiple people can take the qualifying child, they can choose who should take it. If you cannot agree, then 152(c)(4) comes into play.
2. **Qualifying Relative:**
   1. (1) Child or a child’s descendent, parent or parent’s ancestor, sibling, aunt, uncle, cousin, or in-law, or “has the same principal place of abode as the taxpayer and is a member of the taxpayer’s household,”
   2. (2) Has a gross income less than the exemption amount,
   3. (3) ***Receives more than half his or her support from the taxpayer***, AND
   4. (4) Is not a qualifying child of the taxpayer.

**§ 151(d)(2).** If someone else can take you as a deduction, you CANNOT take yourself. If the deduction is “allowable” your exemption amount is zero.

**§ 151(d)(3).** Total exemptions are reduced by 2% for each $2,500 by which the taxpayer’s adjusted gross income exceeds the “threshold amount.” Effectively increases the marginal tax rate as income increases.

**§ 151(d)(4).** Adjusted for inflation.

**§ 151(e)(2).** Deduction goes with custodial parent, unless agreed otherwise. So who takes the deduction should be discussed during divorce proceedings.

**AMT:** no personal exemptions.

## **§ 24 Child Tax Credit**

**§ 24(a).** Allows a $1000 credit against tax for each child under the age of 17 at the close of the taxable year. Child is defined above in § 152. The credit is refundable in limited circumstances.

**§ 24(b).** The credit begins to phase out when the taxpayers’ adjusted gross income reaches the “threshold amount.” The allowable credit is reduced by $50 for each $1000 of adjusted gross income above the threshold ($110K for married, $75K for single).

# **Itemize or Not**

## **§ 63 Taxable Income Defined . . . Again**

**Itemize = can take all deductions (except standard deduction). Better to itemize if you can keep track of it all. It becomes more important when people buy a house.**

**§ 63(a).** The term taxable income means gross income minus the deductions allowed by this chapter (***other than the standard deduction***).

1. Below the line deductions are called itemized deductions and subject to limitations in **§ 68.**
2. Can lose up to 80%.

**Don’t itemize = above the line deductions & can take only the following below the line deductions (standard deduction & personal exemption). Option to keep it simple. Deduction for dependent is decreased.**

**§ 63(b).** In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term taxable income means AGI, minus

1. The standard deduction, AND
2. The deduction for personal exemptions provided in section 151.

**§ 63(c).** Standard deduction – for purposes of this subtitle –

1. In general – except as otherwise provided in this subsection, the term standard deduction means the sum of –
   1. The basic standard deduction, AND
   2. The additional standard deduction.
2. Basic standard deduction – for purposes of paragraph (1), the basic standard deduction is –
   1. 200 percent of the dollar amount in effect under subparagraph (C) for the taxable year in the case of –
      1. A joint return, OR
      2. A surviving spouse.
   2. $4,400 in the case of a head of household, OR
   3. $3,000 in any other case.

**§ 63(c)(4).** Adjusted for inflation ($6,300 or $12,600). So only start itemizing when below the line deductions are greater than this.

**§ 63(c)(5) Limitation on dependent deduction.** If a deduction is allowable for a dependent, it shall not exceed the greater of –

1. $500, OR
2. The sum of $250 and such individual’s earned income.

# **Casualty Losses**

## **§ 165 Losses – below the line**

**§ 165(a).** There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

1. Seems to be broad and encompassing all section 1001 losses, but it is limited for individuals, as seen below.

**§ 165(c).** In the case of an individual, the deduction shall be limited to –

1. Losses incurred in a trade or business.
2. Losses incurred in any transaction entered into for profit, though not connected with a trade or business; AND
3. Allows a deduction for losses from “fire, storm, shipwreck, or other casualty, or from theft.”
   1. Limited to losses that exceed in the aggregate, for the year, 10% of adjusted gross income, after reduction by a $100 floor for each individual loss **[(h)(1)].** This prevents many from being able to take a deduction.

**§ 165(h)(4)(E).** Deductions for losses covered by insurance are allowed only if a timely claim was filed.

**Below the Line.** But losses from sale or exchange of property are included in section 62 and are above the line.

**Casualty Loss:**

1. The loss must occur “with the suddenness comparable to that cause by fire, storm, or shipwreck.” In this case, the court found the destruction of a vase by a household cat’s “fit” was not a casualty loss. ***Dyer v. Commissioner (1961).*** Must be sudden, unexpected, unusual, and physical (added by *Chamales* below).
2. **Must be Physical:** the court found that where petitioners moved in next to O.J. Simpson, it did not constitute the type of damage contemplated by this section. However, b/c they acted reasonably and in good faith in the preparation of their tax return, no additional liability for the **§ 6662(a)** accuracy-related penalty was imposed. ***Chamales v. Commissioner.***
   1. **A casualty loss arises when: (1)** the nature of the occurrence precipitating the damage to the property must qualify as a casualty – press and media attention extending for months bears little similarity to a fire, storm, or shipwreck, and **(2)** the nature of the damage sustained must be such that it is deductible – the Ninth Circuit determined that only physical damage to or permanent abandonment of property is deductible. Contrastingly, the 11th Circuit determined that irreversible changes in the character of the neighborhood could constitute a casualty.
3. **Exception Against Public Policy:** a taxpayer may not take a deduction after setting fire to his wife’s clothes, which results in burning his house down (& no evidence that he tried to put it out before leaving). Deductions are disallowed where national or state public policies would be frustrated by the consequences of allowing the deduction. ***Blackman v. Commissioner (1987).***
   1. Conviction of a crime is not necessary to prove frustration of public policy. Negligence is not necessarily a bar to claiming a deduction but gross negligence is.
4. Does not include termite damage or dry rot. The courts are split on whether lost wedding rings are included (No deduction: lost in mud while hunting, flushed down toilet by husband accidentally; Deduction: husband put in garbage disposal accidentally, lost when husband slammed door on wife’s hand, and stone missing from setting).

**§ 6662(a) Penalty – DID NOT GO OVER**

1. Imposes an accuracy-related penalty in the amount of 20% of any underpayment that is attributable to negligence or disregard of rules or regulations. **§ 6662(a) & (b)(1).**
2. Negligence is “any failure to make a reasonable attempt to comply with the provisions of this title,” and “any disregard” is “any careless, reckless, or intentional disregard.” **§ 6662(c).**
3. **Exception:** “with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.” The taxpayer bears the burden. **§ 6662(c)(1).**
   1. Most important factor is the extent of the taxpayer’s effort to assess the taxpayer’s proper tax liability. **§ 1.6664-4(b)(1).**
   2. Relying on a profession requires showing (1) the accountant was supplied with correct information, and (2) the incorrect return was a result of the accountant’s error.

## **Extraordinary Medical Expenses – Below the line**

**§ 213(a).** Medical expenses are deductible to the extent that they exceed 10 percent of adjusted gross income (AGI) (only makes BIG medical expenses deductible).

1. Does not allow deductions for medical expenses paid by insurance.
2. Can only use if you itemize your deductions – below the line.

**§ 213(d).** Broad definition of medical care. Diagnosis, cure, mitigation, etc. of disease; affecting bodily structure or function; transportation; long-term care; health insurance premiums; prescription drugs or insulin; NOT cosmetic surgery; NO depreciation for medical equipment – can take the full deduction at once.

**“Medical Care”:**

1. Doctor recommended activities do not always constitute deductible medical expenses. For example, where the doctor told the taxpayer to not mow the lawn, he could not deduct the cost of hiring someone to do it. There was no evidence a family member could not do it or that he would have hired someone regardless of the doctor. ***Taylor v. Commissioner (1987).***
2. Childcare is not deductible where the wife is recovering from cancer and cannot provide the childcare services as usual. However, the dissent thought this was no different than if the wife was sent somewhere (deductible) rather than the children being sent to boarding school (not deductible). ***Ochs v. Commissioner (2d Cir. 1952).***
3. May or may not include lawyer’s fees and court fees, there are regulations concerning deductions for blind children, and deductions are allowed for home renovations for medical reasons to the extent they do not add value to the house.

## **§ 262 Personal, Living, and Family Expenses**

**(a)** No deduction shall be allowed for personal, living, or family expenses.

# **Charitable Contributions**

## **§ 170 Charitable Contributions & Gifts – BELOW THE LINE**

**§ 170(a)(1).** Allows individuals & corporations to claim as itemized deductions for charitable contributions as defined in (c). ***ONLY if verified*** under regulations prescribed by the Secretary – need to satisfy substantiation requirement in (f), BEFORE filing tax return.

1. Deduction = the difference between what you gave up – what you received in return but not swag of a nominal value (ex. charity auction).
2. Deduct FMV of property but (e) decreases this amount.

**§ 170(b). Ceiling Limits.**

1. **(1)** Contributions by Individuals
   1. **(A)** Can deduct up to 50% of AGI if donation is to a listed charity (churches, educational organizations, medical organizations, etc.)
   2. **(B)** Can deduct up to 30% of AGI to all other charities (Elks club types, cemetery companies)
2. **(2)** Contributions by corporations – limited to the extent such contributions do not exceed 10% of taxable income.

**§ 170(c).** **Defines “charitable contributions.”** Generally must operate on a nonprofit basis and none of their profits can “inure to the benefit of any private shareholder or individual.”

1. If an employee, cannot deduct time, but can deduct out of pocket expenses.
2. (2) for the use of a corporation, trust, or community chest, fund, or foundation
   1. Created in the U.S. – domestic organization;
   2. Operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster amateur sports, or for the prevention of cruelty to children or animals;
   3. Cannot inure to benefit of private shareholder or individual;
   4. No lobbying – most are a little bit, rules regarding this are under 501(c)(3)
   5. Donations BY corporations can only be deducted if within the U.S.
3. **No Deduction for Business Benefits:** no deduction is allowed if the benefits received, or expected to be received are substantial (“greater than those that inure to the general public from transfers for charitable purposes.”). In this case, the court did not allow the taxpayer a deduction when he donated his land for a high school to be built b/c there was proof he did so to have roads built so he could sell to a developer. There was evidence he could not have obtained those roads without the school making them through neighboring property. ***Ottawa Silica Co. v. United States (Fed. Cir. 1983).***
   1. The result is that the taxpayer can only allocate that basis to his other land.
4. **Charitable:** tax-exempt status is under §§ 170(c) & 501(c)(3) is not available to private schools that concededly are racially discriminatory b/c they are not “charitable” in the common law sense. To be entitled to tax-exempt status under § 501(c)(3), an organization must first fall within one of the categories specified by Congress, and in addition must serve a valid charitable purpose (serve a public purpose and not be contrary to established public policy). ***Bob Jones University v. United States (1983).***

**§ 170(d).** Requires excess donations to be carried over to the succeeding five years.

**§ 170(e). Contributions of ordinary income v. capital gain property. Lower of FMV or basis for**

1. Property other than property that produces capital gain if sold (ex. inventory – ordinary income).
   1. Long-term capital gain: amount allowed as a deduction is generally the full fair market value ($10K FMV of stock with basis of $1K, allowed $10K deduction). Limited to 30% of adjusted gross income or 20% if to a private foundation.
   2. Short-term capital gain or ordinary income: deduction limited to the basis in the property. Also limits on the value of tangible personal property.
2. Tangible personal property that charity doesn’t use in exempt function (ex. art that charity promptly sells instead of art hanging on wall).
3. Intellectual property (additional deduction allowed as charity earns income **(m)).** Section (m) is not great for donors b/c charity doesn’t want to deal with it.

**§ 170(f). Disallowance of deduction in certain cases and special rules – Includes SUBSTANTIATION REQURIEMENTS – need receipts, letter from charity, etc.**

1. **(12)** For vehicles, can only deduct what the charity sells the vehicle for.
2. **(16)** Deduction can only be taken for items in good use.
3. **Collegiate Athletics.** Allows a deduction for 80% of any amount paid to an institution of higher learning if the deduction would be allowable but for the fact the taxpayer receives the right to purchase tickets for seating at an athletic event.

# **Alimony, Child Support, and Property Settlements**

Alimony (and separate maintenance) is taxable to the payee and deductible by the payor, while child support and property settlements are not taxable to the payee and are not deductible by the payor.

## **§ 215. Alimony, etc., Payments – ABOVE THE LINE**

**§ 215(a).** A deduction is allowed for payments of alimony or pursuant to separate maintenance payments.

## **§ 71. Alimony and Separate Maintenance Payments**

**§ 71(a).** Alimony or separate maintenance payments are included in gross income.

**§ 71(b). Requirements.**

1. Must be in cash.
2. Must be a payment received by **or** on behalf of a spouse.
3. Under a divorce or separation instrument – a writing.
4. Must not have elected that the payment will be nontaxable to the payee and nondeductible by the payor – no election to have payment NOT be “alimony.”
5. Must not be members of the same household.
6. Payments cannot continue after the death of the payee spouse.

**§ 71(c). Must not be for child support – payor does not get deduction & not income to payee.**

1. **(c)(2).** If amount is disguised as alimony but will stop being paid when a child reaches a certain age or something, then the amount of decrease will be treated as child support.

**§ 71(f). Excess front-loading of alimony payments.** Provides that only payments that are substantially equal for the first three years will be treated as alimony. Excess is “recaptured” in the third year. Designed to deprive people the opportunity to convert property settlements into alimony (but a trust could be created).

**§ 1041. Property settlement does not get a deduction.**

# **Interest**

## **§ 163. Interest – ABOVE THE LINE**

**§ 163(a).** There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness (originally allowed deduction for interest on both business or personal loans – now restricted).

1. Business or investment income is allowed a deduction. Personal interest is deductible only if it is “qualified residence interest” or student loan interest.
2. NOT deductible: credit card, auto loans, personal lines of credit without home mortgage.

**§ 163(d). Limitation on investment interest.** Limits the deduction to investment interest to an amount not in excess of the taxpayer’s investment income, with disallowed amounts being carried forward to later years.

**§ 163(h). Home mortgage interest allowed as a deduction.**

1. (1) No deduction allowed for personal interest paid or accrued during the taxable year.
2. (2) Defines personal interest, excluding loans for trade or business, investment interest, section 469 interest, qualified residence interest, state tax interest, educational loan interest.
3. (3) Allows deductions for qualified residence interest, which includes:
   1. Acquisition indebtedness – debt incurred to buy, build, or improve a personal residence, and which is secured by the residence, limit of $1 million; OR
   2. Home equity indebtedness – any debt (without limitation as to the use of the proceeds) secured by a personal residence, limited to the lesser of $100,000 or the FMV of the residence minus the amount of any outstanding acquisition indebtedness.
4. (4) Qualified residence means principal residence AND one other residence chosen by the taxpayer – such as vacation home. Using two residences does not double the amount limits.

**Regs. § 1.163-8T(c).** Interest on a loan that is used for personal purposes is characterized as personal interest. It does not matter that it may be secured by business property.

**§ 221.** Allows a deduction for ***interest on indebtedness used to pay higher education expenses*** of the taxpayer, the taxpayer’s spouse, or a dependent of the taxpayer.

1. Limited to $2,500 in the whole year. And there is a phase out over a threshold level of income.

**Above the Line**

1. **Business Interest:** **§** 62(a)(1)
2. **Interest on Rentals:** **§** 62(a)(4)
3. **Student Loan Interest:** **§** 62(a)(17)
4. Other interest deductible below the line, or not at all.

# **Deductions for Taxes**

## **§ 164 SALT (state and local taxes) – BELOW THE LINE**

**§ 164(a).** A taxpayer may claim a deduction for certain taxes paid to state, local, and foreign governments. These taxes include real property taxes, personal property taxes, income taxes, and GST (general sales tax).

1. It is an itemized deduction and the deduction is not allowed for the alternative minimum tax.

**§ 164(b)(5).** Taxpayers may elect to deduct state and local general sales taxes in lieu of state and local income taxes IF in a state that provides both. For sales tax, can use an IRS table to estimate the amount instead of keeping track of it.

**§ 164(d).** Proration on sale of property for amount of property tax that needs to be paid. Buyer gets proration for having to take over the property tax for the year. In this section, whoever bears the burden of the tax gets to deduct it.

**NO Deduction EVER § 275:** for federal income taxes or federal estate and gift taxes.

**Below The Line:**

1. Deductible business taxes: **§ 62(a)(1)**
2. Deductible taxes on rentals: **§ 62(a)(4)**
3. Other taxes deducible below the line, or not at all.

# **Credits Based on Personal Circumstances**

## **§ 32 Earned Income Tax Credit (EITC)**

**§ 32(a).** A taxpayer is entitled to claim a credit equal to a specified percentage of “earned” income up to a certain level.

1. Earned income refers to income from personal services, not investment income.
2. It has become an important part of the federal system for relief of poverty.
3. The amount of the credit depends on the number of children. Must be 25 or have a child.
4. It is a “refundable credit” and results in payment from the government if credit exceeds tax liability.
5. Phased in over a certain income range and then phased out over a certain income level. Point of phase out is higher for married couples (designed to reduce the marriage penalty).
6. Has led to fraud, delays return to determine if qualified.

## **§ 22 Credit for Elderly & Permanently Disabled**

**§ 22(a).** Applies the credit to income from any source, including earnings from services currently performed. Must be age 65.

**§ 22(d).** Limits credit amount as income rises.

## **§ 24 Child Tax Credit**

**§ 24(a).** Allows each taxpayer a $1,000 credit for each dependent child under the age of 17.

1. “Child” defined under **§ 152.**
2. Reduced by $50 for every $1000 that income rises above a certain level.
3. Refundable under limited circumstances.

# **Allowances for Mixed Business & Personal Outlays**

Deductions for business expenses are limited by asking: (1) whether or not the particular expense was “ordinary and necessary”; (2) whether the expenditure was a current expense or a capital investment; AND (3) whether the expense was incurred in business or for personal reasons.

## **§ 67 2% floor on miscellaneous itemized deductions**

**(a)** The miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of AGI. Deductions not allowed for AMT.

**(b)** Miscellaneous deductions (ends up being mostly business) are itemized deductions OTHER THAN: most things, BUT not 162 or 212.

1. Examples: unreimbursed employee business expenses (162), union dues (162), individual tax return preparation fees (212(3)).

## **§ 212 Expenses for Production of Income**

**§ 212.** Allowed as a deduction all the ordinary and necessary expenses paid or incurred (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; OR (3) in connection with the determination, collection, or refund of any tax. Ex. things like magazine subscriptions.

## **§ 162 Trade or business expenses**

**§ 162(a).** Allows a deduction for “ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business.” People who are self-employed may use this (solo attorneys). So this section 183 reaffirms that the cost for hobbies cannot be deducted.

## **§ 262 Personal, Living, and Family Expenses**

**(a)** No deduction shall be allowed for personal, living, or family expenses.

## **§ 183 Activities not engaged in for profit.**

**§ 183(a).** Limits the availability of these deductions if the activity is not engaged in for profit.

1. The taxpayer’s motive must be bona fide, but the court can determine whether it is so with objective factors. The concern is that people may buy unprofitable businesses in order to offset their income with deductions. For example, the court found a taxpayer did buy a farm for profit where he hired someone to manage it, attempted to learn about the industry, even though he rarely went there and purchased it dilapidated with not much prospect. ***Nickerson v. Commissioner (7th Cir. 1983).***
   1. **Reg. § 1.183-2 Factors:**
      1. Manner in which the taxpayer carries on the activity.
      2. The expertise of the taxpayer or his advisors.
      3. The time and effort expended by the taxpayer in carrying on the activity.
      4. Expectation that assets used in the activity may appreciate in value.
      5. The success of the taxpayer in carrying on other similar or dissimilar activities.
      6. The taxpayer’s history of income or losses with respect to the activity.
      7. The amount of occasional profits, if any, which are earned.
      8. The financial status of the taxpayer.
      9. Elements of personal pleasure or recreation.

**§ 183(b).** A deduction is allowed for hobbies, but only to the extent of income created from the hobby.

**§ 183(d).** Presumption that it is for profit if you make a profit for 3 of the 5 past years. For horses, it is 2 of 7 past years.

## **§ 280A Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.**

**(a)** No deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

**(c)** Exceptions & limitations on deductions –

1. Certain business use – subsection (a) shall not apply to a portion of the dwelling which is exclusively used on a regular basis –
   1. As the ***principal place of business*** for any ***trade or business*** of the taxpayer;
      1. **Principal place of business depends on:** (1) relative importance of the activities performed at each business location – where goods and services are delivered is a factor; and (2) the time spent at each location. In one case, the court found part of a one bedroom apartment could be deducted b/c a musician practiced more hours there than performed elsewhere. ***Popov v. Commissioner (9th Cir. 2001) (ctiting Soliman’s test).***
      2. **Trade or business:** Distinguished between traders and investors. To be a trader, a taxpayer’s activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities. The court found the Mollers were investors and not entitled to a deduction where they used their home offices and made long-term investments. ***Moller v. United States (Fed. Cir. 1983).***
   2. As a ***place of business used by patients, clients, or customers in meeting or dealing with the taxpayer*** in the normal course of his trade or business; OR
   3. In the case of a ***separate structure*** which is not attached to the dwelling unit, in connection with the taxpayer’s trade or business.

**(d)** Use of dwelling means use for personal purposes which exceeds the greater of –

1. 14 days; OR
2. 10% of the number of days during the year for which such unit is rented at a fair market value.

**(e) Expenses attributable to rental –** the amount deductible shall not exceed an amount = to the amount you want to deduct x (days rented as a rental/days used by anyone). Renting it more increases the amount of the deduction.

**(g)** If a dwelling unit is rented for less than 15 days, then no deduction shall be allowed. BUT the income derived from such use is not included in gross income.

# **Child Care Expenses**

## **§ 21 Expenses for household and dependent care services necessary for gainful employment (child-care credit)**

**(a)** Allowance of credit –

1. In the case of an individual for which there are 1 or more ***qualifying individuals***, there shall be allowed as a credit against the tax imposed for an amount equal to the applicable percentage of the ***employment-related expenses***.
2. “Applicable percentage” means 35 percent reduced (***but not below 20%***) by 1 percentage point for each $2,000 by which the taxpayer’s AGI for the taxable year exceeds $15,000. Phase-down but no phase-out.

**(b)** Definitions of qualifying individual and employment-related expenses –

1. Qualifying individual –
   1. A dependent of the taxpayer (152) who has not attained age 13,
   2. A dependent who is physically or mentally incapable of caring for himself and who has the same principal place of abode as the taxpayer for more than one-half of the year;
   3. The spouse if physically or mentally incapable of caring for himself and who has the same principal place of abode as the taxpayer for more than one-half of the year.
2. Employment-related expenses –
   1. The following, if incurred to enable the taxpayer to be gainfully employed: expenses for household services – NOT cleaning, and expenses for the care of a qualifying individual. Does NOT include overnight camps.
   2. Exceptions – care outside the home only allowed for qualified individuals in (1)(A) or qualified individuals that regularly spend 8 hours each day in the taxpayer’s household.
   3. Dependent care centers – same exceptions as paragraph (b) and the center must comply with all state and federal laws.

**(c)** Credit limit –

1. ***Expenses incurred*** shall not exceed $3,000 if there is one qualifying child; OR
2. $6,000 if there are two or more.
   1. This is the number that is multiplied by the percent above.
3. Reduced by amounts paid under section 129 (or in cafeteria plan provided by employer).

**(e)(9)** Must “rat” on the nanny – to get the credit, must provide nanny taxpayer identification number.

# **Travel & Entertainment Expenses**

## **§ 162 Trade or Business Expenses – unreimbursed employee expenses BELOW THE LINE & miscellaneous under 67, unlike reimbursed employee expenses**

**(a)** There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including –

1. Traveling expenses (***including amounts expended for meals and lodging*** other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.
   1. ***Correll* Sup. Ct. case:** requires “sleep or rest” rule to deduct meals and lodging.
   2. Having lunch brought in during work meetings is deductible. But see **274(n)** 50% rule.
   3. **Reg**. **§ 1.162-2(b).** Sup. Ct. has said whether sightseeing and other activities while traveling depends on intent, whether primary purpose was personal or business. ***Rudolph v. United States.***

**Commuting Expenses – Regs. § 1.262-1(b)(5):** expenses for commuting are not deductible under § 162 as a business expense. In this case, a taxpayer could not take a deduction for traveling to Mobile for his work for so many days out of the year while maintaining his home in Jackson. The court found that he made the personal decision to live in Jackson and should not be able to deduct the cost b/c it was not necessary to his business. ***Commissioner v. Flowers (1945).***

**“While away from home”:** a taxpayer who pursues temporary employment away from the location of his usual residence, but has no business connection with that location, is not away from home. A law student, who had a residence with her husband in Boston, could not take a deduction for her apartment in New York for her temporary summer job. The only way to take this deduction is to have a business connection back home that required the temporary placement somewhere else. ***Hantzis v. Commissioner (1981).***

1. The code now states “for purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year.”

**Mileage Rates:** (1) Covers fuel, maintenance, depreciation on vehicle; (2) Revised periodically by IRS; (3) Current rate: 54 cents per mile; (4) Parking and tolls may be added on; AND (5) Taxpayer can keep track of costs and take actual expenses if they can prove it amounts to more than 54 cents per mile.

1. **Rev. Ruling 99-7** now allows deduction of the trip home after traveling from work to some other location for work.

## **§ 274 Disallowance of certain entertainment, etc., expenses**

Imposes additional requirements to the basic rules of section 162 for travel and entertainment. Implicates transportation, meals, lodging, and entertainment/recreation.

**(a)** **Entertainment, amusement, or recreation –**

1. **In general** – no deduction otherwise allowable under this chapter shall be allowed for any item
   1. **Activity** – with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, UNLESS the taxpayer established that the item was directly related to, OR, in the case of an item directly preceding or following a substantial and bona fide business discussion, ***that such item was associated with, the active conduct of the taxpayer’s trade or business***; OR
      1. **See (n) 50% rule applies**. If reimbursed, 50% applies to employer.
   2. **Facility** – with respect to a facility used in connection with an activity referred to in subparagraph (A). Often means dues for clubs.
2. **Special Rules** – for purposes of applying subparagraph (1) –
   1. Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.
   2. An activity described in section 212 shall be treated as a trade or business.
   3. In the case of a club, paragraph (1)(B) shall apply unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer’s trade or business and that the item was directly related to the active conduct of such trade or business.
3. **Denial of deduction for club dues** – notwithstanding the preceding provisions, no deduction shall be allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

**(c) Foreign Travel.** Limits deduction on foreign air travel.

**(d) Substantiation Requirement** – no deduction shall be allowed UNLESS the taxpayer “substantiates by adequate records or by sufficient evidence corroborating the taxpayer’s own statement” amount, time and place, purpose, and business relationship.

1. **Reg. § 1.274-5T** Estimates are insufficient, need receipts.
2. ***Per diem* rules – not for entertainment:** can be used if you do not want to deduct more than federal employees do. Many employers will just reimburse for the federal *per diem* amount.

**(e)** **Exceptions to (a).** Food and beverages for employees, expenses treated as compensation, ***reimbursed expenses*** – pushes deduction ABOVE THE LINE & 50% rule for food does not apply BUT does apply to the employer, recreational expenses for employees, employee and stockholder business meetings, meetings of business leagues, items available to the public, entertainment sold to customers, and expenses includible in income of persons who are not employees.

**(h)** **Conventions.** Limits deductions on deductions for conventions outside the U.S., unless it is reasonable for the meeting to be held outside the U.S. as inside.

**(m)(2)** No deduction shall be allowed under this chapter for expenses for travel as a form of education – such as going to France b/c you are a French teacher.

**(m)(3)** No deduction is allowed for an individual accompanying the taxpayer on business travel, UNLESS

1. The spouse, dependent, or other individual is an employee of the taxpayer;
2. The travel of the spouse, dependent, or other individual is for a bona fide business purpose; AND
3. Such expenses would otherwise be deductible by the spouse, dependent, or other individual.

**(n)** Only 50 percent of meal and entertainment expenses are allowed as a deduction. If reimbursed, the 50% rule applies to the employer.

**Business Lunches:** the court found a law firm’s business lunches were not deducible where they met at the same restaurant every day and went over their cases. The court used a totality of the circumstances test and stated there is more justification for a deduction where a person is with a client, solidifying internal relationships – but less often than every day, or being forced to pay more for a meal than they would like. ***Moss v. Commissioner (7th Cir. 1985).***

## **§ 217 Moving Expenses – ABOVE THE LINE [don’t need to know]**

**(a) Deduction allowed** – for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. Includes first job too.

## **Clothing Expenses – 162 v. 262**

**Deductible as a business expense only if:** (1) the clothing is of 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.

**Objective Test:** no reference is made to the individual taxpayer’s lifestyle or personal taste. Instead, adaptability for personal or general use depends upon what is generally accepted for ordinary streetwear. In this case, the taxpayer could not deduct clothing she was supposed to wear for her expensive retail job b/c she could wear the clothes on a day to day basis. ***Pevsner v. Commissioner (5th Cir. 1980).***

## **§ 212 Expenses for production of income – attorney fee deduction BELOW THE LINE & miscellaneous**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year –

1. For the production or collection of income;
2. For the management, ***conservation***, or maintenance of property held for the production of income; OR
   1. **Attorney’s Fees - Defendant:** cannot take a deduction for legal expenses to “conserve” income that may be at risk during a divorce proceeding. In this case, the husband could not deduct the cost of winning the suit and “conserving” his loss of career basically. ***United States v. Gilmore (1963).***
      1. It depends on whether or not the claim arises in connection with the taxpayer’s profit-seeking activities. It does not depend on the consequences that might result to a taxpayer’s income-producing property from a failure to defeat the claim. So you can take a deduction if the suit arises from business matters.
      2. **Basis:** cost of legal fees in this circumstance can be added to basis. But legal expenses may not be added to basis in some personal suits if “the expenses would not have been primarily to defend title.”
   2. **Attorney’s Fees - Plaintiff:** ask what kind of relief the plaintiff is seeking, if it is taxable income (damages), then the legal fees are deductible. **Reg. § 1.262-1(b)(7) –** seeking alimony is deductible.
   3. **Everyday Advice:** common sense approach.
   4. **Tax Advice:** always deductible under § 212(3).
3. In connection with the determination, collection, or refund of any tax.

# **Education Expenses**

## **§ 162 Education as a Business Expense?**

**Education Expenses:** cannot deduct the cost of a general education. To deduct education as a business expense you must prove it is for maintaining or improving skills required by employment. A policeman could not deduct the cost of courses that were general and unrelated to his duties as a policeman. ***Carroll v. Commissioner (7th Cir. 1969).***

1. **Reg. § 1.162-5**
   1. Education must maintain or improve required skills in existing trade/business.
   2. Can’t be entry level education for existing trade/business – no deduction for law school.
   3. Can’t qualify taxpayer for new trade or business.
   4. Reason for 2nd two requirements: nondeductible business related education is “an inseparable and capital expenditure.” And personal too, so no deduction.

**§ 25A Hope & Lifetime Learning Credits -** American Opportunity & Lifetime Learning Credit

**§ 222 Qualified Tuition & Related Expenses – ABOVE THE LINE**

**§ 529 Qualified Tuition Programs** - You can set up education funds in various states for a designated beneficiary.

# **Deductions for the Costs of Earning Income**

## **§ 263 Capital Expenditures**

Disallows deductions for capital expenditures but these deductions are recaptured through provisions such as allowances for depreciation. Amortizations are deductions for intangible assets, depreciations are deductions for tangible assets.

**(a)** No deduction shall be allowed for –

1. Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to –

**Capital expenditure Definition**

1. Current outlays of money creating long-term benefits.
2. Nonrecurring outlays tend to be capital.
3. Costs of buying/selling long-lived property (> 1 year). **Reg. § 1.263(a)-2.**
4. **During test, try to think of long-term benefits to raise this issue.**

**Wages:** If you hire someone to build a capital expenditure, their wages are also capital expenditures. While maybe some creators or buyers of capital goods – some authors and publishers – may deduct as current expenses what realistically are capital expenditures, they may not do so when the expense is tied to producing or acquiring a specific capital asset. In this case, Encyclopaedia Britannica hired David-Stewart to create The Dictionary of Natural Sciences. They could not deduct this cost as a current expenses. ***Encyclopaedia Britannica v. Commissioner (7th Cir. 1982).***

**Repair and Maintenance:** current deductions can be taken for repair and maintenance, but not improvements. Repairs restore to a sound state or mends and replacement connotes a substitution. Improvements prolong the life of the property, increase its value, or make it adaptable to a different use. In this case, putting in a concrete wall to prevent oil from seeping into the factory was repairs and maintenance b/c the inspector required it be done and it was only necessary to put the factory in the position it was in before the seepage. ***Midland Empire Packing Co. v. Commissioner (1950).***

1. **Reg. § 1.162-4 –** allows current deduction for “repairs.”
2. **Reg. § 1.162-4 –** must capitalize improvements: (1) “betterment,” (2) “restoration,” and “adaptation to new or different use.”
3. If a deduction for a loss is allowed, a deduction for any repair to restore the property to the pre-loss condition must be denied.

**§ 263A – Uniform Capitalization (UNICAP) Rules:** Applies to large volume manufacturers and resellers. Require capitalization of the cost of producing capital assets in-house, in addition to hiring others to do it – even includes CEO salary. Does not include marketing and advertising costs. Small retailers and wholesalers, writers, artists, and photographers are excluded.

**§ 195 Start-Up Expenditures must be capitalized –** can be amortized over 15 years.

## **Ordinary & Necessary**

**(1)** Not personal = necessary.

**(2)** Not capital = ordinary.

**(3)** Case law regarding there is more to this – Prof. doesn’t think so. It can all be explained with the categories above.

**Goodwill:** paying the debts of others without legal obligation to reestablish goodwill is NOT an ordinary business expense and therefore not deductible. This can just be explained by saying his actions here were in pursuit of obtaining a capital asset. ***Welch v. Helvering (1933).*** However, the court has distinguished preserving an existing business from establishing a new business. So a taxpayer can deduct the cost of paying current debts to save existing goodwill and credit.

1. This goodwill is considered a capital expenditure that cannot be amortized. However, section 197 was created to allow amortization of goodwill acquired through purchase, not self-created.

# **Depreciation**

**§ 1016** requires reduction in basis when taking deduction.

## **§ 167 Depreciation –** intangible assets

Applies the straightline method to intangible assets, such as patents and copyrights that are NOT purchased.

**(a)** There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) –

1. Of property used in the trade or business, OR
2. Of property held for the production of income.

## **§ 168 Accelerated Cost Recovery System –** depreciation for tangible assets

**(a)** Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using –

1. **The applicable depreciation method,**
   1. **(b)** Describes methods:
      1. Straight-line method deduction = original basis/total number of years in period.
         1. Required for real estate. **(b)(3).**
         2. Optional for personal property. **(g)(2).**
      2. 200 percent declining method deduction = [adjusted basis/total number of years in period] x 2.
         1. Switch to straight-line when straight-line would yield more than the 200 percent method = adjusted basis/number of remaining years.
         2. More deductions in the beginning years b/c the basis is adjusted each year.
         3. 200 percent declining balance for 3-year, 5-year, 7-year, and 10-year classifications.
         4. 150 percent declining balance for 15-year, and 20-year classifications.
2. **The applicable recovery period, AND**
   1. **(c)** The applicable recovery period shall be determined in accordance with [useless] table.
   2. **(e)** Classification of property – except as otherwise provided in this subsection, property shall be classified under the class life table.
3. **The applicable convention.**
   1. Prorated deductions if you only own the asset for part of the year.
   2. **(d)(1)** The applicable convention is the half-year convention.
   3. **(d)(2)** For real property, there is a mid-month convention.

**Rev. Proc. 87-57** Table does the math for you. Lists the percent of basis allowed as a deduction.

## **§ 179 Election to expense certain depreciable business assets**

Allows small business to deduct immediately for equipment. This goes away when basis in property exceeds $2 million.

## **§ 168(k) Bonus depreciation – ignore it**