**Income Taxation**

Spring 2022 – Prof. Blair-Stanek

Complete Statutory Supplement

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# Chapter 1: Overview

**§ 1 Tax imposed.**

…

**(j)** … **(2)** … **(C) Unmarried individuals other than surviving spouses and heads of households.** The following table shall be applied …

|  |  |  |
| --- | --- | --- |
| If taxable income is: |  | The tax is: |
| Not over $9,525 |  | 10% of taxable income. |
| Over $9,525 but not over $38,700 |  | $952.50, plus 12% of the excess over $9,525. |
| Over $38,700 but not over $82,500 |  | $4,453.50, plus 22% of the excess over $38,700. |
| Over $82,500 but not over $157,500 |  | $14,089.50, plus 24% of the excess  over $82,500. |
| Over $157,500 but not over $200,000 |  | $32,089.50, plus 32% of the excess  over $157,500. |
| Over $200,000 but not over $500,000 |  | $45,689.50, plus 35% of the excess  over $200,000. |
| Over $500,000 |  | $150,689.50, plus 37% of the excess  over $500,000. |

…

**§ 61 Gross income defined.**

**(a)****General definition.** Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

**(1)**Compensation for services, including fees, commissions, fringe benefits, and similar items;

**(2)**Gross income derived from business;

**(3)**Gains derived from dealings in property;

**(4)** Interest;

**(5)** Rents;

**(6)** Royalties;

**(7)** Dividends;

**(8)**Annuities;

**(9)**Income from life insurance and endowment contracts;

**(10)**Pensions;

**(11)**Income from discharge of indebtedness;

**(12)**Distributive share of partnership gross income;

**(13)**Income in respect of a decedent; and

**(14)**Income from an interest in an estate or trust.

…

**§ 62 Adjusted gross income defined.**

**(a)****General rule.** For purposes of this subtitle, the term “adjusted gross income” means, in the case of an individual, gross income minus the following deductions:

**(1)****Trade and business deductions.**

The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

…

**(3) Losses from sale or exchange of property.**

The deductions allowed … as losses from the sale or exchange of property.

**(4) Deductions attributable to rents and royalties.**

The deductions … which are attributable to property held for the production of rents or royalties. ***[For example, landlords’ deductions on rental property is deductible in reaching adjusted gross income.]***

…

**§ 63 Taxable income defined.**

**(a)****In general.** Except as provided in subsection (b), for purposes of this subtitle, the term “taxable income” means gross income minus the deductions allowed by this chapter (other than the standard deduction).

**(b)****Individuals who do not itemize their deductions.**

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 adjusted gross income, minus–

**(1)** the standard deduction …

***[Note: Chapter 1 explains what personal exemptions and the standard deduction are.]***

**(3)** any deduction provided in section 199A …

**(d)****Itemized deductions.** For purposes of this subtitle, the term “itemized deductions” means the deductions allowable under this chapter other than–

**(1)**the deductions allowable in arriving at adjusted gross income, and

**(2)**any deduction referred to in any paragraph of subsection (b).

*…*

***[Revenue Procedures like the document excerpted below are IRS statements of how to apply the tax laws passed by Congress. Congress has said that the standard deduction should go up with inflation, and the IRS does those calculations and releases them in Revenue Procedures like this one.]***

**Revenue Procedure 2021-45 Tax rates and brackets–2022 inflation adjustments.**

**§ 3.16 Standard Deduction**

(1) In general. For taxable years beginning in 2022, the standard deduction amounts under §63(c)(2) are as follows:

| **Filing Status** | **Standard Deduction** |
| --- | --- |
| Married Individuals Filing Joint Returns and Surviving Spouses | $25,900 |
| Heads of Households | $19,400 |
| Unmarried Individuals (other than Surviving Spouses and Heads of Households) | $12,950 |
| Married Individuals Filing Separate Returns | $12,950 |

…

**§ 67 2-percent floor on miscellaneous itemized deductions.**

**…**

**(b)** **Miscellaneous itemized deductions.**

For purposes of this section, the term “miscellaneous itemized deductions” means the itemized deductions other than–

**(1)** the deduction under section 163 (relating to interest),

**(2)** the deduction under section 164 (relating to taxes),

**(3)** the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

**(4)** the deductions under section 170 (relating to charitable, etc., contributions and gifts) … ,

**(5)** the deduction under section 213 (relating to medical, dental, etc., expenses),

**…**

**(9)** the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

**…**

**(g) Suspension for taxable years 2018 through 2025.**

… no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026. ***[For eight years, all miscellaneous itemized deductions are totally denied.]***

**§ 275 Certain taxes.**

**(a)****General rule.**

No deduction shall be allowed for the following taxes:

**(1)**Federal income taxes, including–

(A)  the tax imposed by section 3101 (relating to the tax on employees under the Federal Insurance Contributions Act); ***[This refers to Medicare and Social Security taxes]***

…

(C)  the tax withheld at source on wages under section 3402.

…

***[Federal income taxes (both normal federal income taxes and Medicare and Social Security taxes) cannot be deducted in calculating your federal income taxes. This avoids a tautology. Of course, some state and local taxes can be deducted.]***

**§ 164 Taxes.**

**(a)****General rule.**

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

**(1)**State and local, and foreign, real property taxes.

**(2)**State and local personal property taxes. ***[For example, Virginia imposes an annual property tax on cars. Personal property is any property that is not real property, so cars are personal property. ]***

**(3)**State and local, and foreign, income … taxes.

**…**

**(b)****Definitions and special rules …**

**(5)****General sales taxes.**

For purposes of subsection (a)–

(A)  Election to deduct State and local sales taxes in lieu of State and local income taxes. At the election of the taxpayer for the taxable year, subsection (a) shall be applied–

(i)  without regard to the reference to State and local income taxes, and

(ii)  as if State and local general sales taxes were referred to in a paragraph thereof.

(B)  Definition of general sales tax. The term “general sales tax” means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.

…

**(6) Limitation on individual deductions for taxable years 2018 through 2025.** In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026– …

(B) the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) and paragraph (5) of this subsection for any taxable year shall not exceed $10,000…. ***[This subparagraph was the most contentious provision of the December 2017 tax-reform bill.]***

***[Section §199A below will not be on the final exam. The 2017 tax-reform bill lowered the corporate tax rate substantially. Some Republican senators did not like the idea of cutting only the tax on corporations in §11 to 21%. To placate those senators, the 2017 tax-reform bill also added §199A, which is a clumsy, poorly-drafted attempt to lower tax rates on non-corporate businesses by 20%. Section 199A expires in 2025.]***

**§ 199A. Qualified business income**

**(a)** **Allowance of deduction.** In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to … the combined qualified business income amount of the taxpayer…

**(b)** **Combined qualified business income amount.** For purposes of this section–

**(1)** **In general.** The term “combined qualified business income amount” means, with respect to any taxable year, an amount equal to … the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer…

**(2)** **Determination of deductible amount for each trade or business.** The amount determined under this paragraph with respect to any qualified trade or business is ***[generally]*** … 20 percent of the taxpayer’s qualified business income with respect to the qualified trade or business…

***[There is a phase out of the deduction for businesses like law, medicine, dentistry, architecture, finance, etc. when the taxpayers’ incomes get fairly high. There is no similar phase out for businesses like manufacturing.]***

# Chapter 2: Introduction to Gross Income

**§ 61 Gross income defined.**

**(a)****General definition.**

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

**(1)**Compensation for services, including fees, commissions, fringe benefits, and similar items;

**(2)**Gross income derived from business;

**(3)**Gains derived from dealings in property;

**(4)**Interest;

**(5)**Rents;

**(6)**Royalties;

**(7)**Dividends;

**(8)**Annuities;

**(9)**Income from life insurance and endowment contracts;

**(10)**Pensions;

**(11)**Income from discharge of indebtedness;

**(12)**Distributive share of partnership gross income;

**(13)**Income in respect of a decedent; and

**(14)**Income from an interest in an estate or trust.

**(b)****Cross references.**

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

**§ 1.61-1 Gross income.**

**(a) General definition.** Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61–14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

…

**§ 1.61-2. Compensation for services, including fees, commissions, and similar items.**

**(a) In general.**

*(1)* Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. … ***[Note that “rewards” above governs in Roco v. Commissioner.]***

**(d) Compensation paid other than in cash –**

(1) In general. … if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation. If the services are rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. …

(2) Property transferred to employee or independent contractor.

(i) … if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value ***[This is talking about “bargain purchases”]***, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

…

**§ 1.61-14. Miscellaneous items of gross income.**

**(a) In general.** In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. ***[The prior sentence codifies Glenshaw Glass.]***Another person’s payment of the taxpayer’s income taxes constitutes gross income to the taxpayer unless excluded by law. ***[The prior sentence codifies Old Colony Trust.]*** Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession. ***[The prior sentence was at issue in Cesarini.]***

…

# Chapter 3: The Effect of an Obligation to Repay

**§ 1.61-8. Rents and royalties.**

**…**

**(b) Advance rentals; cancellation payments.** … gross income includes advance rentals, which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer. An amount received by a lessor from a lessee for cancelling a lease constitutes gross income for the year in which it is received, since it is essentially a substitute for rental payments. …

…

# Chapter 4: Gains Derived from Dealings in Property

**§ 61 Gross income defined.**

**(a) General definition.** Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

**…**

**(3)**Gains derived from dealings in property;

**…**

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

**(a) Computation of gain or loss.** The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized. ***[This formula is incredibly simple: Gain = Amount Realized – Basis ]***

**(b) Amount realized.** The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. …

**(c) Recognition of gain or loss.** 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. ***[“Recognized” means that the gain must show up as gross income on the taxpayer’s tax return.]***

…

**§ 1011. Adjusted basis for determining gain or loss**

**(a) General rule.** The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections … ), adjusted as provided in section 1016. ***[We will cover the adjustments made in section 1016 in Chapters 13 and 14.]***

**…**

**§ 1012. Basis of property–cost**

(a) **In general.** The basis of property shall be the cost of such property…

**§ 1016. Adjustments to basis**

**(a) General rule.** Proper adjustment in respect of the property shall in all cases be made–

**(1)** for expenditures, receipts, losses, or other items, properly chargeable to capital account …

***[We will see more of this section in Chapter 14 on Capital Expenditures. For this chapter, if you spend $75k to remodel a property, your basis in that property increases by the $75k because of this section. ]***

**§ 1.61-2. Compensation for services, including fees, commissions, and similar items.**

**… (d) Compensation paid other than in cash. …**

(2) Property transferred to employee or independent contractor.

(i) … if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income.

…

**§ 1.61-6 Gains derived from dealings in property.**

**(a) In general.** Gain realized on the sale or exchange of property is included in gross income, unless excluded by law. For this purpose property includes tangible items, such as a building, and intangible items, such as goodwill. Generally, the gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged. The specific rules for computing the amount of gain or loss are contained in section 1001 and the regulations thereunder. 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. The sale of each part is treated as a separate transaction and gain or loss shall be computed separately on each part. Thus, gain or loss shall be determined at the time of sale of each part and not deferred until the entire property has been disposed of. This rule may be illustrated by the following examples:

**Example 1.** A, a dealer in real estate, acquires a 10–acre tract for $10,000, which he divides into 20 lots. The $10,000 cost must be equitably apportioned among the lots so that on the sale of each A can determine his taxable gain or deductible loss.

…

**(b) Nontaxable exchanges.** Certain realized gains or losses on the sale or exchange of property are not “recognized”, that is, are not included in or deducted from gross income at the time the transaction occurs. Gain or loss from such sales or exchanges is generally recognized at some later time. ***[A large chunk of tax practice involves keeping realized gains from being “recognized” so that they do not need to be included in gross income.]*** Examples of such sales or exchanges are the following:

**…**

**(3)** Exchange of certain property held for productive use or investment for property of like kind, see section 1031;

**…**

**(5)** Certain involuntary conversions of property if replaced, see section 1033;

**…**

***[Section 1031 will not be on the final, but is a good section to know about.]***

**§ 1031 Exchange of real property held for productive use or investment.**

**(a)** **Nonrecognition of gain or loss from exchanges solely in kind.**

**(1)** **In general.**

No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

**(2)** **Exception for real property held for sale.**

This subsection shall not apply to any exchange of real property held primarily for sale.

…

**(b)** **Gain from exchanges not solely in kind.**

If an exchange would be within the provisions of subsection (a) … if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. ***[If person A exchanges land worth $5m with person B for land worth $4m, then A will require that B also give A $1m in cash to boot, to make it a fair exchange. This subsection allows such “boot”.]***

…

**(d)** **Basis.**

If property was acquired on an exchange described in this section…, then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. … For purposes of this section, … where as part of the consideration to the taxpayer another party to the exchange assumed … a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

…

***[Section 1033 will not be on the final, but is a good section to know about.]***

**§ 1033. Involuntary conversions**

***[This is an example of a provision that keeps gain from being recognized. This section applies to situations as varied as receipt of “just compensation” under the Fifth Amendment, to money paid by insurance companies to replace property.]***

**(a) General rule.** If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted–

**(1) Conversion into similar property.** Into property similar or related in service or use to the property so converted, no gain shall be recognized.

**…**

**(b) Basis of property acquired through involuntary conversion.**

…the basis shall be the same as in the case of the property so converted…

***[Section 121 will not be on the final, but is a good section to know about.]***

**§ 121 Exclusion of gain from sale of principal residence.**

***[This section will not be on the final, but it excludes up to $500,000 of gain on the sale of a primary residence. This is a huge subsidy for homeownership.]***

**(a)****Exclusion.** Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating 2 years or more.

**(b)****Limitations.**

**(1)****In general.** The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed $250,000.

**(2)****Special rules for joint returns.** In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property–

(A)  $500,000 Limitation for certain joint returns. Paragraph (1) shall be applied by substituting “$500,000” for “$250,000” …

**(3)****Application to only 1 sale or exchange every 2 years.** Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

**…**

**§ 1.1001-2 Discharge of liabilities.**

(a) **Inclusion in amount realized–**(1) **In general.** … the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition….

***[The rule in subsection (a) is short, but very important. This rule plays a role in many varied situations, ranging from large corporate transactions to home foreclosures. You can remember this rule as: “A dollar of debt relieved is as good as dollar of cash received.”]***

**(b) Effect of fair market value of security.** The fair market value of the security ***[by “security” this means “collateral”, which for a home mortgage would be the property itself]*** at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property….

***[The rule in subsection (b) was upheld by the U.S. Supreme Court in an important case Commissioner v. Tufts (1983). As an example, suppose that you took out a $500k mortgage to purchase a house for $500k, and the bank’s only possible action if you default on the mortgage is to take the property (e.g. in foreclosure). Then suppose the fair market value of the house fell to just $200k, and you couldn’t pay any of the $500k of the mortgage. If you give the bank the house, your amount realized is still the $500k mortgage outstanding, not the $200k the house is worth. This rule can have serious, harsh tax implications.]***

…

# Chapter 5: Gifts, Bequests and Inheritance

**§ 102 Gifts and inheritances.**

**(a) General rule.**  Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

**(b)****Income.** Subsection (a) shall not exclude from gross income–

**(1)**the income from any property referred to in subsection (a); or

**(2)**where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property…. ***[Subsection (b) will not be on the final exam.]***

**(c) Employee gifts.**

**(1) In general.** Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee. ***[This prevents employers from giving bonuses that are called “gifts” and thus excluded from the employee’s gross income.]***

…

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

…

**(b) Gifts.**

**(1) Limitation.** No deduction shall be allowed ***[as a business expense]*** … for any expense for gifts made directly or indirectly to any individual to the extent that such expense, when added to prior expenses of the taxpayer for gifts made to such individual during the same taxable year, exceeds $25. For purposes of this section, the term “gift” means any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision of this chapter …

***[This provision provides the IRS with additional ammunition to attack sketchiness like what we see in the* Duberstein *case. In* Duberstein*, the donor took a business deduction for the gift but Mr. Duberstein claimed that the gift was excluded from his gross income. In* Duberstein*’s facts, this provision would have denied a deduction to the donor. We will cover business deductions in Chapter 12.]***

…

**§ 1014 Basis of property acquired from a decedent.**

**(a) In general.** Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent’s death by such person, be–

(1) the fair market value of the property at the date of the decedent’s death,

…

**(e) Appreciated property acquired by decedent by gift within 1 year of death.**

**(1) In general.** … if–

(A) appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent’s death, and

(B) such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor),

the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent. ***[In other words, the general rule from (a) that basis equals fair market value is overruled when this subsection (e) applies.]***

**(2) Definitions.** For purposes of paragraph (1) –

(A) Appreciated property. The term “appreciated property” means any property if the fair market value of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.

…

**§ 1015 Basis of property acquired by gifts and transfers in trust.**

(a) **… If the property was acquired by gift … the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis … is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value.…**

…

**§ 1.102-1. Gifts and inheritances.**

**(a) General rule.** Property received as a gift, or received under a will or under statutes of descent and distribution, is not includible in gross income, although the income from such property is includible in gross income…. Section 102 does not apply to prizes and awards (see section 74 and § 1.74-1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

***[We will cover sections 74 and 117 in Chapter 7.]***

…

**Prop. Reg. § 1.102-1. Gifts and inheritances.**

***[Proposed Regulations like this one are not binding like normal Treasury Regulations, but they have persuasive authority. Incidentally, these regulations were proposed in 1989 and have yet to be finalized, largely because the IRS is overburdened and underfunded.]***

*…*

**(f)** … (2) *Employer/Employee transfers*. For purposes of section 102(c), extraordinary transfers to the natural objects of an employer’s bounty will not be considered transfers to, or for the benefit of, an employee if the employee can show that the transfer was not made in recognition of the employee’s employment. Accordingly, section 102(c) shall not apply to amounts transferred between related parties (e.g., father and son) if the purpose of the transfer can be substantially attributed to the familial relationship of the parties and not to the circumstances of their employment.

**…**

**§ 1.1001-1. Computation of gain or loss.**

…

**(e) Transfers in part a sale and in part a gift.**

(1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. …

(2) Examples. The provisions of subparagraph (1) may be illustrated by the following examples: ***[Working through these examples is a great way to understand how these concepts work.]***

Example 1. A transfers property to his son for $60,000. Such property in the hands of A has an adjusted basis of $30,000 (and a fair market value of $90,000). A’s gain is $30,000, the excess of $60,000, the amount realized, over the adjusted basis, $30,000. He has made a gift of $30,000, the excess of $90,000, the fair market value, over the amount realized, $60,000.

Example 2. A transfers property to his son for $30,000. Such property in the hands of A has an adjusted basis of $60,000 (and a fair market value of $90,000). A has no gain or loss, and has made a gift of $60,000, the excess of $90,000, the fair market value, over the amount realized, $30,000.

Example 3. A transfers property to his son for $30,000. Such property in A’s hands has an adjusted basis of $30,000 (and a fair market value of $60,000). A has no gain and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

Example 4. A transfers property to his son for $30,000. Such property in A’s hands has an adjusted basis of $90,000 (and a fair market value of $60,000). A has sustained no loss, and has made a gift of $30,000, the excess of $60,000, the fair market value, over the amount realized, $30,000.

**…**

**§ 1.1001-2. Discharge of liabilities.**

**(a) Inclusion in amount realized –**

(1) In general. … the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. ***[Remember that debt relieved is as good as cash received. If a donee takes on a mortgage, the donor has been relieved of paying the mortgage, which is a form of consideration as good as cash.]***

…

(4) Special rules. For purposes of this section–

…

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

***[Note that the term “disposition” is very broad, including not only sales, but also every way to dispose of ownership ranging from a gift to involuntary seizure of a house by a bank in a foreclosure.]***

…

**§ 1.1015-1. Basis of property acquired by gift after December 31, 1920.**

**(a) General rule.**

(1) In the case of property acquired by gift … the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis … is greater than the fair market value of the property at the time of the gift. In such case, the basis for determining loss is the fair market value at the time of the gift.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example. ***[Understanding this example is useful.]***

Example: A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

…

**§ 1.1015-4. Transfers in part a gift and in part a sale.**

**(a) General rule.** Where a transfer of property is in part a sale and in part a gift, the … basis of the property in the hands of the transferee is …

1. Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor’s adjusted basis for the property at the time of the transfer, and

…

For determining loss, the … basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see § 1.1001-1(e) …

**(b) Examples.** The rule of paragraph (a) of this section is illustrated by the following examples: ***[Working through these examples is a great way to understand the rules.]***

Example 1. If A transfers property to his son for $30,000, and such property at the time of the transfer has … basis of $30,000 in A’s hands (and a fair market value of $60,000), the … basis of the property in the hands of the son is $30,000.

Example 2. If A transfers property to his son for $60,000, and such property at the time of transfer has … basis of $30,000 in A’s hands (and a fair market value of $90,000), the … basis of such property in the hands of the son is $60,000.

Example 3. If A transfers property to his son for $30,000, and such property at the time of transfer has … basis in A’s hands of $60,000 (and a fair market value of $90,000), the … basis of such property in the hands of the son is $60,000.

Example 4. If A transfers property to his son for $30,000 and such property at the time of transfer has a[] basis of $90,000 in A's hands (and a fair market value of $60,000), the … basis of the property in the hands of the son is $90,000. However, since the … basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property by the son its … basis in his hands is $60,000.

# Chapter 7: Scholarships and Prizes

**§ 74 Prizes and awards.**

**(a) General rule.** Except as otherwise provided in this section or in section 117 (relating to qualified scholarships), gross income includes amounts received as prizes and awards.

**(b)** **Exception for certain prizes and awards transferred to charities.**

Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if –

**(1)** the recipient was selected without any action on his part to enter the contest or proceeding;

**(2)** the recipient is not required to render substantial future services as a condition to receiving the prize or award; and

**(3)** the prize or award is transferred by the payor to a governmental unit or organization described in paragraph (1) or (2) of section 170(c) pursuant to a designation made by the recipient. ***[Section 170(c) describes charities, churches, and similar non-profits.]***

***[President Obama used the above provision to exclude his 2009 Nobel Peace Prize money from his gross income. He donated all of it to various charities. Subsections (b) and (d) will not be on the final exam; subsection (a) may be on the final exam.]***

…

**(d)** **Exception for Olympic and Paralympic medals and prizes.**

**(1)** **In general.** Gross income shall not include the value of any medal awarded in, or any prize money received from the United States Olympic Committee on account of, competition in the Olympic Games or Paralympic Games. ***[An Olympic gold medal has a FMV of approximately $20,000 and would be included in gross income if this exclusion did not exist!]***

…

**§ 117 Qualified scholarships.**

**(a)** **General rule.** Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization….

**(b)** **Qualified scholarship.** For purposes of this section–

**(1)** **In general.** The term “qualified scholarship” means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.

**(2)** **Qualified tuition and related expenses.** For purposes of paragraph (1), the term “qualified tuition and related expenses” means–

(A) tuition and fees required for the enrollment or attendance of a student at an educational organization … , and

(B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.

***[Note that room and board are not in this definition.]***

**(c)** **Limitation.**

**(1)** **In general.** … subsections (a) and (d) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship.

**…**

**§ 127 Educational assistance programs.**

**(a)****Exclusion from gross income.**

**(1)****In general.** Gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program which is described in subsection (b). ***[This is a “fringe benefit” that employers can provide to their employees without it being included in the employees’ gross income. We will see many more such fringe benefits in Chapter 11.]***

**(2)****$5,250 maximum exclusion.**  If, but for this paragraph, this section would exclude from gross income more than $5,250 of educational assistance furnished to an individual during a calendar year, this section shall apply only to the first $5,250 of such assistance so furnished. ***[Note that this exclusion is not indexed to inflation like some other dollar figures in the I.R.C.]***

**…**

**(c)****Definitions; special rules.** For purposes of this section–

**(1)****Educational assistance.** The term “educational assistance” means-

(A) the payment, by an employer, of expenses incurred by or on behalf of an employee for education of the employee (including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment),

(B) in the case of payments made before January 1, 2026, the payment by an employer, whether paid to the employee or to a lender, of principal or interest on any qualified education loan … incurred by the employee for education of the employee, and

(C) the provision, by an employer, of courses of instruction for such employee (including books, supplies, and equipment),

but does not include payment for, or the provision of, tools or supplies which may be retained by the employee after completion of a course of instruction, or meals, lodging, or transportation. The term “educational assistance” also does not include any payment for, or the provision of any benefits with respect to, any course or other education involving sports, games, or hobbies.

…

**§ 1.74-1. Prizes and awards.**

**(a) Inclusion in gross income.**

(1) Section 74(a) requires the inclusion in gross income of all amounts received as prizes and awards, unless such prizes or awards qualify as an exclusion from gross income …, or unless such prize or award is a scholarship or fellowship grant excluded from gross income by section 117. Prizes and awards which are includible in gross income include (but are not limited to) amounts received from radio and television giveaway shows, door prizes, and awards in contests of all types, as well as any prizes and awards from an employer to an employee in recognition of some achievement in connection with his employment.

(2) If the prize or award is not made in money but is made in goods or services, the fair market value of the goods or services is the amount to be included in income.

…

**§ 1.102-1. Gifts and inheritances.**

**(a) General rule.** … Section 102 does not apply to prizes and awards (see section 74 and § 1.74-1) nor to scholarships and fellowship grants (see section 117 and the regulations thereunder).

**…**

**§ 1.117-4. Items not considered as scholarships or fellowship grants.**

The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:

**…**

**(c) Amounts paid as compensation for services or primarily for the benefit of the grantor.**

(1) … any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.

(2) Any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research primarily for the benefit of the grantor.

However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. Neither the fact that the recipient is required to furnish reports of his progress to the grantor, nor the fact that the results of his studies or research may be of some incidental benefits to the grantor shall, of itself, be considered to destroy the essential character of such amount as a scholarship or fellowship grant.

***[Note that this was the regulation unsuccessfully challenged in* Bingler v. Johnson*.]***

**Prop. Reg. § 1.117-6. Qualified scholarships.**

…

**(d) Inclusion of qualified scholarships and qualified tuition reductions representing payment for services.**

(1) In general. The exclusion from gross income under this section does not apply to that portion of any amount received as a qualified scholarship … that represents payment for teaching, research, or other services by the student required as a condition to receiving the qualified scholarship … , regardless of whether all candidates for the degree are required to perform such services. The provisions of this paragraph (d) apply not only to cash amounts received in return for such services, but also to amounts by which the tuition or related expenses of the person who performs services are reduced…

(2) Payment for services. For purposes of this section, a scholarship or fellowship grant represents payment for services when the grantor requires the recipient to perform services in return for the granting of the scholarship or fellowship. A requirement that the recipient pursue studies, research, or other activities primarily for the benefit of the grantor is treated as a requirement to perform services. A requirement that a recipient furnish periodic reports to the grantor for the purpose of keeping the grantor informed as to the general progress of the individual, however, does not constitute the performance of services. A scholarship or fellowship grant conditioned upon either past, present, or future teaching, research, or other services by the recipient represents payment for services under this section. …

(3) Determination of amount of scholarship or fellowship grant representing payment for services. If only a portion of a scholarship or fellowship grant represents payment for services, the grantor must determine the amount of the scholarship or fellowship grant (including any reduction in tuition or related expenses) to be allocated to payment for services. Factors to be taken into account in making this allocation include, but are not limited to, compensation paid by–

(i) The grantor for similar services performed by students with qualifications comparable to those of the scholarship recipient, but who do not receive scholarship or fellowship grants;

(ii) The grantor for similar services performed by full-time or part-time employees of the grantor who are not students; and

(iii) Educational organizations, other than the grantor of the scholarship or fellowship, for similar services performed either by students or other employees.

If the recipient includes in gross income the amount allocated by the grantor to payment for services and such amount represents reasonable compensation for those services, then any additional amount of a scholarship or fellowship grant received from the same grantor that meets the requirements of paragraph (b) of this section is excludable from gross income. See paragraph (d)(5), Examples (5) and (6) of this section.

…

(5) Examples. The provisions of this paragraph may be illustrated by the following examples:

Example (1). On November 15, 1987, A receives a $5,000 qualified scholarship … for academic year 1988-1989 under a federal program requiring A’s future service as a federal employee. The $5,000 scholarship represents payment for services for purposes of this section. Thus, the $5,000 must be included in A’s gross income as wages.

Example (2). B receives a $10,000 scholarship from V Corporation on June 4, 1987, for academic year 1987-1988. As a condition to receiving the scholarship, B agrees to work for V after graduation. B has no previous relationship with V. The $10,000 scholarship represents payment for future services for purposes of this section. Thus, the $10,000 scholarship must be included in B’s gross income as wages.

Example (3). On March 15, 1987, C is awarded a fellowship for academic year 1987-1988 to pursue a research project the nature of which is determined by the grantor, University W. C must submit a paper to W that describes the research results. The paper does not fulfill any course requirements. Under the terms of the grant, W may publish C’s results, or otherwise use the results of C’s research. C is treated as performing services for W. Thus, C’s fellowship from W represents payment for services and must be included in C’s gross income as wages.

Example (4). On September 27, 1987, D receives a qualified scholarship … from University X for academic year 1987-1988. As a condition to receiving the scholarship, D performs services as a teaching assistant for X. Such services are required of all candidates for a degree at X. The amount of D’s scholarship from X is equal to the compensation paid by X to teaching assistants who are part-time employees and not students at X. D’s scholarship from X represents payment for services. Thus, the entire amount of D’s scholarship from X must be included in D’s gross income as wages.

Example (5). On June 11, 1987, E receives a $6,000 scholarship for academic year 1987-1988 from University Y. As a condition to receiving the scholarship, E performs services as a researcher for Y. Other researchers who are not scholarship recipients receive $2,000 for similar services for the year. Therefore, Y allocates $2,000 of the scholarship amount to compensation for services performed by E. Thus, the portion of the scholarship that represents payment for services, $2,000, must be included in E’s gross income as wages. However, if E establishes expenditures of $4,000 for qualified tuition and related expenses …, then $4,000 of E’s scholarship is excludable from E’s gross income as a qualified scholarship.

…

# Chapter 9: Discharge of Indebtedness

**§ 61 Gross income defined.**

**(a) General definition.** Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

**(1)**Compensation for services, including fees, commissions, fringe benefits, and similar items;

**(2)**Gross income derived from business;

**(3)**Gains derived from dealings in property;

**…**

**(11)**Income from discharge of indebtedness;

**…**

**§ 1.61-12. Income from discharge of indebtedness.**

**(a) In general.** The discharge of indebtedness, in whole or in part, may result in the realization of income. ***[Discharge of indebtedness is a realization event, meeting Glenshaw Glass factor (2).]*** If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value.... ***[The previous sentence codifies the* Kirby Lumber *case.]***

**§ 108 Income from discharge of indebtedness.**

**(a)** **Exclusion from gross income.**

**(1)** **In general.** Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if–

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent,

… or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged–

(i) before January 1, 2026, or

(ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.

**…**

**(3)** **Insolvency exclusion limited to amount of insolvency.**

In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

…

**(d)** **Meaning of terms; special rules relating to certain provisions.**

**(1)** **Indebtedness of taxpayer.** For purposes of this section, the term “indebtedness of the taxpayer” means any indebtedness–

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property. ***[For example, houses are often held subject to a mortgage owed to the bank.]***

**(2)** **Title 11 case.** For purposes of this section, the term “title 11 case” means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

**(3)** **Insolvent.** For purposes of this section, the term “insolvent” means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.

…

**(e)** **General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency).** For purposes of this title–

**(1)** **No other insolvency exception.** Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness. ***[In other words, if you have a discharge of indebtedness, your only hope for not having gross income must be here in section 108.]***

**(2)** **Income not realized to extent of lost deductions.**

No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

**…**

**(4)** **Acquisition of indebtedness by person related to debtor.**

(A) Treated as acquisition by debtor. For purposes of determining income of the debtor from discharge of indebtedness … the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor … from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor…. ***[For individuals, “related” means close family members. For corporations, “related” means subsidiaries and other corporations under common control. Employees and their employers are not considered related.]***

(B) Members of family. For purposes of this paragraph, … the family of an individual consists of the individual’s spouse, the individual’s children, grandchildren, and parents, and any spouse of the individual’s children or grandchildren.

(C) Entities under common control treated as related…. ***[A corporation is related to its own subsidiary. Two subsidiaries of the same corporation are also treated as related.]***

***[With any debt, there are two parties: the debtor and the creditor. In paragraph (4) above, “acquiring” a debt means that the related party has stepped into the shoes of the creditor. For example, suppose hypothetically that Kirby Lumber had had a subsidiary that purchased the bonds from the bondholders at a low price. In that hypothetical, the bondholders were the creditors and the subsidiary has stepped into the bondholders’ shoes. Thus, paragraph (4) above would apply. Basically, Kirby Lumber would owe a debt to its own subsidiary, which is economically similar to the debt simply being cancelled. That is the motivation for paragraph (4).]***

**(5)** **Purchase-money debt reduction for solvent debtor treated as price reduction.** If–

(A) the debt of a purchaser of property to the seller of such property ***[this does not apply to services]*** which arose out of the purchase of such property is reduced,

(B) such reduction does not occur–

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment. ***[The consequence of a purchase price adjustment is that there is no gross income from discharge of indebtedness, and instead the purchaser’s basis in the property is reduced.]***

…

**(f)** **Student loans.**

**(1)** **In general.** In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers. ***[This permanent provision in paragraph (1) above excludes student-loan-discharge conditioned on working in public interest jobs, with fairly strict eligibility requirements. The temporary rule in paragraph (5) below is broader.]***

**…**

**(5)****Special rule for discharges in 2021 through 2025.**

Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) after December 31, 2020, and before January 1, 2026, of–

(A) any loan provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by–

(i) the United States, or an instrumentality or agency thereof,

(ii) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or

(iii) an eligible educational institution (as defined in section 25A),

***[The statute lists several other, less-common categories of exempted student-loan discharges.]***

…

**(h) Special rules relating to qualified principal residence indebtedness. …**

(2) Qualified principal residence indebtedness. For purposes of this section, the term “qualified principal residence indebtedness” means acquisition indebtedness … with respect to the principal residence of the taxpayer.

…

**§ 1.1001-2. Discharge of liabilities.**

**(a) Inclusion in amount realized –**

(1) In general. … the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. ***[Note that “disposition” is broad and includes property being disposed of involuntarily, such as by foreclosure or repossession of the property by a bank.]***

…

**(c) Examples.**

…

*Example 8.* In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 − $6,000).

***[In other words, F has gross income that is “gain from dealings in property” equal to $6,000 minus F’s basis in the asset. None of this “gain from dealings in property” can ever be excluded under section 108. F also has gross income from “discharge of indebtedness” of $1,500. F can potentially exclude some or all of this $1,500 using section 108.]***

# Chapter 10: Compensation for Personal Injury and Sickness

**§ 104 Compensation for injuries or sickness.**

**(a)****In general.** Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include–

**(1)**amounts received under workmen’s compensation acts as compensation for personal injuries or sickness;

**(2)**the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

**(3)**amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

… For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care … attributable to emotional distress.

…

**§ 105 Amounts received under accident and health plans.**

**(a)****Amounts attributable to employer contributions.** Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer. ***[This general rule in subsection (a) is swallowed by the exceptions in subsections (b) and (c) below.]***

**(b)****Amounts expended for medical care.** Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care … of the taxpayer, his spouse, his dependents …, and any child … of the taxpayer who as of the end of the taxable year has not attained age 27. …

**(c)****Payments unrelated to absence from work.** Gross income does not include amounts referred to in subsection (a) to the extent such amounts–

**(1)**constitute payment for the permanent loss or loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent …, and

**(2)**are computed with reference to the nature of the injury without regard to the period the employee is absent from work.

**…**

**§ 106 Contributions by employer to accident and health plans.**

**(a)****General rule.** Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.

***[This simple provision is the root cause of America’s bizarre healthcare system.]***

…

**§ 213 Medical, dental, etc., expenses.**

**(a) Allowance of deduction.** There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent… , to the extent that such expenses exceed 7.5 percent of adjusted gross income.

***[Very few people have medical expenses not reimbursed by insurance that get above 7.5% of their adjusted gross income (AGI). AGI was discussed in Chapter 1 and is gross income minus “above-the-line” deductions like business expenses. If a taxpayer has unreimbursed medical expenses above 7.5% of AGI, this section allows a deduction only of the excess. For example, a taxpayer with $100,000 in AGI and $9,000 in unreimbursed medical expenses gets only a $1,500 deduction.]***

…

**§ 1.104-1. Compensation for injuries or sickness.**

…

**(c) Damages received on account of personal physical injuries or physical sickness –**

(1) In general. Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care … for emotional distress. For purposes of this paragraph (c), the term damages means an amount received (other than workers’ compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

(2) Cause of action and remedies. The section 104(a)(2) exclusion may apply to damages recovered for a personal physical injury or physical sickness under a statute, even if that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law. ***[These regulations, which make clear that the cause of action need not be a tort, come from 2012.]***

…

**(d) Accident or health insurance.** Section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). … If, therefore, an individual purchases a policy accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under section 104(a)(3). … Conversely, if an employer is … the sole purchaser of a policy of accident or health insurance for his employees … , the exclusion provided under section 104(a)(3) does not apply to any amounts received by his employees through such fund or insurance. ***[Health insurance benefits paid for exclusively by an employer are excluded by section 105(b), rather than any portion of section 104(a).]*** If the employer and his employees … purchase insurance which pays accident or health benefits to employees, section 104(a)(3) does not apply to amounts received thereunder by employees to the extent that such amounts are attributable to the employer’s contributions. ***[The clear implication is that amount received attributable to the employees’ contributions are excluded. The amounts received attributable to the employer’s contributions are covered under section 105(b). The end result is that all the accident and health benefits are excluded.]*** … Although amounts paid by or on behalf of an employer to an employee for personal injuries or sickness are not excludable from the employee’s gross income under section 104(a)(3), they may be excludable therefrom under section 105. …

**§ 1.105-2. Amounts expended for medical care.**

Section 105(b) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) … which are paid, directly or indirectly, to the taxpayer to reimburse him for expenses incurred for the medical care … of the taxpayer, his spouse, and his dependents …. However, the exclusion does not apply to amounts which are attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year. … Section 105(b) applies only to amounts which are paid specifically to reimburse the taxpayer for expenses incurred by him for the prescribed medical care. Thus, section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether or not he incurs expenses for medical care. For example, if under a wage continuation plan the taxpayer is entitled to regular wages during a period of absence from work due to sickness or injury, amounts received under such plan are not excludable from his gross income under section 105(b) even though the taxpayer may have incurred medical expenses during the period of illness. … If the amounts are paid to the taxpayer solely to reimburse him for expenses which he incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care. If the taxpayer incurs an obligation for medical care, payment to the obligee in discharge of such obligation shall constitute indirect payment to the taxpayer as reimbursement for medical care. ***[The previous sentence describes what typically happens in the real world, with employer health plans paying doctors’ and hospitals’ bills on the employee’s behalf.]*** Similarly, payment to or on behalf of the taxpayer’s spouse or dependents shall constitute indirect payment to the taxpayer.

**§ 1.105-3. Payments unrelated to absence from work.**

Section 105(c) provides an exclusion from gross income with respect to the amounts referred to in section 105(a) to the extent that such amounts (a) constitute payments for the permanent loss or permanent loss of use of a member or function of the body, or the permanent disfigurement, of the taxpayer, his spouse, or a dependent …, and (b) are computed with reference to the nature of the injury without regard to the period the employee is absent from work. Loss of use or disfigurement shall be considered permanent when it may reasonably be expected to continue for the life of the individual. For purposes of section 105(c), loss or loss of use of a member or function of the body includes the loss or loss of use of an appendage of the body, the loss of an eye, the loss of substantially all of the vision of an eye, and the loss of substantially all of the hearing in one or both ears. The term “disfigurement” shall be given a reasonable interpretation in the light of all the particular facts and circumstances. Section 105(c) does not apply if the amount of the benefits is determined by reference to the period the employee is absent from work. For example, if an employee is absent from work as a result of the loss of an arm, and under the accident and health plan established by his employer, he is to receive $125 a week so long as he is absent from work for a period not in excess of 52 weeks, section 105(c) is not applicable to such payments. … However, for purposes of section 105(c), it is immaterial whether an amount is paid in a lump sum or in installments. Section 105(c) does not apply to amounts which are treated as workmen’s compensation ….

**§1.213-1 Medical, dental, etc., expenses.**

…

**(g) Reimbursement for expenses paid in prior years.**

(1) Where reimbursement, from insurance or otherwise, for medical expenses is received in a taxable year subsequent to a year in which a deduction was claimed on account of such expenses, the reimbursement must be included in gross income in such subsequent year to the extent attributable to (and not in excess of) deductions allowed under section 213 for any prior taxable year. See section 104, relating to compensation for injuries or sickness, and section 105(b), relating to amounts expended for medical care, and the regulations thereunder, with regard to amounts in excess of or not attributable to deductions allowed. ***[This rule is one instance of the “inclusionary tax benefit doctrine” which we will cover in depth in Chapter 29.]***

(2) If no medical expense deduction was taken in an earlier year, for example, if the standard deduction … was taken for the earlier year, the reimbursement received in the taxable year for the medical expense of the earlier year is not includible in gross income.

…

# Chapter 11: Fringe Benefits

**§ 61 Gross income defined.**

**(a) General definition.** Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

**…**

**§ 119 Meals or lodging furnished for the convenience of the employer.**

**(a)****Meals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment.**

There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents ***[dependents normally just means children]*** by or on behalf of his employer for the convenience of the employer, but only if–

**(1)**in the case of meals, the meals are furnished on the business premises of the employer, or

**(2)**in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

**(b)****Special rules.** For purposes of [subsection (a)](https://checkpoint.riag.com/app/main/docLinkNew?DocID=i84e1412a19d711dcb1a9c7f8ee2eaa77&SrcDocId=T0TCODE%3A3606.1-1&feature=tcheckpoint&lastCpReqId=609c4c&pinpnt=TCODE%3A3607.1&d=d" \l "TCODE%3A3607.1" \t ") –

**(1) Provisions of employment contract or State statute not to be determinative.**

In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

...

**§ 107 Rental value of parsonages.**

In the case of a minister of the gospel, gross income does not include–

**(1)**the rental value of a home furnished to him as part of his compensation; or

**(2)**the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities.

**§ 132 Certain fringe benefits.**

**(a)****Exclusion from gross income.**

Gross income shall not include any fringe benefit which qualifies as a–

**(1)**no-additional-cost service,

**(2)**qualified employee discount,

**(3)**working condition fringe,

**(4)**de minimis fringe,

**(5)**qualified transportation fringe,

…

**(b)****No-additional-cost service defined.** For purposes of this section, the term “no-additional-cost service” means any service provided by an employer to an employee for use by such employee if–

**(1)**such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and

**(2)**the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service). ***[The most common “no-additional-cost service” is free standby flights for airline employees.]***

**(c)****Qualified employee discount defined.** For purposes of this section–

**(1)****Qualified employee discount.**

The term “qualified employee discount” means any employee discount with respect to qualified property or services to the extent such discount does not exceed–

(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or

(B)  in the case of services, 20 percent of the price at which the services are being offered by the employer to customers. ***[Note that airlines and hotels both provide services to their customers.]***

**(2)** **Gross profit percentage.**

(A) In general. The term “gross profit percentage” means the percent which–

(i) the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer, is of

(ii) the aggregate sale price of such property.

…

**(3)****Employee discount defined.**

The term “employee discount” means the amount by which–

(A) the price at which the property or services are provided by the employer to an employee for use by such employee, is less than

(B) the price at which such property or services are being offered by the employer to customers.

…

**(d)****Working condition fringe defined.**

For purposes of this section, the term “working condition fringe” means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.

**(e)****De minimis fringe defined.** For purposes of this section–

**(1)****In general.** The term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer’s employees) so small as to make accounting for it unreasonable or administratively impracticable. ***[Free coffee for employees is the most common de minimis fringe benefit.]***

…

**(f)****Qualified transportation fringe.**

**(1)****In general.**

For purposes of this section, the term “qualified transportation fringe” means any of the following provided by an employer to an employee:

(A) Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee’s residence and place of employment. ***[An example is the “Google bus”.]***

(B) Any transit pass.

(C) Qualified parking.

…

**(2)****Limitation on exclusion.**

The amount of the fringe benefits which are provided by an employer to any employee and which may be excluded from gross income under subsection (a)(5) shall not exceed–

(A)  $175 per month in the case of the aggregate of the benefits described in subparagraphs (A) and (B) of paragraph (1),

(B)  $175 per month in the case of qualified parking, …

**(3)****Cash reimbursements.**

For purposes of this subsection, the term “qualified transportation fringe” includes a cash reimbursement by an employer to an employee for a benefit described in paragraph (1). The preceding sentence shall apply to a cash reimbursement for any transit pass only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee. ***[For example, my law firm gave me a special debit card that could be used only to put cash on a DC Metro SmarTrip card.]***

…

**(5)****Definitions.** For purposes of this subsection–

(A)  Transit pass. The term “transit pass” means any pass, token, farecard, voucher, or similar item entitling a person to transportation (or transportation at a reduced price) if such transportation is–

(i)  on mass transit facilities ….

(C)  Qualified parking. The term “qualified parking” means parking provided to an employee on or near the business premises of the employer …

**(6)****Inflation adjustment.**

(A)  In general. … the dollar amounts contained in subparagraphs (A) and (B) of paragraph (2) shall be increased by an amount equal to–

(i)  such dollar amount, multiplied by

(ii)  the cost-of-living adjustment …

(B)  Rounding. If any increase determined under subparagraph (A) is not a multiple of $5, such increase shall be rounded to the next lowest multiple of $5.

…

**(h)****Certain individuals treated as employees for purposes of subsections (a)(1) and (2).** For purposes of paragraphs (1) and (2) of subsection (a) –

**(1)****Retired and disabled employees and surviving spouse of employee treated as employee.** With respect to a line of business of an employer, the term “employee” includes–

(A)  any individual who was formerly employed by such employer in such line of business and who separated from service with such employer in such line of business by reason of retirement or disability, and

(B)  any widow or widower of any individual who died while employed by such employer in such line of business or while an employee within the meaning of subparagraph (A).

**(2)****Spouse and dependent children.**

(A)  In general. Any use by the spouse or a dependent child of the employee shall be treated as use by the employee.

(B)  Dependent child. For purposes of subparagraph (A), the term “dependent child” means any child … of the employee – … who is a dependent of the employee…. ***[Children can generally be “dependents” of their parents if the parents provide at least one-half of the child’s support and the child is a student under 24.]***

**(3)****Special rule for parents in the case of air transportation.**

Any use of air transportation by a parent of an employee (determined without regard to paragraph (1)(B)) shall be treated as use by the employee. ***[The airline pilots’ union and flight attendants’ union both have lots of lobbying heft in Congress, and this provision is the result.]***

…

**Revenue Procedure 2021-45 Tax rates and brackets–2022 inflation adjustments.**

…

**§ 3.17. Qualified Transportation Fringe Benefit.** For taxable years beginning in 2022, the monthly limitation under § 132(f)(2)(A) regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $280. The monthly limitation under § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $280.

…

***[Revenue Procedures like the one above are the way in which the IRS implements the annual inflation adjustments provided for in the Internal Revenue Code.]***

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

**(a) General rule.**

There shall be included in the gross income of an employee for the taxable year an amount equal to the cost of group-term life insurance on his life provided for part or all of such year under a policy (or policies) carried directly or indirectly by his employer (or employers); but only to the extent that such cost exceeds the sum of–

(1) the cost of $50,000 of such insurance, and

(2) the amount (if any) paid by the employee toward the purchase of such insurance.

***[The wording is awkward, but this is an exclusion for the cost of the employer providing $50k worth of life insurance. For example, if the employer buys the employee a policy that will pay $50k cash to the employee’s kids if the employee dies, then the employee has no gross income. By contrast, if an employer paid for the employee’s home insurance or renters insurance, the amount paid would be in the employee’s gross income.]***

…

**§ 125 Cafeteria plans.**

***[This has nothing to do with food in a cafeteria! The analogy is that you pick-and-choose which health plan, parking benefit, etc. you want.]***

**(a) General rule.** … no amount shall be included in the gross income of a participant in a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan. …

**(d)****Cafeteria plan defined.** For purposes of this section–

**(1)****In general.**

The term “cafeteria plan” means a written plan under which–

(A)  all participants are employees, and

(B)  the participants may choose among 2 or more benefits consisting of cash and qualified benefits.

…

**§ 127 Educational assistance programs.**

**(a) Exclusion from gross income.**

**(1) In general.**

Gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program ….

**(2) $5,250 maximum exclusion.**

If, but for this paragraph, this section would exclude from gross income more than $5,250 of educational assistance furnished to an individual during a calendar year, this section shall apply only to the first $5,250 of such assistance so furnished.

…

***[We already saw this in Chapter 7, but it is worth re-reading now, since it is a fringe benefit.]***

**§ 1.61-21. Taxation of fringe benefits.**

**(a) Fringe benefits –**

(1) In general. Section 61(a)(1) provides that, except as otherwise provided … gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. … Examples of fringe benefits include: an employer-provided automobile, a flight on an employer-provided aircraft, an employer-provided free or discounted commercial airline flight, an employer-provided vacation, an employer-provided discount on property or services, an employer-provided membership in a country club or other social club, and an employer-provided ticket to an entertainment or sporting event.

(2) Fringe benefits excluded from income. To the extent that a particular fringe benefit is specifically excluded from gross income … that section shall govern the treatment of that fringe benefit. Thus, if the requirements of the governing section are satisfied, the fringe benefits may be excludable from gross income. Examples of excludable fringe benefits include … meals or lodging furnished to an employee for the convenience of the employer (section 119); benefits provided under a dependent care assistance program (section 129); and no-additional-cost services, qualified employee discounts, working condition fringes, and de minimis fringes (section 132). … The fact that another section … addresses the taxation of a particular fringe benefit will not preclude section 61 and the regulations thereunder from applying, to the extent that they are not inconsistent with such other section. For example, many fringe benefits specifically addressed in other sections … are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded or the requirements are not met, some or all of the fringe benefit may be includible in gross income pursuant to section 61. …

(3) Compensation for services. A fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for such services….

(4) Person to whom fringe benefit is taxable –

(i) In general. A taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. If a fringe benefit is furnished to someone other than the service provider such benefit is considered in this section as furnished to the service provider, and use by the other person is considered use by the service provider. For example, the provision of an automobile by an employer to an employee’s spouse in connection with the performance of services by the employee is taxable to the employee. The automobile is considered available to the employee and use by the employee’s spouse is considered use by the employee.

…

**(b) Valuation of fringe benefits –**

(1) In general. An employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of–

(i) The amount, if any, paid for the benefit by or on behalf of the recipient, and

(ii) The amount, if any, specifically excluded from gross income by some other section ….

Therefore, for example, if the employee pays fair market value for what is received, no amount is includible in the gross income of the employee. ….

(2) Fair market value. In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm’s-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee’s subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit’s fair market value nor is the cost incurred by the employer determinative of its fair market value. …

**§ 1.119-1. Meals and lodging furnished for the convenience of the employer.**

…

**(b) Lodging.** The value of lodging furnished to an employee by the employer shall be excluded from the employee’s gross income if three tests are met:

(1) The lodging is furnished on the business premises of the employer,

(2) The lodging is furnished for the convenience of the employer, and

(3) The employee is required to accept such lodging as a condition of his employment.

The requirement of subparagraph (3) of this paragraph that the employee is required to accept such lodging as a condition of his employment means that he be required to accept the lodging in order to enable him properly to perform the duties of his employment. Lodging will be regarded as furnished to enable the employee properly to perform the duties of his employment when, for example, the lodging is furnished because the employee is required to be available for duty at all times or because the employee could not perform the services required of him unless he is furnished such lodging. …

**(c) Business premises of the employer –**

(1) In general. For purposes of this section, the term “business premises of the employer” generally means the place of employment of the employee. For example, meals and lodging furnished in the employer’s home to a domestic servant would constitute meals and lodging furnished on the business premises of the employer. Similarly, meals furnished to cowhands while herding their employer’s cattle on leased land would be regarded as furnished on the business premises of the employer. ***[Cowboys eat tax-free while on the range!]***

…

**§ 1.132-2. No-additional-cost services.**

**(a) In general –**

(1) Definition. Gross income does not include the value of a no-additional-cost service. A “no-additional-cost service” is any service provided by an employer to an employee for the employee’s personal use if–

(i) The service is offered for sale by the employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services, and

(ii) The employer incurs no substantial additional cost in providing the service to the employee (including foregone revenue and excluding any amount paid by or on behalf of the employee for the service).

…

(2) Excess capacity services. Services that are eligible for treatment as no-additional-cost services include excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services. Services that are not eligible for treatment as no-additional-cost services are non-excess capacity services such as the facilitation by a stock brokerage firm of the purchase of stock. Employees who receive non-excess capacity services may, however, be eligible for a qualified employee discount of up to 20 percent of the value of the service provided. …

…

(5) No substantial additional cost –

(i) In general. The exclusion for a no-additional-cost service applies only if the employer does not incur substantial additional cost in providing the service to the employee. For purposes of the preceding sentence, the term “cost” includes revenue that is forgone because the service is provided to an employee rather than a nonemployee….

(ii) Labor intensive services. An employer must include the cost of labor incurred in providing services to employees when determining whether the employer has incurred substantial additional cost. An employer incurs substantial additional cost, whether non-labor costs are incurred, if a substantial amount of time is spent by the employer or its employees in providing the service to employees. This would be the result whether the time spent by the employer or its employees in providing the services would have been “idle,” or if the services were provided outside normal business hours. An employer generally incurs no substantial additional cost, however, if the services provided to the employee are merely incidental to the primary service being provided by the employer. For example, the in-flight services of a flight attendant and the cost of in-flight meals provided to airline employees traveling on a space-available basis are merely incidental to the primary service being provided ( i.e. , air transportation). Similarly, maid service provided to hotel employees renting hotel rooms on a space-available basis is merely incidental to the primary service being provided ( i.e. , hotel accommodations).

…

**(c) Example.** The rules of this section are illustrated by the following example:

Example. Assume that a commercial airline permits its employees to take personal flights on the airline at no charge and receive reserved seating. Because the employer forgoes potential revenue by permitting the employees to reserve seats, employees receiving such free flights are not eligible for the no-additional-cost exclusion.

**§ 1.132-3. Qualified employee discounts.**

**(a) In general –**

(1) Definition. Gross income does not include the value of a qualified employee discount. A “qualified employee discount” is any employee discount with respect to qualified property or services provided by an employer to an employee for use by the employee to the extent the discount does not exceed–

(i) The gross profit percentage multiplied by the price at which the property is offered to customers in the ordinary course of the employer’s line of business, for discounts on property, or

(ii) Twenty percent of the price at which the service is offered to customers, for discounts on services.

(2) Qualified property or services –

(i) In general. The term “qualified property or services” means any property or services that are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee performs substantial services….

…

**(e) Excess discounts.** Unless excludable under a provision … other than section 132(a)(2), an employee discount provided on property is excludable to the extent of the gross profit percentage multiplied by the price at which the property is being offered for sale to customers. If an employee discount exceeds the gross profit percentage, the excess discount is includible in the employee’s income. For example, if the discount on employer-purchased property is 30 percent and the employer’s gross profit percentage for the period in the relevant line of business is 25 percent, then 5 percent of the price at which the property is being offered for sale to customers is includible in the employee’s income. With respect to services, an employee discount of up to 20 percent may be excludable. If an employee discount exceeds 20 percent, the excess discount is includible in the employee’s income. For example, assume that a commercial airline provides a pass to each of its employees permitting the employees to obtain a free round-trip coach ticket with a confirmed seat to any destination the airline services. ***[“Confirmed” means the same as reserved. If a seat on a flight is reserved, then it cannot be no-additional-cost, because the airline lost the revenue from selling that seat to a paying customer.]*** Neither the exclusion of section 132(a)(1) (relating to no-additional-cost services) nor any other statutory exclusion applies to a flight taken primarily for personal purposes by an employee under this program. However, an employee discount of up to 20 percent may be excluded as a qualified employee discount. Thus, if the price charged to customers for the flight taken is $300 (under restrictions comparable to those actually placed on travel associated with the employee airline ticket), $60 is excludible from gross income as a qualified employee discount and $240 is includible in gross income.

**§ 1.132-4. Line of business limitation.**

**(a) In general –**

(1) Applicability –

(i) General rule. A no-additional-cost service or a qualified employee discount provided to an employee is only available with respect to property or services that are offered for sale to customers in the ordinary course of the same line of business in which the employee receiving the property or service performs substantial services. Thus, an employee who does not perform substantial services in a particular line of business of the employer may not exclude from income under section 132(a)(1) or (a)(2) the value of services or employee discounts received on property or services in that line of business. …

(iii) Performance of substantial services in more than one line of business. An employee who performs services in more than one of the employer’s lines of business may only exclude no-additional-cost services and qualified employee discounts in the lines of business in which the employee performs substantial services.

(iv) Performance of services that directly benefit more than one line of business –

(A) In general. An employee who performs substantial services that directly benefit more than one line of business of an employer is treated as performing substantial services in all such line of business. For example, an employee who maintains accounting records for an employer’s three lines of business may receive qualified employee discounts in all three lines of business. …

**§ 1.132-6. De minimis fringes.**

…

**(e) Examples –**

(1) Benefits excludable from income. Examples of de minimis fringe benefits are occasional typing of personal letters by a company secretary; occasional personal use of an employer’s copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes ***[this regulation was written when copying machines were a fairly new invention and were very costly to operate]***; occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).

(2) Benefits not excludable as de minimis fringes. Examples of fringe benefits that are not excludable from gross income as de minimis fringes are: season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; employer-provided group-term life insurance on the life of the spouse or child of an employee; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend. Some amount of the value of certain of these fringe benefits may be excluded from income under other statutory provisions, such as the exclusion for working condition fringes….

***[Section 401 will not be on the final, but is useful to know about. ]***

**§ 401. Qualified pension, profit-sharing, and stock bonus plans**

**(a) Requirements for qualification.** A trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries shall constitute a qualified trust under this section–

**(1)** if contributions are made to the trust by such employer, or employees, or both, … for the purpose of distributing to such employees or their beneficiaries the corpus and income of the fund accumulated by the trust in accordance with such plan;

…

**(k) Cash or deferred arrangements. *[This is section 401(k).]***

**(1) General rule.** A profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan shall not be considered as not satisfying the requirements of subsection (a) merely because the plan includes a qualified cash or deferred arrangement.

….

***[The section below will not be on the final, but is useful to know about. ]***

**§1.401(k)-1 Certain cash or deferred arrangements.**

**(a) … (4) … (iii)** *Tax treatment of employees*. … elective contributions under a qualified cash or deferred arrangement are neither includible in an employee’s gross income at the time the cash would have been includible in the employee’s gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan…. ***[In other words, money the employer contributes to the employee’s 401(k) plan is excluded from the employee’s gross income – a hugely valuable tax-free fringe benefit.]***

# State and Local Bond Interest

**§ 103 Interest on State and local bonds.**

**(a) Exclusion.** … gross income does not include interest on any State or local bond.

…

**(c)****Definitions.** For purposes of this section and part IV–

**(1)****State or local bond.**

The term “State or local bond” means an obligation of a State or political subdivision thereof.

**(2)****State.**

The term “State” includes the District of Columbia and any possession of the United States.

# Chapter 12: Business and Profit-Seeking Expenses

**§ 162. Trade or business expenses**

**(a) In general.** 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)** a reasonable allowance for salaries or other compensation for personal services actually rendered;

**(2)** 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; and

**(3)** rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

***[Note that the word “including” above means the three items listed in (1), (2), and (3) are important examples of expenses that are deductible under §162. But all sorts of ordinary and necessary expenses in carrying on a trade or business are deductible. For example, a business paying its electric bill is not described in (1), (2) or (3), but is clearly deductible under §162(a).]***

**…**

**(c) Illegal bribes, kickbacks, and other payments.**

**(1) Illegal payments to government officials or employees.** No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback …

**…**

**(e) Denial of deduction for certain lobbying and political expenditures.**

**(1) In general.** No deduction shall be allowed under subsection (a) for any amount paid or incurred in connection with–

**(A)** influencing legislation,

**(B)** participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office,

**(C)** any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or

**(D)** any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official.

**…**

**(f)** **Fines, penalties, and other amounts.**

**(1)** **In general.**

Except as provided in the following paragraphs of this subsection, no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

**…**

**(m)** **Certain excessive employee remuneration.**

**(1)** **In general.**

In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000. ***[“Covered employee” generally includes the CEO, CFO, and other three highest-paid employees. Republicans tightened this provision in 2017 to combat perceived runaway CEO pay.]***

**…**

**(q)** **Payments related to sexual harassment and sexual abuse.**

No deduction shall be allowed under this chapter for–

**(1)** any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement… ***[Congress added this in 2017 because of #MeToo]***

**…**

**§ 195. Start-up expenditures**

**(a) Capitalization of expenditures.** Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

**(b) Election to deduct.**

**(1) Allowance of deduction.** If a taxpayer elects the application of this subsection ***[and most taxpayers do indeed make this election]*** with respect to any start-up expenditures–

**(A)** the taxpayer shall be allowed a deduction for the taxable year in which the active trade or business begins in an amount equal to the lesser of–

**(i)** the amount of start-up expenditures with respect to the active trade or business, or

**(ii)** $5,000, reduced (but not below zero) by the amount by which such start-up expenditures exceed $50,000, ***[Thus, if the start-up expenditures are $51k, then $4k and not $5k is deductible immediately.]*** and

**(B)** the remainder of such start-up expenditures shall be allowed as a deduction ratably ***[this means pro-rata]*** over the 180-month period beginning with the month in which the active trade or business begins.

**…**

**(c) Definitions.** For purposes of this section–

**(1) Start-up expenditures.** The term “start-up expenditure” means any amount–

**(A)** paid or incurred in connection with–

**(i)** investigating the creation or acquisition of an active trade or business, or

**(ii)** creating an active trade or business, or

**(iii)** any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

**(B)** which, if paid or incurred in connection with the operation of an existing active trade or business … , would be allowable as a deduction for the taxable year in which paid or incurred. ***[“Start-up expenditures” are those that would have been deductible under §162(a) if the business had, hypothetically, already been up and running.]***

…

**§ 212. Expenses for production of income**

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

**(3)** in connection with the determination, collection, or refund of any tax.

***[Section 212 was Congress’ response to the Higgins case. Congress overruled the result in Higgins by enacting section 212. Higgins’s holding that investing is not a trade or business remains good law.]***

**§ 1.212-1. Nontrade or nonbusiness expenses.**

**…**

**(d)**Expenses, to be deductible under section 212, must be “ordinary and necessary”. Thus, such expenses must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income.

…

**§ 262. Personal, living, and family expenses**

(a) **General rule.** Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

…

**§ 1.162-1 Business expenses.**

**(a) In general.** Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer’s trade or business… . Among the items included in business expenses are management expenses, commissions… , labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business…, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. …

**§ 1.162-2 Traveling expenses.**

**(a)** Traveling expenses include travel fares, meals and lodging, and expenses incident to travel such as expenses for sample rooms, telephone and telegraph, public stenographers, etc. Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer’s business and directly attributable to it may be deducted. If the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses. …

**(b)**

**(1)** If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer’s trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer’s trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

**(2)** Whether a trip is related primarily to the taxpayer’s trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer’s trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

…

**§ 1.162-7 Compensation for personal services.**

**(a)** There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

**(b)** The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

**(1)** Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock…. ***[In other words, excessive portions of “salaries” paid to shareholders or shareholders’ relatives may be dividends. Dividends are not deductible to the corporation, unlike salaries, which are deductible under §162.]***

**…**

**(3)** In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

…

**§ 1.162-8 Treatment of excessive compensation.**

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend….

**§ 11 Tax imposed.**

**(a)****Corporations in general.**

A tax is hereby imposed for each taxable year on the taxable income of every corporation.

**(b)****Amount of tax.**

The amount of the tax imposed by subsection (a) shall be 21 percent of taxable income.

…

***[Corporations are taxable persons just like individuals, with the tax rate generally equal to 21% of taxable income. Corporations can deduct reasonable compensation paid to employees per §162(a)(1), but corporations cannot deduct dividends that they pay. This difference explains why corporations would attempt to disguise dividends (which are not deductible) as compensation paid (which is deductible).]***

**§ 1.162-9 Bonuses to employees.**

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind….

**§ 1.262-1 Personal, living, and family expenses.**

**(a) In general.** In computing taxable income, no deduction shall be allowed, except as otherwise expressly provided … for personal, living, and family expenses.

**(b) Examples of personal, living, and family expenses.** Personal, living, and family expenses are illustrated in the following examples:

…

**(3)** Expenses of maintaining a household, including amounts paid for rent, water, utilities, domestic service, and the like, are not deductible. A taxpayer who rents a property for residential purposes, but incidentally conducts business there (his place of business being elsewhere) shall not deduct any part of the rent. If, however, he uses part of the house as his place of business, such portion of the rent and other similar expenses as is properly attributable to such place of business is deductible as a business expense.

…

**(5)** … The taxpayer’s costs of commuting to his place of business or employment are personal expenses and do not qualify as deductible expenses. …

…

**(c) Cross references.** Certain items of a personal, living, or family nature are deductible to the extent expressly provided under the following sections, and the regulations under those sections:

(1) Section 163 (interest). ***[allows deducting home-mortgage interest]***

(2) Section 164 (taxes).

(3) Section 165 (losses).

(4) Section 166 (bad debts).

(5) Section 170 (charitable, etc., contributions and gifts).

(6) Section 213 (medical, dental, etc., expenses).

…

**§ 280E. Expenditures in connection with the illegal sale of drugs**

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

***[This section is a huge problem for marijuana businesses that are legal under state law, since marijuana is still illegal under federal law. To put this section into perspective, recall that income from illegal activities is still gross income, so – in general – deductions from illegal trades or businesses are deductible under §162. For example, illegal bookies and prostitutes can deduct their ordinary and necessary expenses under §162.]***

**§ 62 Adjusted gross income defined.**

**(a) General rule.** For purposes of this subtitle, the term “adjusted gross income” means, in the case of an individual, gross income minus the following deductions:

**(1) Trade and business deductions.**

The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee. ***[Normally, trade or business expenses, such as for Caroline Taxpayer in Chapter 1, are deductible above-the-line. But the trade or business expenses of an employee are below-the-line. In fact, as we shall see, they are miscellaneous itemized deductions, which totally disallowed between now and 2025.]***

…

**(3) Losses from sale or exchange of property.**

The deductions allowed … as losses from the sale or exchange of property.

**(4) Deductions attributable to rents and royalties.**

The deductions allowed … by section 212 (relating to expenses for production of income) … which are attributable to property held for the production of rents or royalties. ***[Thus, landlords’ deductions under §212 for rental property are deductible above-the-line. However, many non-landlord deductions theoretically allowed by §212 are below-the-line and, in fact, are miscellaneous itemized deductions and totally disallowed between now and 2025. For example, amounts paid to brokers for investment advice are deductible under §212, but the deduction is taken away by §67(g), as a miscellaneous itemized deduction.]***

…

**§ 67 2-percent floor on miscellaneous itemized deductions.**

**…**

**(b) Miscellaneous itemized deductions.**

For purposes of this section, the term “miscellaneous itemized deductions” means the itemized deductions other than– ***[Notably missing from this list are §212 deductions other than those for landlords and §162 deductions where the taxpayer is an employee. Thus many of those deductions are totally disallowed between now and 2025.]***

**(1)** the deduction under section 163 (relating to interest),

**(2)** the deduction under section 164 (relating to taxes),

**(3)** the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),

**(4)** the deductions under section 170 (relating to charitable, etc., contributions and gifts) … ,

**(5)** the deduction under section 213 (relating to medical, dental, etc., expenses),

**…**

**(9)** the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),

**…**

**(g) Suspension for taxable years 2018 through 2025**

… no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026. ***[For the next eight years, all miscellaneous itemized deductions are totally denied.]***

**§ 132 Certain fringe benefits.**

**(a) Exclusion from gross income.**

Gross income shall not include any fringe benefit which qualifies as a–

**…**

**(3)**working condition fringe,

…

**(d) Working condition fringe defined.**

For purposes of this section, the term “working condition fringe” means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.

***[Recall that the §162 deductions of a taxpayer whose trade or business is being an employee are not deductible at all through 2025, because they are miscellaneous itemized deductions. The reason why we care about employees’ expense deductibility under §162 is that – if the employer pays for the expenses instead of the employee paying – then the expenses are excluded from the employee’s gross income under §132(d).]***

***…***

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

**(a) Entertainment, amusement, recreation, or qualified transportation fringes.**

**(1) In general.** No deduction otherwise allowable under this chapter shall be allowed for any item–

**(A) Activity.** With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, …

***[This total disallowance of entertainment-expense deductions was enacted as part of the 2017 tax-reform.]***

**…**

**(n)****Only 50 percent of meal expenses allowed as deduction.**

**(1)****In general.**

The amount allowable as a deduction under this chapter for any expense for food or beverages shall not exceed 50 percent of the amount of such expense which would (but for this paragraph) be allowable as a deduction under this chapter.

***…***

**§1.274-12 Limitation on deductions for certain food or beverage expenses paid or incurred after December 31, 2017.**

**(a) Food or beverage expenses.**

(1)In general. Except as provided in this section, no deduction is allowed for the expense of any food or beverages provided by the taxpayer (or an employee of the taxpayer) unless–

(i) The expense is not lavish or extravagant under the circumstances;

(ii) The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and

(iii) The food or beverages are provided to the taxpayer or a business associate.

(2)Only*50 percent*of food or beverage expenses allowed as deduction. Except as provided in this section, the amount allowable as a deduction for any food or beverage expense described in paragraph (a)(1) of this section may not exceed 50 percent of the amount of the expense that otherwise would be allowable.

(3)Examples. The following examples illustrate the application of paragraph (a)(1) and (2) of this section. In each example, assume that the food or beverage expenses are ordinary and necessary expenses under section 162(a) that are paid or incurred during the taxable year in carrying on a trade or business and are not lavish or extravagant under the circumstances. Also assume that none of the exceptions in paragraph (c) of this section apply.

(i) Example (1).Taxpayer A takes client B out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, A may deduct 50 percent of the food or beverage expenses.

(ii) Example (2).Taxpayer C takes employee D out to lunch. Under section 274(k) and (n) and paragraph (a) of this section, C may deduct 50 percent of the food or beverage expenses.

(iii) Example (3).Taxpayer E holds a business meeting at a hotel during which food and beverages are provided to attendees. Expenses for the business meeting, other than the cost of food and beverages, are not subject to the deduction limitations in section 274 and are deductible if they meet the requirements for deduction under section 162. Under section 274(k) and (n) and paragraph (a) of this section, E may deduct 50 percent of the food and beverage expenses.

…

# Chapter 14: Capital Expenditures

**§ 263. Capital expenditures**

**(a) General rule.** 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.

…

**§ 263A Capitalization and inclusion in inventory costs of certain expenses.**

**(a)****Nondeductibility of certain direct and indirect costs.**

**(1)****In general.** In the case of any property to which this section applies, any costs described in paragraph (2) –

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property,

shall be capitalized.

**(2)****Allocable costs.** The costs described in this paragraph with respect to any property are–

(A) the direct costs of such property, and

(B) such property’s proper share of those indirect costs … part or all of which are allocable to such property….

***[For example, if a car company pays a factory worker $25/hour, those wages are not deductible, but increase the company’s basis in the cars that worker produces.]***

**(b)****Property to which section applies.** Except as otherwise provided in this section, this section shall apply to–

**(1)****Property produced by taxpayer.** Real or tangible personal property produced by the taxpayer.

**(2)****Property acquired for resale.** Real or personal property described in section 1221(a)(1) ***[e.g., inventory]*** which is acquired by the taxpayer for resale.

**…**

**§ 161. Allowance of deductions**

In computing taxable income … there shall be allowed as deductions the items specified in this part ***[“this part” refers to §§ 162-199]***, subject to the exceptions provided in part IX (sec. 261 and following, relating to items not deductible ***[§263 above is one of those sections detailing items not deductible.]***).

**§ 162. Trade or business expenses**

**(a) In general.** 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–

**…**

**(3)** rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

***[Rent paid to rent office space or equipment is deductible, but only if the amount paid is genuinely rent, as opposed to something the taxpayer has effectively bought but described as a “rental”.]***

**…**

**§ 261. General rule for disallowance of deductions**

In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part. ***[“this part” refers to §§ 262-280H.]***

***[The section above is somewhat hilarious. Congress is so fond of taking away deductions with one hand that it has previously authorized with the other hand that there is a whole range of the tax code, sections 261 through 280H, devoted just to disallowing deductions. And there are plenty of other places in the tax code where Congress denies deductions other than sections 261-280H.]***

**§ 1016. Adjustments to basis**

**(a) General rule.** Proper adjustment in respect of the property shall in all cases be made–

**(1)** for expenditures, receipts, losses, or other items, properly chargeable to capital account …

***[What this section means is that any expenditure that is capitalized is added to the basis of the property that has been improved. Adding the capitalized expenditure to the basis is what is mean by “proper adjustment.” Congress worded this very poorly. ]***

**§ 1.162-3 Materials and supplies.**

(a) **In general…**

(2) **Incidental materials and supplies.** Amounts paid to acquire or produce incidental materials and supplies … that are carried on hand and for which no record of consumption is kept or of which physical inventories at the beginning and end of the taxable year are not taken, are deductible in the taxable year in which these amounts are paid, provided taxable income is clearly reflected.

***[This proviso that taxable income must be “clearly reflected” gives the IRS a tool to attack abuse of this provision.]***

…

**§ 1.162-4 Repairs.**

(a) **In general.** A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized….

**§ 1.162-11 Rentals.**

(a) **Acquisition of a leasehold.** If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run….

***[“aliquot” is just a fancy word for “pro rata”. Thus, if a business pays $5m up front for a 5-year lease on a building, then the business can deduct $1m each year for five years.]***

**(b) Improvements by lessee on lessor’s property –**

*(1) In general.* The cost to a taxpayer of erecting buildings or making permanent improvements on property of which the taxpayer is a lessee is a capital expenditure. ***[i.e., is capitalized]***

*…*

**§ 1.212-1. Nontrade or nonbusiness expenses.**

…

**(k)** Expenses paid or incurred in defending or perfecting title to property, in recovering property … , or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. ***[Rather, they must be capitalized.]*** Attorneys’ fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one’s right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

…

**§ 1.263(a)-1 Capital expenditures; in general.**

**(a) General rule for capital expenditures.** … no deduction is allowed for–

**(1)** Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or

**(2)** Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

…

**(d) Examples of capital expenditures.** The following amounts paid are examples of capital expenditures:

**(1)** An amount paid to acquire or produce a unit of real or personal tangible property. See § 1.263(a)–2.

**(2)** An amount paid to improve a unit of real or personal tangible property. See § 1.263(a)–3.

**(3)** An amount paid to acquire or create intangibles. See § 1.263(a)–4.

…

**§ 1.263(a)-2 Amounts paid to acquire or produce tangible property.**

**(a) Overview.** This section provides rules for applying section 263(a) to amounts paid to acquire or produce a unit of real or personal property….

**(b) Definitions.** For purposes of this section, the following definitions apply:

…

**(2)**Personal property means tangible personal property… ***[All property that is not real property is “personal” property. Thus, a huge widget-making machine owned by a corporation is “personal” property. Note that patents, copyrights, and other IP are personal property, but they are not “tangible” personal property. Intangible property is covered under §1.263(a)-4, covered later.]***

**(3)**Real property means land and improvements thereto, such as buildings or other inherently permanent structures (including items that are structural components of the buildings or structures) that are not personal property…

…

**(c) Coordination with other provisions of the Code.**

…

**(2) Materials and supplies***.* Nothing in this section changes the treatment of amounts paid to acquire or produce property that is properly treated as materials and supplies under § 1.162-3. ***[We saw 1.162-3 earlier in the reading.]***

**(d) Acquired or produced tangible property–**

**(1) Requirement to capitalize.** … a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property … including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. …

(2) **Examples.** The following examples illustrate the rules of this paragraph (d)….

**Example 1.** **Acquisition of personal property**. A purchases new cash registers for use in its retail store… A must capitalize under paragraph (d)(1) of this section the amount paid to acquire each cash register.

…

**(e) Defense or perfection of title to property–(1) In general.** Amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the meaning of this section and must be capitalized.

**(2) Examples.** The following examples illustrate the rule of this paragraph (e):

**Example 1.** **Amounts paid to contest condemnation**. X owns real property located in County. County files an eminent domain complaint condemning a portion of X’s property to use as a roadway. X hires an attorney to contest the condemnation. The amounts that X paid to the attorney must be capitalized because they were to defend X’s title to the property.

**Example 2.** **Amounts paid to invalidate ordinance**. Y is in the business of quarrying and supplying for sale sand and stone in a certain municipality. Several years after Y establishes its business, the municipality in which it is located passes an ordinance that prohibits the operation of Y’s business. Y incurs attorney’s fees in a successful prosecution of a suit to invalidate the municipal ordinance. Y prosecutes the suit to preserve its business activities and not to defend Y’s title in the property. Therefore, the attorney’s fees that Y paid are not required to be capitalized under paragraph (e)(1) of this section.

**Example 3.** **Amounts paid to challenge building line**. The board of public works of a municipality establishes a building line across Z’s business property, adversely affecting the value of the property. Z incurs legal fees in unsuccessfully litigating the establishment of the building line. The amounts Z paid to the attorney must be capitalized because they were to defend Z’s title to the property.

**(f) Transaction costs– (1) In general.** … a taxpayer must capitalize amounts paid to facilitate the acquisition of real or personal property. …

**(2) Scope of facilitate– (i) In general.** Except as otherwise provided in this section, an amount is paid to facilitate the acquisition of real or personal property if the amount is paid in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate an acquisition, the fact that the amount would (or would not) have been paid but for the acquisition is relevant but is not determinative. Amounts paid to facilitate an acquisition include, but are not limited to, inherently facilitative amounts specified in paragraph (f)(2)(ii) of this section.

**(ii) Inherently facilitative amounts.** An amount is paid in the process of investigating or otherwise pursuing the acquisition of real or personal property if the amount is inherently facilitative. An amount is inherently facilitative if the amount is paid for–

(A) Transporting the property (for example, shipping fees and moving costs);

(B) Securing an appraisal or determining the value or price of property;

(C) Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition; ***[This includes many fees spent on lawyers.]***

(D) Application fees, bidding costs, or similar expenses;

(E) Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement); ***[This includes many fees spent on lawyers.]***

(F) Examining and evaluating the title of property; ***[This includes many fees spent on lawyers.]***

(G) Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees; ***[This includes many fees spent on lawyers.]***

(H) Conveying property between the parties, including sales and transfer taxes, and title registration costs; ***[This includes many fees spent on lawyers.]***

(I) Finders’ fees or brokers’ commissions, including contingency fees …

(J) Architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; or

…

(4) **Examples.** The following examples illustrate the rules of paragraph (f) of this section….

**Example 1.** **Broker’s fees to facilitate an acquisition**. A decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. A pays fees to the broker to find property for A to acquire. Under paragraph (f)(2)(ii)(I) of this section, A must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

**Example 2.** **Inspection and survey costs to facilitate an acquisition**. B decides to purchase Building X and pays amounts to third-party contractors for a termite inspection and an environmental survey of Building X. … B must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

**Example 3.** **Moving costs to facilitate an acquisition**. C purchases all the assets of D and, in connection with the purchase, hires a transportation company to move storage tanks from D’s plant to C’s plant. … C must capitalize the amount paid to move the storage tanks from D’s plant to C’s plant because this cost is inherently facilitative to the acquisition of personal property.

…

**Example 5.** **Scope of facilitate**. F is in the business of providing legal services to clients. F is interested in acquiring a new conference table for its office. F hires and incurs fees for an interior designer to shop for, evaluate, and make recommendations to F regarding which new table to acquire.… F must capitalize the amounts paid to the interior designer to provide these services because they are paid in the process of investigating or otherwise pursuing the acquisition of personal property.

…

**§ 1.263(a)-3 Amounts paid to improve tangible property.**

…

**(d) Requirement to capitalize amounts paid for improvements.** … a taxpayer generally must capitalize the related amounts … paid to improve a unit of property owned by the taxpayer. … For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer–

**(1)** Are for a betterment to the unit of property (see paragraph (j) of this section);

**(2)** Restore the unit of property (see paragraph (k) of this section); or

**(3)** Adapt the unit of property to a new or different use (see paragraph (*l*) of this section).

**(e) Determining the unit of property …**

**(2) Building–**

**(i) In general.** Except as otherwise provided … , each building and its structural components … is a single unit of property (“building”). …

**(ii) Application of improvement rules to a building.** An amount is paid to improve a building under paragraph (d) of this section if the amount is paid for an improvement under paragraphs (j), (k), or paragraph (l) of this section to any of the following:

(A) Building structure. A building structure consists of the building … other than the structural components designated as buildings systems….

(B) Building system. Each of the following structural components … including the components thereof, constitutes a building system that is separate from the building structure, and to which the improvement rules must be applied–

(1) Heating, ventilation, and air conditioning (“HVAC”) systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);

(2) Plumbing systems …;

(3) Electrical systems … ;

(4) All escalators;

(5) All elevators;

(6) Fire-protection and alarm systems … ;

(7) Security systems … ;

(8) Gas distribution system …

**(3) Property other than building –**

**(i) In general.** … all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer.

…

**(6) Examples.**

…

**Example 9.****Personal property**. J provides legal services to its clients. J purchased a laptop computer and a printer for its employees to use in providing legal services. … Under paragraph (e)(3)(i) of this section, the computer and the printer are separate units of property because the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer).

…

**(g) Special rules for determining improvement costs–(1) Certain costs incurred during an improvement– (i) In general.** A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair costs) that directly benefit or are incurred by reason of an improvement. Indirect costs arising from activities that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under section 263(a), regardless of whether the activities are performed at the same time as an improvement.

…

**(i) Safe harbor for routine maintenance on property–**

(1) **In general.** An amount paid for routine maintenance … is deemed not to improve that unit of property. …

(ii) … Routine maintenance … is the recurring activities that a taxpayer expects to perform as a result of the taxpayer’s use of the unit of property to keep the unit of property in its ordinarily efficient operating condition. Routine maintenance activities include, for example, the inspection, cleaning, and testing of the unit of property, and the replacement of damaged or worn parts of the unit of property with comparable and commercially available replacement parts….

**(j) Capitalization of betterments–**

**(1) In general.** A taxpayer must capitalize as an improvement an amount paid for a betterment to a unit of property. An amount is paid for a betterment to a unit of property only if it–

**(i)** Ameliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production; ***[Note that this subparagraph (i) would apply to Mt. Morris Drive-in Theatre Co.’s situation]***

**(ii)** Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component … to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or

**(iii)** Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.

**…**

**(3) Examples.** The following examples illustrate the application of this paragraph (j) …

**Example 6. Not a betterment; building refresh.**

(i) F owns a nationwide chain of retail stores that sell a wide variety of items. To maintain the appearance and functionality of its store buildings after several years of wear, F periodically pays amounts to refresh the look and layout of its stores. The work that F performs during a refresh consists of cosmetic and layout changes to the store’s interiors and general repairs and maintenance to the store building to modernize the store buildings and reorganize the merchandise displays. The work to each store consists of replacing and reconfiguring display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing wood flooring throughout the store building, and power washing building exteriors. … Finally, assume that the work does not ameliorate any material conditions or defects that existed when F acquired the store buildings or result in any material additions to the store buildings.

(ii) … Considering the facts and circumstances including the purpose of the expenditure, the physical nature of the work performed, and the effect of the expenditure on the buildings’ structure and systems, the amounts paid for the refresh of each building are not for any material additions to, or material increases in the capacity of, the buildings’ structure or systems as compared with the condition of the structure or systems after the previous refresh. Moreover, the amounts paid are not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of any building structure or system under as compared to the condition of the structures or systems after the previous refresh. Rather, the work performed keeps F’s store buildings’ structures and buildings’ systems in their ordinarily efficient operating condition. Therefore, F is not required to treat the amounts paid for the refresh of its store buildings’ structures and buildings’ systems as betterments….

**Example 12.** **Not a betterment; regulatory requirement**. L owns a meat processing plant. After operating the plant for many years, L discovers that oil is seeping through the concrete walls of the plant. Federal inspectors advise L that it must correct the seepage problem or shut down its plant. To correct the problem, L pays an amount to add a concrete lining to the walls from the floor to a height of about four feet and also to add concrete to the floor of the plant. … an amount is paid to improve a building unit of property if the amount is paid for a betterment to the building structure or any building system. The walls are part of the building structure…. The condition necessitating the expenditure was the seepage of the oil into the plant. Prior to the seepage, the walls did not leak and were functioning for their intended use. L is not required to treat the amount paid as a betterment … because it is not paid for a material addition to, or a material increase in the capacity of, the building’s structure as compared to the condition of the structure prior to the seepage of oil. Moreover, the amount paid is not reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the building structure … as compared to the condition of the structure prior to the seepage of the oil Therefore, L is not required to treat the amount paid to correct the seepage as a betterment to the building …. The federal inspectors’ requirement that L correct the seepage to continue operating the plant is not relevant in determining whether the amount paid improves the plant. ***[This example is based on* Midland Empire Packing Co. v. Commissioner*]***

**…**

**(k) Capitalization of restorations–**

**(1) In general.** A taxpayer must capitalize as an improvement an amount paid to restore a unit of property… . An amount restores a unit of property only if it–

…

**(iv)** Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use;

**(v)** Results in the rebuilding of the unit of property to a like-new condition … ; or

**(vi)** Is for the replacement of a part or combination of parts that comprise a major component or a substantial structural part of a unit of property … .

…

(7) **Examples.** The following examples illustrate the application of this paragraph (k)

…

**Example 28. Not replacement of major component or substantial structural part; floors. V owns and operates a hotel building. V decides to refresh the appearance of the hotel lobby by replacing the floors in the lobby. The hotel lobby comprises less than 10 percent of the square footage of the entire hotel building. V pays an amount to replace the wood flooring in the lobby with new wood flooring of a similar quality. V did not replace any other flooring in the building. … Under paragraphs (e)(2)(ii) and (k)(2) of this section, an amount is paid to improve a building if the amount restores the building structure or any building system. The wood flooring is part of the building structure under paragraph (e)(2)(ii)(A) of this section. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. However, the lobby floors are not a significant portion of a major component (that is, all the floors) …, nor do the lobby floors comprise a substantial structural part of the building structure …. Therefore, … the replacement of the lobby floors is not the replacement of a major component or substantial structural part of the building unit of property, and V is not required to treat the amount paid for the replacement of the lobby floors as a restoration to the building under paragraph (k)(1)(iv) of this section.**

**Example 29. Replacement of major component or substantial structural part; floors. Assume the same facts as Example 28, except that V decides to refresh the appearance of all the public areas of the hotel building by replacing all the floors in the public areas. To that end, V pays an amount to replace all the wood floors in all the public areas of the hotel building with new wood floors. The public areas include the lobby, the hallways, the meeting rooms, the ballrooms, and other public rooms throughout the hotel interiors. The public areas comprise approximately 40 percent of the square footage of the entire hotel building. All the floors in the hotel building comprise a major component of the building structure because they perform a discrete and critical function in the operation of the building structure. The floors in all the public areas of the hotel comprise a significant portion of a major component (that is, all the building floors) of the building structure. Therefore, … the replacement of all the public area floors constitutes the replacement of a major component of the building structure. Accordingly, V must treat the amount paid to replace the public area floors as a restoration of the building unit of property under paragraphs (k)(1)(vi) and (k)(2) of this section and must capitalize the amounts as an improvement to the building under paragraph (d)(2) of this section.**

**…**

**(*l*) Capitalization of amounts to adapt property to a new or different use–**(1) **In general.** A taxpayer must capitalize as an improvement an amount paid to adapt a unit of property to a new or different use. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer’s ordinary use of the unit of property at the time originally placed in service by the taxpayer.

**…**

**§ 1.263(a)-4 Amounts paid to acquire or create intangibles.**

**(a) Overview.** This section provides rules for applying section 263(a) to amounts paid to acquire or create intangibles. … the rules provided by this section do not apply to amounts paid to acquire or create tangible assets.

**…**

**(b) Capitalization with respect to intangibles–(1) In general.** Except as otherwise provided in this section, a taxpayer must capitalize–

**(i)** An amount paid to acquire an intangible …

**(ii)** An amount paid to create an intangible described in paragraph (d) of this section;

**(iii)** An amount paid to create or enhance a separate and distinct intangible asset … ;

**…**

**(v)** An amount paid to facilitate … an acquisition or creation of an intangible … .

**…**

(c) **Acquired intangibles–**(1) **In general.** A taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Examples of intangibles … include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

…

(vi) A lease.

…

**(xiv)** Computer software. ***[This includes software to run a website]***

**…**

(d) **Created intangibles**

**…**

(3) **Prepaid expenses–**(i) **In general.** A taxpayer must capitalize prepaid expenses. ***[Note that there is a huge exception to this rule: the 12-month rule below in subsection (f).]***

…

**(5) Certain rights obtained from a governmental agency–(i) In general.** A taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

**(ii) Examples.** The following examples illustrate the rules of this paragraph (d)(5):

**Example 1.** **Business license**. X corporation pays $15,000 to state Y to obtain a business license that is valid indefinitely. Under this paragraph (d)(5), the amount paid to state Y is an amount paid to a government agency for a right granted by that agency. Accordingly, X must capitalize the $15,000 payment.

**Example 2.** **Bar admission**. A, an individual, pays $1,000 to an agency of state Z to obtain a license to practice law in state Z that is valid indefinitely, provided A adheres to the requirements governing the practice of law in state Z. Under this paragraph (d)(5), the amount paid to state Z is an amount paid to a government agency for a right granted by that agency. Accordingly, A must capitalize the $1,000 payment.

**…**

**(e) Transaction costs–**

**(1) Scope of facilitate–(i) In general.** Except as otherwise provided in this section, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction.

**…**

**(4) Simplifying conventions–**

**(i) In general.** For purposes of this section, employee compensation … costs … are treated as amounts that do not facilitate the acquisition or creation of an intangible.

**(ii) Employee compensation–**(A) In general. The term employee compensation means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer.

…

**(f) 12–month rule–**

**(1) In general.** Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of–

**(i)** 12 months after the first date on which the taxpayer realizes the right or benefit; or

**(ii)** The end of the taxable year following the taxable year in which the payment is made.

***[The 12-month rule is merely a comparison of three dates: (A) The date the right or benefit ends, which for an insurance policy is the last day the insurance policy provides coverage. (B) The date 12 months after the right or benefit begins, which for an insurance policy is simply one year after coverage starts. (C) December 31st of the year after the year payment was made. If A comes after the earlier of B and C, then the taxpayer must capitalize the expenditure; otherwise, the taxpayer can deduct the expenditure.]***

…

**(8) Examples.** …

**Example 1.** **Prepaid expenses**. On December 1, 2005, N corporation pays a $10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1–year term that begins on February 1, 2006. The amount paid by N is a prepaid expense …. Because the right or benefit attributable to the $10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12–month rule provided by this paragraph (f) does not apply. N must capitalize the $10,000 payment.

**Example 2.** **Prepaid expenses**. (i) Assume the same facts as in Example 1, except that the policy has a term beginning on December 15, 2005. The 12–month rule of this paragraph (f) applies to the $10,000 payment because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, N is not required to capitalize the $10,000 payment.

…

**Example 6. Lease.** On December 1, 2005, W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2005. W pays its outside counsel $7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property…. W’s $7,000 payment to its outside counsel is an amount paid to facilitate W’s creation of the lease as described in paragraph (e)(1)(i) of this section. The 12-month rule of this paragraph (f) applies to the $7,000 payment because the right or benefit that the $7,000 payment facilitates the creation of neither extends more than 12 months beyond December 1, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, W is not required to capitalize its payment to its outside counsel.

…

**(g) Treatment of capitalized costs–(1) In general.** An amount required to be capitalized by this section is not currently deductible under section 162. Instead, the amount generally is added to the basis of the intangible acquired or created. ***[These two sentences nicely sum up what capitalization means: no deduction, and the amount spent is added to the basis of the asset.]***

…

**(*l*) Examples….**

**Example 7. Product launch costs.**

(i) R corporation, a manufacturer of pharmaceutical products, is required by law to obtain regulatory approval before selling its products. While awaiting regulatory approval on Product A, R pays to develop and implement a marketing strategy and an advertising campaign to raise consumer awareness of the purported need for Product A. R also pays to train health care professionals and other distributors in the proper use of Product A.

(ii) The amounts paid by R are not amounts paid to acquire or create an intangible under paragraph (c) or (d) of this section or to facilitate such an acquisition or creation. In addition, the amounts do not create a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section. Accordingly, R is not required to capitalize these amounts under this section. While the amounts may benefit R by creating consumer demand for Product A and increasing awareness of Product A among distributors, these benefits, without more, are not intangibles for which capitalization is required under this section. ***[This example is a natural extension of the* RJR Nabisco *case’s holding.]***

…

# Chapter 15: Depreciation

**§ 167. Depreciation**

**(a) General rule.** 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 ***[cf. §162]***, or

**(2)** of property held for the production of income ***[cf. §212]***.

**(b) Cross reference.** For determination of depreciation deduction in case of property to which section 168 applies, see section 168.

**…**

**§ 168. Accelerated cost recovery system**

**(a) General rule.** 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,

**(2)** the applicable recovery period, and

**(3)** the applicable convention.

**(b) Applicable depreciation method.** For purposes of this section–

…

**(3) Property to which straight line method applies.** The applicable depreciation method shall be the straight line method in the case of the following property:

**(A)** Nonresidential real property.

**(B)** Residential rental property.

…

**(4) Salvage value treated as zero.** Salvage value shall be treated as zero. ***[The salvage value at the end of the useful life (also called the “recovery period”) is always treated as zero under section 168]***

…

**(c) Applicable recovery period.** For purposes of this section, the applicable recovery period shall be determined in accordance with the following table:

|  |  |
| --- | --- |
| **In the case of:** | **The applicable**  **recovery period is:** |

…

Residential rental property 27.5 years

Nonresidential real property 39 years

**…**

**(d) Applicable convention.** For purposes of this section–

**(1) In general.** Except as otherwise provided in this subsection, the applicable convention is the half-year convention ***[meaning that to keep the math simple, the property is considered put into service on July 1st of the year the property is actually put into service].***

**(2) Real property.** In the case of–

**(A)** nonresidential real property,

**(B)** residential rental property, and

**(C)** any railroad grading or tunnel bore,

the applicable convention is the mid-month convention. ***[To keep the math simple, Congress enacted the “mid-month convention,” which assumes that the property is considered put into service halfway into the month that the property is put into service. See (4)(B) below.] …***

**(4)****Definitions.**

…

(B)  Mid-month convention. The mid-month convention is a convention which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.

…

**(e) Classification of property.** For purposes of this section–

…

**(2) Residential rental or nonresidential real property.**

**(A) Residential rental property.**

**(i) Residential rental property.** The term “residential rental property” means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.

…

***[Subsection (k) below is a key part of the 2017 tax-reform bill (the TCJA). For most property that is not real estate, taxpayers can depreciate 100% of its cost in the year they put the property into service. The goal is to spur business investment over the next few years.]***

**(k)****Special allowance for certain property.**

**(1)****Additional allowance.**

In the case of any qualified property–

(A)  the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property…

**(2)****Qualified property.**

For purposes of this subsection–

(A)  In general. The term “qualified property” means property–

(i) (I) to which this section applies which has a recovery period of 20 years or less …

***[Generally, “qualified property” is all tangible property that is not real estate.]***

**(6)****Applicable percentage.**

For purposes of this subsection–

(A)  In general. Except as otherwise provided in this paragraph, the term “applicable percentage” means–

(i)  in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent… ***[The percentages then phase down to zero between 2023 and 2027.]***

…

**§ 1016. Adjustments to basis**

**(a) General rule.** Proper adjustment in respect of the property shall in all cases be made–

**…**

**(2)** … for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount–

**(A)** allowed as deductions in computing taxable income under this subtitle or prior income tax laws …

***[A depreciation deduction taken on a piece of property reduces the taxpayer’s basis in that piece of property by the amount of the depreciation deduction.]***

**§ 1.167(a)-1. Depreciation in general.**

**…**

**(b) Useful life.** For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer’s trade or business, (3) the climatic and other local conditions peculiar to the taxpayer’s trade or business, and (4) the taxpayer’s policy as to repairs, renewals, and replacements.

**…**

**§ 1.167(a)-2 Tangible property.**

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to … land apart from the improvements or physical development added to it. … No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business … may be depreciated.

**§ 1.167(a)-3 Intangibles.**

**(a) In general.** If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. ***[Patents have a 20-year term, so you know that they are subject to obsolescence, with a useful life of no more than 20 years. Copyrights also have limited terms.]*** An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. …

**§ 1.167(a)-5. Apportionment of basis.**

In the case of the acquisition … of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time….

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

***[This section allows small businesses to immediately deduct (rather than capitalize) much of the tangible personal property that they purchase. This is a subsidy for small businesses.]***

**(a)****Treatment as expenses.**

A taxpayer may elect to treat the cost of any section 179 property as an expense which is not chargeable to capital account. Any cost so treated shall be allowed as a deduction for the taxable year in which the section 179 property is placed in service.

**(b)****Limitations.**

**(1)****Dollar limitation.**

The aggregate cost which may be taken into account under subsection (a) for any taxable year shall not exceed $1,000,000.

**(2)****Reduction in limitation.**

The limitation under paragraph (1) for any taxable year shall be reduced (but not below zero) by the amount by which the cost of section 179 property placed in service during such taxable year exceeds $2,500,000.

**(3)****Limitation based on income from trade or business.**

(A)  In general. The amount allowed as a deduction under subsection (a) for any taxable year (determined after the application of paragraphs (1) and (2)) shall not exceed the aggregate amount of taxable income of the taxpayer for such taxable year which is derived from the active conduct by the taxpayer of any trade or business during such taxable year. ***[The section 179 deduction can reduce the taxable income from a trade or business to zero, but not below zero.]***

…

**(d)****Definitions and special rules.**

**(1)****Section 179 property.** For purposes of this section, the term “section 179 property” means property–

(A)  which is–

(i)  tangible property (to which section 168 applies), or

(ii)  computer software … ,

(B)  which is ***[not real estate]*** … , and

(C)  which is acquired by purchase for use in the active conduct of a trade or business.

…

# Chapter 16: Losses and Bad Debts

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

**(a) Computation of gain or loss.** The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

**…**

***[The formula for a loss is simple:***

***Loss = Basis for Loss – Amount realized***

***Note that “Basis for Loss” is almost always the same as Basis, with exceptions such as §1015(a) when the donor’s basis is greater than FMV at the time of the gift. We came across this situation in Ch. 5.]***

**§ 165. Losses**

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

**(b) Amount of deduction.** For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

**(c) Limitation on losses of individuals.** In the case of an individual, the deduction under subsection (a) shall be limited to–

**(1)** losses incurred in a trade or business ***[cf. §162]***;

**(2)** losses incurred in any transaction entered into for profit, though not connected with a trade or business ***[cf. §212]***; and

**(3)** except as provided in subsection (h), ***[subsection (h) makes (c)(3) almost never apply]*** losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. **…**

**(e) Theft losses.** For purposes of subsection (a), any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers such loss.

**(f) Capital losses.** Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212. ***[Section 1211 is a huge deduction-denying provision, denying loss deductions in many circumstances. We will cover it more in Ch. 29 on Capital Gains and Losses.]***

**(g) Worthless securities.**

**(1) General rule.** If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. ***[We will cover Capital Losses more in Ch. 29, but this language says that worthless securities are treated as sold or exchanged for $0 in cash consideration. The result is a capital loss.]***

**(2) Security defined.** For purposes of this subsection, the term “security” means … stock in a corporation … or … a bond, debenture, note, or certificate, or other evidence of indebtedness….

**§ 1.165-1. Losses.**

…

**(b) Nature of loss allowable.** To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and … actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

…

**(d) Year of deduction. …**

(2)

(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. ***[Here again we see the maddeningly vague “facts and circumstances” standard rather than bright line rules, but there is likely no better way to administer this provision.]*** Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(ii) If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of $10,000 is completely destroyed by fire in 1961, and if the taxpayer’s only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 1962, the taxpayer sustains a loss of $2,000 in 1961. However, if the taxpayer’s automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 1962, $1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 1963.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted. ***[This subparagraph (iii) relates to something called the “tax benefit doctrine”, which we will cover more in Chapter 28.]***

…

**§ 1.165-4. Decline in value of stock.**

**(a) Deduction disallowed.** No deduction shall be allowed under section 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause. A mere shrinkage in the value of stock owned by the taxpayer, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as the date of loss. No loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized … upon the sale or exchange of the stock and except as otherwise provided … with respect to stock which becomes worthless during the taxable year.

**…**

**§ 1.165-8. Theft losses.**

**(a) Allowance of deduction. …**

**(2)** A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165(e). Thus, a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, see paragraph (d) of § 1.165-1.

**…**

**(c) Amount deductible.** … the fair market value of the property immediately after the theft shall be considered to be zero. …

**(d) Definition.** For purposes of this section the term “theft” shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery. ***[As we see in the reading, “theft” also includes Ponzi schemes.]***

…

**§ 1.165-9 Sale of residential property.**

**(a) Losses not allowed.** A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a).

**(b) Property converted from personal use.**

**(1)** If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under section 165(a). ***[This is the provision at issue in the* Cowles *case.]***

**(2)** The loss allowed under this paragraph upon the sale of the property shall be the excess of the adjusted basis prescribed in § 1.1011–1 for determining loss over the amount realized from the sale. For this purpose, the adjusted basis for determining loss shall be the lesser of either of the following amounts … for the period subsequent to the conversion of the property to income-producing purposes:

**(i)** The fair market value of the property at the time of conversion, or

**(ii)** The adjusted basis for loss, at the time of conversion… .

***[Note that the provisions directly above create a “basis for loss” that is the lesser of the FMV at the time of the conversion and the taxpayer’s basis for loss. Note that this is very similar to what §1015 does with the bases of gifts, causing the basis for loss to be the lesser of FMV at the time of give and the donor’s basis. (We saw §1015 and gifts in Ch. 5.)]***

***…***

**§ 1.167(g)-1. Basis for depreciation.**

… In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

***[Cowles was able to take depreciation deductions on his house after he had moved out and was attempting to sell or rent it. The section above explains what basis Cowles could use to calculate his depreciation deductions during this time: it is the lesser of his basis and the FMV of the property at the time he moved out.]***

**§ 166. Bad debts**

**(a) General rule.**

**(1) Wholly worthless debts.** There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

**(2) Partially worthless debts.** When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. ***[Partly worthless debts will not be on the final, since determining which portion of a debt is worthless is quite complicated.]***

**(b) Amount of deduction.** For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

…

**(d) Nonbusiness debts.**

**(1) General rule.** In the case of a taxpayer other than a corporation–

**(A)** subsection (a) shall not apply to any nonbusiness debt; and

**(B)** where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

***[This means that bad non-business debts are treated as short-term capital losses, which we will cover more in Ch. 29. Capital losses are often not deductible.]***

**(2) Nonbusiness debt defined.** For purposes of paragraph (1), the term “nonbusiness debt” means a debt other than–

**(A)** a debt created or acquired … in connection with a trade or business of the taxpayer; or

**(B)** a debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business.

**(e) Worthless securities.** This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

…

**§ 1.166-1 Bad debts.**

**…**

**(c) Bona fide debt required.** Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. …

**…**

**§ 1.166-2 Evidence of worthlessness.**

**(a) General rule.** In determining whether a debt is worthless in whole or in part … will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

**(b) Legal action not required.** Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

**(c) Bankruptcy – (1) General rule.** Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

**…**

***[On the final exam, any question will state expressly whether the bad debt is indeed worthless.]***

***[The section below will not be on the final, but it is important to know about. This section shut down most tax-shelters, but it also keeps many taxpayers from taking deductions on side businesses or rental activities. In the problems, it would most likely keep Mary from taking many of the deductions otherwise allowed.]***

**§ 469 Passive activity losses and credits limited.**

**(a)****Disallowance.**

**(1)****In general.** … neither–

(A)  the passive activity loss, nor

(B)  the passive activity credit,

for the taxable year shall be allowed.

…

**(c)****Passive activity defined.** For purposes of this section –

**(1)****In general.**

The term “passive activity” means any activity–

(A)  which involves the conduct of any trade or business, and

(B)  in which the taxpayer does not materially participate.

…

**(h)****Material participation defined.** For purposes of this section–

**(1)****In general.** A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is–

(A)  regular,

(B)  continuous, and

(C)  substantial.

…

# Chapter 24: Charitable Deductions

**§ 170** **Charitable, etc., contributions and gifts.**

**(a)****Allowance of deduction.**

**(1)****General rule.**

There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

…

**(3)****Future interests in tangible personal property.**

For purposes of this section, payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired….

…

**(c)** **Charitable contribution defined.** For purposes of this section, the term “charitable contribution” means a contribution or gift to or for the use of–

**(1)** A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

**(2)** A corporation, trust, or community chest, fund, or foundation–

**(A)** created or organized in the United States… ;

**(B)** organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

**(C)** no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

**(D)** which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

…

**(e) Certain contributions of ordinary income and capital gain property.**

**(1) General rule.** The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by … the amount of gain which would not have been long-term capital gain … if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution)…. ***[This statute is confusingly worded. Here is what it is generally saying: If you donate a capital asset held for over a year, you can deduct the full fair market value. But if you donate something that is either not a capital asset or that you have held for one year or less, you can deduct only your basis in the property.]***

**(f) Disallowance of deduction in certain cases and special rules.**

…

**(3) Denial of deduction in case of certain contributions of partial interests in property.**

**(A) In general.** In the case of a contribution … of an interest in property which consists of less than the taxpayer’s entire interest in such property, a deduction shall be allowed under this section only ***[in very unusual circumstances]***…. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property ***[e.g. a lease]*** shall be treated as a contribution of less than the taxpayer’s entire interest in such property.

**(B) Exceptions.** Subparagraph (A) shall not apply to–

**(i)** a contribution of a remainder interest in a personal residence or farm,

**(ii)** a contribution of an undivided portion of the taxpayer’s entire interest in property, and

**(iii)** a qualified conservation contribution. ***[This clause allows a deduction for contributing a “conservation easement,” which is key component of national policy for conserving open spaces like farms and forests. There is a whole industry built upon this clause.]***

**…**

**(8) Substantiation requirement for certain contributions.**

**(A) General rule**. No deduction shall be allowed under subsection (a) for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization…. ***[Not having the right paperwork can lose entire deductions!]***

**(17) Recordkeeping.** No deduction shall be allowed under subsection (a) for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

**…**

**(*l*) Treatment of certain amounts paid to or for the benefit of institutions of higher education. *[This subsection, added by the 2017 tax-reform bill, prevents people from deducting the cost of their tickets to college football and basketball as “charitable contributions” to the colleges.]***

**(1)** **In general.** No deduction shall be allowed under this section for any amount described in paragraph (2).

**(2) Amount described.** For purposes of paragraph (1), an amount is described in this paragraph if–

**(A)** the amount is paid by the taxpayer to or for the benefit of an educational organization… , and

**(B)** the taxpayer receives (directly or indirectly) as a result of paying such amount the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.

…

**§ 1.170A–1 Charitable, etc., contributions and gifts; allowance of deduction.**

**…**

(c) **Value of a contribution in property.** (1) If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) ***[which generally reduces the deduction to the taxpayer’s basis if selling the property would not result in long-term capital gain.]***

**…**

(e) **Transfers subject to a condition or power.** If as of the date of a gift a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. If an interest in property passes to, or is vested in, charity on the date of the gift and the interest would be defeated by the subsequent performance of some act or the happening of some event, the possibility of occurrence of which appears on the date of the gift to be so remote as to be negligible, the deduction is allowable. For example, A transfers land to a city government for as long as the land is used by the city for a public park. If on the date of the gift the city does plan to use the land for a park and the possibility that the city will not use the land for a public park is so remote as to be negligible, A is entitled to a deduction under section 170 for his charitable contribution.

…

(g) **Contributions of services.** No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible….

(h)**Payment in exchange for consideration –**

*(1) Burden on taxpayer to show that all or part of payment is a charitable contribution or gift.* No part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for … goods or services … is a contribution or gift within the meaning of section 170(c) unless the taxpayer–

(i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and

(ii) Makes a payment in an amount that exceeds the fair market value of the goods or services.

*(2) Limitation on amount deductible –*

(i) In general. The charitable contribution deduction under section 170(a) for a payment a taxpayer makes partly in consideration for goods or services may not exceed the excess of–

(A) The amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over

(B) The fair market value of the goods or services the organization provides in return.

…

**§ 1.170A–7 Contributions not in trust of partial interests in property.**

… (d) **Illustrations.** …

**Example 1.** A, an individual owning a 10–story office building, donates the rent-free use of the top floor of the building for the year 1971 to a charitable organization. Since A’s contribution consists of a partial interest to which section 170(f)(3)(A) applies, he is not entitled to a charitable contributions deduction for the contribution of such partial interest.

**Example 2.** In 1971, B contributes to a charitable organization an undivided one-half interest in 100 acres of land, whereby as tenants in common they share in the economic benefits from the property. The present value of the contributed property is $50,000. Since B’s contribution consists of an undivided portion of his entire interest in the property to which section 170(f)(3)(B) applies, he is allowed a deduction in 1971 for his charitable contribution of $50,000.

**Example 3.** In 1971, D loans $10,000 in cash to a charitable organization and does not require the organization to pay any interest for the use of the money. Since D’s contribution consists of a partial interest to which section 170(f)(3)(A) applies, he is not entitled to a charitable contributions deduction for the contribution of such partial interest.

…

***[This section below is not on the final exam, but it deals with the treatment of many donees (whereas §170 deals with donors). Tax-exemption is a fabulous benefit for charities, churches, universities, etc.]***

**§ 501. Exemption from tax on corporations, certain trusts, etc.**

(a) **Exemption from taxation.** An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

…

(c) **List of exempt organizations.** The following organizations are referred to in subsection (a):

…

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided …), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

…

# Chapter 28: Annual Accounting

**§ 441. Period for computation of taxable income**

**(a) Computation of taxable income.** Taxable income shall be computed on the basis of the taxpayer’s taxable year.

…

**(d)****Calendar year.** For purposes of this subtitle, the term “calendar year” means a period of 12 months ending on December 31.

…

**(g)****No books kept; no accounting period.** … the taxpayer’s taxable year shall be the calendar year if–

**(1)**the taxpayer keeps no books … ***[This refers to accounting books******. The vast majority of human taxpayers don’t keep accounting books, and hence the calendar year is the default for most people. Even many businesses that do keep accounting books still use the calendar year because it is simple.]***

…

**§ 111. Recovery of tax benefit items**

**(a) Deductions.** Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax imposed by this chapter.

***[Section 111 sets out the exclusionary tax benefit doctrine. By contrast, the inclusionary tax benefit doctrine has been created purely by case law.]***

…

**§ 164. Taxes**

…

***[Subsection (e) below was at issue in Hillsboro National Bank.]***

**(e) Taxes of shareholder paid by corporation.** Where a corporation pays a tax imposed on a shareholder on his interest as a shareholder, and where the shareholder does not reimburse the corporation, then–

**(1)** the deduction … shall be allowed to the corporation; and

**(2)** no deduction shall be allowed the shareholder for such tax.

…

**§ 172. Net operating loss deduction**

**(a) Deduction allowed**

There shall be allowed as a deduction for the taxable year an amount equal to- … (2) … (B) the lesser of-

(i) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, carried to such taxable year, or

(ii) 80 percent of the excess (if any) of-

(I) taxable income …, over

(II) the amount determined under subparagraph (A).

For purposes of this subtitle, the term “net operating loss deduction” means the deduction allowed by this subsection.

**(b) Net operating loss carrybacks and carryovers.**

**(1) Years to which loss may be carried. (A) General rule.** A net operating loss for any taxable year-

(i) shall be a net operating loss carryback to the extent provided ***[only for farmers, life insurance companies, and other lucky taxpayers]*** … and

(ii) … shall be a net operating loss carryover … to each taxable year following the taxable year of the loss. …

**(2) Amount of carrybacks and carryovers.** The entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the “loss year”) shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall-

(A) be computed … by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

(B) not be considered to be less than zero, and

(C) for taxable years beginning after December 31, 2020, be reduced by 20 percent of the excess (if any) described in subsection (a)(2)(B)(ii) for such taxable year. …

**(c) Net operating loss defined.** For purposes of this section, the term “net operating loss” means the excess of the deductions allowed … over the gross income.

…

**§ 1341. Computation of tax where taxpayer restores substantial amount held under claim of right**

**(a) General rule.** If–

**(1)** an item was included in gross income for a prior taxable year … because it appeared that the taxpayer had an unrestricted right to such item;

**(2)** a deduction is allowable for the taxable year because it was established after the close of such prior taxable year … that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and

**(3)** the amount of such deduction exceeds $3,000,

then the tax imposed by this chapter for the taxable year shall be the lesser of the following:

**(4)** the tax for the taxable year computed with such deduction; or

**(5)** an amount equal to-

**(A)** the tax for the taxable year computed without such deduction, minus

**(B)** the decrease in tax … for the prior taxable year … which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year

…

# Chapter 29: Capital Gains and Losses

**§ 1211. Limitation on capital losses**

**(a) Corporations.** In the case of a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of gains from such sales or exchanges.

**(b) Other taxpayers.** In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of –

**(1)** $3,000 ($1,500 in the case of a married individual filing a separate return), or

**(2)** the excess of such losses over such gains.

**§ 165. Losses**

**…**

**(f) Capital losses.** Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

**…**

**§ 1221. Capital asset defined**

**(a) In general.** For purposes of this subtitle, the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include –

**(1)** stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

**(2)** property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business; ***[Such assets are covered §1231.]***

**(3)** a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by –

**(A)** a taxpayer whose personal efforts created such property,

**(B)** in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

**(C)** a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B); ***[for example, if the property is given by gift, with the basis determined under §1015.]***

**…**

**(8)** supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

**…**

**§ 64. Ordinary income defined**

For purposes of this subtitle, the term “ordinary income” includes any gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b). Any gain from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as “ordinary income” shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231(b).

**§ 65. Ordinary loss defined**

For purposes of this subtitle, the term “ordinary loss” includes any loss from the sale or exchange of property which is not a capital asset. Any loss from the sale or exchange of property which is treated or considered, under other provisions of this subtitle, as “ordinary loss” shall be treated as loss from the sale or exchange of property which is not a capital asset.

**§ 1. Tax imposed**

… **(h) … (11)** **Dividends taxed as net capital gain.**

**(A) In general.** For purposes of this subsection ***[subsection (h) reduces the tax rate on “net capital gains”]***, the term “net capital gain” means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.

…

***[Section 1 of the tax code is a beastly mess, showing years of last-minute congressional tax-rate changes, weird compromises, and temporary rate cuts. In general, §1 is not worth reading. Paragraph (h)(11) basically says that the long-term capital gains rate applies to “net capital gains” as defined in §1222(11), plus any “qualified dividends.” Virtually all dividends one would get from holding a company’s stock will be “qualified dividends.” For the final exam, assume that all dividends are qualified dividends.]***

**§ 1222. Other terms relating to capital gains and losses**

For purposes of this subtitle–

**(1) Short-term capital gain.** The term “short-term capital gain” means gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent such gain is taken into account in computing gross income.

**(2) Short-term capital loss.** The term “short-term capital loss” means loss from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent that such loss is taken into account in computing taxable income.

**(3) Long-term capital gain.** The term “long-term capital gain” means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

**(4) Long-term capital loss.** The term “long-term capital loss” means loss from the sale or exchange of a capital asset held for more than 1 year, if and to the extent that such loss is taken into account in computing taxable income.

**(5) Net short-term capital gain.** The term “net short-term capital gain” means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

**(6) Net short-term capital loss.** The term “net short-term capital loss” means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

**(7) Net long-term capital gain.** The term “net long-term capital gain” means the excess of long-term capital gains for the taxable year over the long-term capital losses for such year.

**(8) Net long-term capital loss.** The term “net long-term capital loss” means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

…

**(11) Net capital gain.** The term “net capital gain” means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

***[Note that Section 1231 is not on the final exam. But it is worth looking at to understand why the properties described in §1221(a)(2) are not capital assets. Also, much of any business’s assets are governed by §1231.]***

**§ 1231. Property used in the trade or business and involuntary conversions**

**(a) General rule.**

**(1) Gains exceed losses.** If–

**(A)** the section 1231 gains for any taxable year, exceed

**(B)** the section 1231 losses for such taxable year,

such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be. ***[If there are net gains on §1231 assets, then the gains receive the favorable long-term capital gains rates. ]***

**(2) Gains do not exceed losses.** If –

**(A)** the section 1231 gains for any taxable year, do not exceed

**(B)** the section 1231 losses for such taxable year,

such gains and losses shall not be treated as gains and losses from sales or exchanges of capital assets. ***[If there are net losses on §1231 assets, then the losses are not treated as capital losses, and hence are not subject to the loss-deduction limitations in §1211. This is very favorable treatment.]***

**(3) Section 1231 gains and losses.** For purposes of this subsection –

**(A) Section 1231 gain.** The term “section 1231 gain” means –

**(i)** any recognized gain on the sale or exchange of property used in the trade or business, …

**(B) Section 1231 loss.** The term “section 1231 loss” means any recognized loss from a sale or exchange or conversion described in subparagraph (A). …

**(b) Definition of property used in the trade or business.** For purposes of this section–

**(1) General rule.** The term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not–

**(A)** property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, ***[cf. §1221(a)(1)]***

**(B)** property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, ***[cf. §1221(a)(1)]***

**(C)** … described in paragraph (3) of section 1221(a) …

***[This definition – used just for §1231 purposes – of “property used in the trade or business” covers assets described in §1221(a)(2), as long as the taxpayer has held them for over one year. Colloquial terms for assets like those described above are “section 1231 assets” or “quasi-capital assets.”]***

***…***