BASIC INCOME TAX OUTLINE w/ Professor Corbett

I. Chapter 1 – Computing Tax Liability

a. Computations
   1. GI (§61) – §62 deductions = AGI
   2. TI (§ 61)= AGI – [SD or (ID + MID exceeding 2%)] – PE (for 2 TP if jointly filing and dep)
      a) ID and PE are subject to phase-out/limitation for high AGI.
      b) CREDITS come off the TAX LIABILITY
   3. Capital Gain
      a) Subtract from TI and tax at preferential rate.
      b) Keep in TI to determine tax bracket?

b. Accounting
   1. Cash
      a) Amounts are treated as income when received in cash and are deductible when paid
   2. Accrual
      a) Items are included in gross income when earned regardless of when payment is actually received and items of expense are deducted when the obligation it to pay is incurred, regardless of when payment is made.

c. §61 Gross Income:
   1. Includes all income from whatever source derived, including but not limited to the 15 items listed in §61(a)(1).
   2. Does not include –
      a) a mere return of capital (i.e. someone paying you back loan principle)
      b) a financial benefit with an obligation to repay (i.e. take out a loan)
      c) anything excluded by a specific statutory provision

d. §62 Adjusted Gross Income:
   1. §62 provides certain deductions to Gross Income.
      a) Alimony §215, Trade & Biz deductions, Losses from sale or exchange of property §161, Moving expenses §217, Interest on education loans §221, Reimbursed expenses of employees §161, Deductions attributable to rents/royalties §212

e. §63 Taxable Income:
   1. Known as the tax base
      a) GI - § 62 deductions = AGI
      b) **Subtract either Standard OR Itemized deductions.**
         a. Standard Deduction
            i. Automatically get the Standard Deduction unless choose to itemize. – see Rev Proc for amount
            ii. If dependent, Look at §63(c)(5).
               1. The greater of $850 and [$300+ earned inc.]
               2. If [$300+earned inc] is higher than $5150, take $5150
         b. Itemized Deductions (can only take if don't take the standard)
            i. Itemized Deductions §63
               1. All deductions other than Personal Exemption and §62 deductions
               2. Miscellaneous Itemized Deductions §67 = all itemized deductions not listed in §67b
                  a. Can only take if the sum exceeds 2% of AGI.
                     1) Deduct the amt over 2%.
               3. **Limitation** on how much you can take §68(b)
                  a. Applicable Amount Joint = $150,500k (.11)
                  b. Applicable Amount Separate = $71,250k (.11)
                  c. If AGI > AA, the ID will be reduced by **2/3 of** the lessor of:
                     1) 3% of AGI-AA
                     2) 80% of the amt of the ID otherwise allowable.
                  d. § 68(f) is a phaseout limitation – get some of it back!
                     1) ID that you can take = ID – 2/3(x, where x is lesser of 1 or 2)
      c) **Subtract Personal Exemption §151**

a. Amt is $3,300 for TP, spouse (if filing jointly or if spouse is non-working) and each dependant.

i. $3,300 * N = **PE**

ii. Do not take if you are claimed as a dependent on another TP's return.

b. Subject to **Phase-out**: if your AGI > AA in Rev Proc (.17)

i. AGI - AA = *x*

ii. (*x*/2,500), then round # up

iii. Multiply # by (2), which will give you a **%**

iv. PE you can take = **PE** – [2/3*(**%**)(**PE**)]

1. 2/3 comes from § 151(e).

II. Chapter 2 – Gross Income

→ Receipt of a Financial Benefit

a. Found $$/property = Treasure Trove Rule: When you *find* property, value of property must be reported.
  1. However much it is worth on the day that you found it is how much income you have.
    a) Find 5k in diamonds, report 5k income
    b) Even if you find it inside something you bought.
  2. Will not have to recognize the appreciation until you sell it.
  3. Borrow money, you do not have income b/c you have to pay it back.
    a) If have a loan that you do not have to pay back, then you have income (i.e., discharge of debt)

b. Payment of Taxes by 3rd party is income
  1. If TP has a legal obligation to pay, and the obligation is discharged by some third party, the discharge by that third party will be considered income!
  2. Company paid the income tax for its President. Court held that this was the receipt of an economic benefit and thus income.

c. Punitive damages is considered income for tax purposes.
  1. If get lost profits and punitive damages in a lawsuit, then both are considered income.

d. When an employer gives an employee something of value it will be considered income EVEN if there is consideration.
    a) Converted frequent flyer miles into cash.
    b) What if employee was trading in Biz miles to go on a personal trip – like if she used her miles to buy a $600 ticket to Paris? --- Not taxable b/c IRS hasn't ruled on it
    c) If receive the credits after buying ticket for a personal trip, no income b/c you have personally purchased the ticket.

e. Repayment of Loan
  1. Return of principle is NOT income, interest received on the loan IS income.
  2. Borrowed $$does not have income when take a loan.

f. Non-cash receipts - may be income even if the benefit is in the form of property or service

g. Unsolicited Property
  1. Property received in the mail, is not income unless there is intent to retain the property or some associated benefit is shown.

h. Illegal earnings IS INCOME!! (kickbacks)

i. Unemployment Benefits pursuant to a federal or state program are fully taxable

j. Winnings from a raffle = INCOME, can subtract the cost of the entry ticket.

k. Employer "gifts" like stock/new car = INCOME (in consideration of continued employment)

l. Flyer receives frequent flyer mileage credits (self or employer purchase, doesn't matter). Flyer has income? Not unless sells them.

→ Income w/o Receipt of Cash/Property

m. Rental value of TP's own residence's Rental is not Income.

n. Barter Transactions = If services are paid for other than in $$$, the FMV of the property/services must be included in INCOME.
  1. Owner agrees to rent Tenant her lake house for the summer for 4K.
    a) Charge only 1K if tenant makes 3K (FMV) of improvements to the house? = 4K income
      a. Tenant does repairs then Tenant TP can deduct cost of supplies.
      b. Tenant pays 3k for repairs, then Tenant TP doesn't report any income, still 4K for LL.
    b) If svcs are rendered at a stipulated price, that price will be the FMV.
  2. If payments are in the form of services, FMV of services rec'd includable in each of their GROSS. (i.e if painter paints lawyers house in exchange for legal advice, both report FMV)

o. <u>If given anything from a third party</u> (corporation) then it's income even if you are the 100% shareholder of the corp.
    1. T is President of Corporation transfers his residence to the Corporation and then doesn't pay rent to the corporation. Court holds that T has income equal to Fair Rental Value of home in which he and his family are living. Essentially what is happening is that a third party is discharging the debt obligation owed by TP. He has the obligation to provide his family w/ shelter

p. <u>Imputed Income</u> is income that results when the <u>TP performs a service for himself or his family</u>
    1. Farmer grows own food for own consumption – NOT income
    2. Sells $100 worth of veggies or exchanges them for $100 worth of fruit, she has income. Both parties are better off than they were before the transaction. Barter Transaction.
    3. Doctor needs tax return, lawyer needs physical. Both valued at $200.
        a) If they swap svcs, each will have income of 200.
        b) If lawyer fills out his own tax return, no income. Example of imputed income.

III. Chapter 3 – Gifts and Inheritances

→ Gifts §102

a. General –
    1. Property acquired by gift is NOT income.
    2. §1041 Transfers between <u>spouses</u> are automatically gift.
    3. To be a gift, Transferor must have had DONATIVE intent
        a) <u>The transferor must be motivated out of disinterested generosity, mutual admiration and respect.</u>
            a. Not doing it b/c he may receive some benefit in the future expected benefit.
            b. Not doing it for repayment of some past action, repayment (Employer).
        b) Burden of proof is on TP.

b. Whether it is a gift is a question of FACT to be determined by the trial court's trier of fact.

→ Employee Gifts §102(c)

c. General – Transfers of property or money by an employer to an employee cannot be GIFTS.
    1. EE must show that the transfer was not made in recognition of the EE's employment.
    2. The Tax Reform Act of 1986 prevents employers from giving gifts to EE.
    3. <u>Exceptions:</u>
        a) <u>Payments made by ER because of EE's death</u> up to 5k.
        b) <u>Qualified Employee Achievement Award</u> under §274(j) and value of award does not need to be included in income
        c) Certain <u>de minimis fringe benefits</u> may be excluded from gross under §132(e)
            a. Traditional Retirement gifts are de minimus

d. Requirements of 274(j) **Qualified Employee Achievement Award-**
    1. Award must be given to recognize <u>length of service (min 5y) or safety</u> achievement.
        a) For length of service award, can't have received in last 4 years.
        b) Safety award cannot be given to more than 10% of employees.
        c) Safety award cannot be given to manager, admin, clerical or other prof. Emp.
    2. Cannot be cash or gift certificates - <u>tangible personal property</u> is all that can be given.
    3. Has to be given as part of a <u>meaningful presentation</u>.
    4. < $400 unless there is a qualified program, then can be $600.
    5. Not disguised compensation.

e. Employer gives all of her employees, except her son, a black and white television set at Christmas, worth $100. She gives Son, who also is an employee, a color television set, worth $500. Does Son have gross income?
    1. Other employees have income of $100. If the TV was in the workplace then, it could be all income. If it was under the Christmas tree, then maybe $400 is gift and $100 is for work. Bifurcation

f. <u>Tips</u> are income, not gifts

g. Congregation gift to Reverend is a gift since the "Church" is the actual employer.

h. <u>Coworker gifts</u>: $$$ from fellow coworkers is non-taxable gift. If employer contributes, the portion from the employer is income

→ Bequests, Devises and Inheritances

i. Under §102 -Bequests, Devises and Inheritances are <u>not</u> income for tax purposes.

j. <u>Note</u>: Inheritance differs from bequest in that there is no will and so the testator's property is passed intestate.

k. <u>Note</u>: Bequest is personal property given pursuant to terms of a will while a devise is $$$.

l. <u>Settlements regarding the estate</u> - "in lieu of" law (Supp. Ct). If you are asserting a claim against someone and you settle that claim, then the tax consequences will be determined what will the money you got will be "in lieu of".

1. Lyeth's g-mom died leaving estate to church. Lyeth contested under undue influence. Before trial, a compromise was reached and the estate was split between church and heirs. Lyeth got the $$ as an heir, so not taxed.
2. Father leaves several family members out of will. Daughter and others attack the will. As a result of a settlement of the controversy, daughter rec's 20k. - Will be treated as an inheritance and be excluded, no income.
3. <u>Quantum Meriuit</u> claim against estate – one is a creditor and it is income. i.e. Boyfriend who has a mental problem with marriage agrees with TP that the will leave her everything at his death in return for her staying with him throughout the marriage. She does, he does not, she sues his estate on a theory of quantum meruit and settles her claim. Not excludable.

m. A bequest cannot be supported by any consideration.
   1. Bequest at death instead of payment for services during lifetime - Ct holds bequest to be taxable b/c its not really a bequest but payment for svcs rendered.
   2. <u>Executor/Executrix:</u> Father appointed Daughter executrix of his estate and made a $20,000 bequest to her in lieu of all compensation or commissions to which she would otherwise be entitled as executrix. <u>Not excludable b/c Income for svcs.</u>
   3. Father leaves 20k to daughter "in appreciation of her long and devoted service to him." - No indication that she's performed svcs so no income. Need to know what long and what devoted service is; however, this is <u>customary language</u> so is excludable.
   4. Father leaves 20k to daughter pursuant to <u>written agreement</u> that she would take care of him in his declining yrs. - Income b/c contract for svcs rendered.

IV. Chapter 4 – Employee Benefits

a. §132 - FRINGE Benefits - Fringe benefits <u>are income</u> b/c they are addit'l compensation by the employer
b. <u>Exceptions:</u>
   1. <u>No Additional cost service § 132(a)(1)</u>
      a) Service provided to the employee that is <u>regularly offered for sale to customers</u> where
      b) Employer incurs <u>no substantial additional cost</u> in providing service to employee AND
      c) Services are provided on a <u>nondiscriminatory basis</u>.
      d) Services must be in the <u>same line of Biz</u>.
         a. Examples include airline, RR and hotel; giving tickets on standby, rooms when not booked.
         b. You are not taking Biz from customers that ER would have had in the ordinary course of the line of Biz of which the EE is providing services.
            i. If desk clerk bounces a paying guest so employee can stay rent free. - Not excluded (but can get proper employee discount)
         c. No income even if rebate
   2. <u>Qualified employee discount § 132(a)(2)</u>
      a) The Value of courtesy discounts on a good or service routinely sold by the employer at a price equal to cost (products) or not more than a **20%** discount (services) purchased from employer.
      b) <u>Same line of Biz</u> & <u>no addlt cost svcs</u>.
      c) <u>Nondiscrimination</u> applies
      d) **Before looking at statute, must determine whether you're dealing w/ Services or Property!!**
      e) <u>Ceiling</u> imposed –
         a. ON SERVICES- max 20% of the price at which the svcs are offered to cust.
            i. Insurance is a service.
         b. On PROPERTY- max discount for property is employer's **Gross Profit %**
            i. Gross Profit % = (aggregate sales price - cost)/(aggregate sales price)
            ii. Example - Employee works for electronics store which had 1mil in sales and 600k cost of goods sold. If employee buys a 2k video cassette recorder for 1k –
               1. This is property so discount cannot exceed Gross Profit %
               2. (Aggregate sales of 1mil – Cost of 600k)/(Aggregate sales of 1mil) = 40%. He's getting 50% off which is the above the GP% of 40% so can only exclude $800, not $1k. The excess will be income which is $200.
   3. **Same Line of Biz Rule:** If hotel is owned by a conglomerate who also owns a shipping line and employee works for shipping line, no exclusion for staying at hotel.
      a) If employee works for conglomerate, amt will be excluded. In theory works, for both Bizes.
   4. **Nondiscrimination Rule:** fringe benefits may be made available to highly compensated employees only if the benefits are also provided on substantially equal terms to other employees.

a) Where different % discount applies in discriminating way, the whole benefit is void and the value will be income
b) EE cannot discriminate in favor of highly compensated employees but they can discriminate in respect to other benefits such as free parking. 132(a)(2).
    a. Is it a highly compensated EE. Then go to section 414q.
    b. The term "highly compensated employee" means any employee who—
        i. **(A)** was a 5-percent owner at any time during the year or the preceding year, or
        ii. **(B)** for the preceding year—
            1. **(i)** had compensation from the employer in excess of $80,000, and
            2. **(ii)** if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

5. Rebates/vouchers are fine (discount/freebie now or later doesn't matter).
6. Family (spouse/dependents) can get the discount/freebie and it's not income.
7. Written reciprocal agreement 132(i) Employee stays in the hotel of a rival chain under a written reciprocal agreement under which employees pay 50% of the normal rent. Excluded under 132(i) so long as neither employer incurs substantial addlt costs (including foregone revenue).
8. Working condition fringe § 132(a)(3) -
    a) An employee may exclude a working condition fringe benefit, that is, any property or service provided to an employee that the employee could have deducted (162) or depreciated (167) if he had paid for the item himself.
    b) Nondiscrimination does NOT apply
    c) Examples: company car, on the job training provided by employer.
9. De minimus fringe § 132(a)(4) -
    a) Value of services is so small as to make required accounting for it unreasonable or impracticable.
    b) Includes use of copy machine, taxi fare for overtime work, coffee and donuts, occasional tickets for theater or sporting events
        a. Employer has a bar and provides employees w/ happy hour cocktails at the end of each week. De Minimus Fringe exclusion. However, if get free drinks EVERY week, may not be de minimus.
        b. Case of scotch each Christmas from employer is de minimus UNLESS very expensive. Might be a holiday gift under 162.
10. Qualified transportation fringe § 132(a)(5)
    a) Examples: parking, MBTA pass
    b) Limits of $110 for pass and $205 for parking
    c) There is no nondiscrimination rule
        a. Employee is an officer of a corp which pays his parking fees. Non-officers pay own parking. Can exclude up to $205 per month. Doesn't matter that there's discrimination in favor of officer.
11. Qualified moving expense reimbursement § 132(a)(6) - Moving expenses are deductible anyway
12. Qualified retirement planning services § 132(a)(7) - Moving away from this toward an IRA
13. Group term life insurance policies §79 – this is a valuable exclusion
14. Employer provided coverage under an accident or health plan §106
15. Biz Trip costs paid by employer – Not income. (i.e. attend convention & employer pays.)
16. On-Premesis athletic facility § 32(j)(4)- Employer puts in a gym at the Biz facilities for the use of employees and their families.
    a) "on-premises athletic facility" means any gym or other athletic facility which is 1) located on the premises of the employer, 2) which is operated by the employer, and 3) substantially all the use of which is by employees of the employer, their spouses, and their dependent children.

→ Exclusion for Meals & Lodging (119)

c. In order for §119 to apply – 3 requirements
    1. Meals and lodging must be on the Biz premises of the employer.
        a) Ownership is not the test. Test of Biz premises and that the term means "either at a place where the employee performs a significant portion of his duties or where the employer conducts a significant portion of his Biz."
            a. Motel manager was always on call at a residence owned by the motel owner two blocks from the motel – excludable

b. Court holding that a residence adjacent to the motel (across the street) was not geographically separated from the motel and was therefore "on the Biz premises."

2. Must be provided for the convenience of the employer. Meaning there is a <u>legitimate Biz reason</u> why employer giving employee free meals and lodging. (not for compensation)
    a) Cannot just agree to a clause in the employment contract requiring employee to live on the premises must be legitimate Biz reason.
3. Must be <u>required</u> as a condition of employment (this 3rd req applies to LODGING, not meals).
    a) TP lived on premises of employer (Funeral home) and rec'd free rent. Biz was a funeral home. Customary to have someone there 24hrs/day, was required as condition of employment and is for the convenience of employer.

d. <u>Groceries do not qualify as MEALS (Circuit courts differ)</u>
e. Fee simple land transfer wouldn't qualify. (property fee not lodging)
f. <u>Not for reimbursements</u> - Highway Patrolman is on duty from 8am-5pm. Eats lunch everyday at restaurants adjacent to state highway. Gets reimbursed by state for luncheon expenses. Not excluded b/c benefit is for meals NOT <u>REIMBURSEMENTS</u>. It is income.

V. Chapter 5 – Awards

→ Prizes

a. §74(a) **-** As a general rule, prizes and awards <u>ARE income.</u>
    1. Unless it's a qualified scholarship (§ 117, see below)
    2. Biz trips are not prizes and awards, therefore they are excludable (see)
b. <u>Exceptions</u>
    1. §74(b) <u>Exception for prizes and awards transferred to charities</u> ONLY if:
        a) In recognition of religious, charitable, scientific, educational, artistic, literary or civic <u>achievement.</u>
            a. Being an amateur athlete does not qualify as a civic achievement.
        b) Individual <u>did not</u> enter a contest to get the award
        c) Individual <u>not</u> required to render substantial future services as a condition of receiving the award
        d) Grantor must transfer the award directly to a charity/governmental entity.
            a. Individual must never have possession if so then income. There is a limit.
                i. If take possession and donate later, it's income and then a later deduction as a donation (see)
    2. §74(c) <u>Exception for employee awards</u>.
        a) §274(j) Qualified Employee Achievement Award (see above)
    3. Also want to check if it could be <u>de minimus</u> or some other exclusion (see above)

→ Scholarships & Fellowships

c. General rule under §117 is that <u>a qualified scholarship will be excluded</u> from gross income.
    1. A qualified scholarship is one which covers **tuition, books and supplies.**
    2. Room and board does <u>not</u> qualify
    3. **117(c)** – if your scholarship is conditioned on you <u>providing services</u> then it is <u>not</u> excludable. If you must do some kind of service for the scholarship, that portion will be taxed. (allocate proportionally)
        a) Student awarded scholarship of 6k for full tuition and R&B. Tuition is 3k, R&B is 3k. Student is required to do 300 hrs of research (students normally paid $10/hr). – student can't deduct because $3k worth of services, and R&B can't deduct. (allocate proportionally: $1500 in of income allocated in the tuition and $1500 in room and boarding)
        b) No work required, but receives the $6,000 as an <u>athletic scholarship</u>?
            a. IRS allows exclusion but must be gratuitous in nature and:
                i. the university <u>can expect but not require participation</u>, cannot require the student to participate in other sport in lieu, and
                ii. cannot terminate the scholarship if the student does not participate in sport.
    4. **§117(d) - Qualified Tuition Reduction**. EE of educational institutions (or their spouses)
        a) <u>Excluded</u> if: (1) or undergraduate only (2) it must not discriminate and does not have to perform services.
    5. <u>Educational grants made by an ER to a current or former EE</u> have generally been held <u>**taxable**</u> because they represent compensation for past, present or future services; §127 Employer Educational Assistance Programs <u>allows exclusion of $5,250</u>
        a) Secretary receives 10k stipend from her law firm to assist her while on leave of absence to obtain college degree. Required to return to firm following educational leave (can exclude $5250) (127). Not a scholarship under 117c.

VI. **Chapter 6 – Gains from Dealings in Property** (taxpayer has transferred some piece of property)

→ Determination of Basis

a. General Rule: If you sell a piece of property for more than you paid, you will have a GAIN which must be reported. If sell property for less, you will have a loss which may or may not be deductible.
b. Basis - the basis of property is the cost thereof, including the cash or property given up to obtain the asset.
c. **§1001(a)** – Computation of Gain or Loss
    1. Gain from sale or disposition = AR-AB (§ 1011) (amount realized – adjusted basis)
    2. You will report unless another section says otherwise about not reporting the gain.
    3. Steps:
        a) Realized Gain = Amt Realized (AR) – Adjusted Basis (AB)
        b) Amt Realized §1001(b) = Money rec'd + the FMV (fair market value) of any property rec'd (i.e. sale price paid)
        c) AB = Initial Basis +/- Adjustments
            a. **Initial basis** is function of **how you acquire the property**
                i. Purchase or exchange = cost basis
                ii. Gift = gift basis
            b. **Depreciation** – AB must subtract depreciation deduction **(can only depreciate to 0)**
            c. **Improvements** – Get added into AB.
d. §1001(c)
    1. You shall record for tax purposes your gain or loss.
    2. Abandoning is also a realization.
e. Swaps/Exchange of property - Property is disposed and therefore you should figure out if there is a gain.
    1. The **Cost basis** of the property received in a taxable exchange is the FMV (at time of exchange) of the property rec'd in the exchange.
        a) If FMV cannot be ascertained, will be assumed to be equal to what it was exchanged for.
    2. Stocks should be seen as swaps for cash and then purchases for cash.
    3. HYPO: A has a car for which he paid $8k, now worth 10k. B has a boat for which he paid 6k, now worth 11k. They decide to swap the property.
        a) A: AR=11k (gets the boat), AB=8k, Gain of 3k.
        b) B: AR=10k (gets the car), AB=6k, Gain of 4k.
        c) If both later decide to sell to C for 15k?
            a. A – AR=15k, AB=?
                i. Acquired boat by **exchange** so will have a COST basis.
                ii. If have a cost basis, must look at the FMV of the boat when rec'd it, AB=11k -- Gain=4k.
            b. B – AR=15k, AB=FMV of car when rec'd which is 10k -- Gain=5k
f. Options: If acquire an option then exercise that option, the price paid will be merger of both the option and purchase price.
    1. If owner purchased the land by paying $1,000 for an option to purchase the land for an additional $9,000 and subsequently exercised the option; Basis is $10k (regardless of the actual value at the time of exercising)
        a) What result to owner if rather than ever actually acquiring the landowner sold the option to investor for $1,500? - The option itself is property and the taxable amount is the $1,500. Will report a 500 gain with the sale of the option. The buyers Cost basis is 1500 because that is what he paid for it and then he exercises it (paying 9k) his basis is 10,500.
g. Mortgages (Recourse) & Down-payments: If bought land using 2k own cash and 8k **recourse** mortgage, still have a cost basis of 10k.
    1. **Recourse mortgage** – personal obligation to repay
    2. **Non-recourse** – no personal obligation to repay land is security for the obligation. creditor to go against the owner of the property and not the owner (usually not real estate)
h. Positive Adjustments: Things that add to basis are called capital expenditures (i.e. new roof).
    1. Exception is lessee's improvements which are already excluded under §109 (where lessee pays for improvements and it's not deducted from the rent), can't use it to adjust the basis since already excluded it.
        a) §109 "Gross income does not include income other than rent derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee." Do not report as income, and do not increase your basis.

2. What difference in result in (a) if when the land had a value of $10,000, owner, a real estate salesperson, received it from employer as a bonus for putting together a major real estate development, and owner's income tax was increased $3,000 by reason of the receipt of the land?
    a) Here the tax liability is NOT a direct cost to the property. The question here is what you pay the seller. If there is a sales tax, then that is part of the property. Thus, the basis is only $10,000.
3. Employee discounts do not factor into COST basis.
    a) Cost basis is FMV of prop, not what paid for it. (10k at discount of 9k, basis is 10k.)

→ Property Acquired by Gift

i. Only a gift if there is donative intent
    1. Cannot be any consideration for a gift.

j. Value of property acquired by gift is not income to the donee §102. No tax to donee.

k. **§1015 – General Rule –** Donee takes Donor's Basis (transferred basis) **with 2 EXCEPTIONS:**
    1. Donor's basis > FMV on date of gift AND the donee has sold it for a LOSS (i.e. less than FMV):
        a) Donee's Basis = FMV
    2. Donor's basis > FMV on date of gift BUT the donee sells for > FMV but less than Donor's basis :
        a) Donee's Basis = AR. Neither gain nor loss will be reported. (AR-AB=0)
    3. Example: Donor's cost was 20k, FMV at time of gift 30k. (Donor's basis is < FMV at time of gift – general rule applies) If donee sold for:
        a) 35k? AR=35k, AB=20k so 15kGain
        b) 15k? AR=15k, AB =20k so 5k Loss (15k eco loss)
        c) 25k? AR=25k, AB= 20k so 5k Gain (5k eco loss)
    4. Example: Donor's cost was 30k, FMV at time of gift 20k. (Donor's basis > FMV at time of gift) If donee sold for:
        a) 35k? Not selling for loss so General Rule applies. AR=35k, AB=30k, Gain of 5k
        b) 15k? Selling at a loss so Exception 1 applies. AR= 15k, AB=20k, Loss of 5k
        c) 24k? Exception 2 – selling for less than donor's basis but for more than FMV. AB will be equal to AR so AR=24k, AB=24k. neither loss nor gain.
    5. Tax implications to her when first executed Pre-Nup?
        a) RULE: W/ respect to prenup agreement, BASIS will be equal to value of prop rec'd.
        b) Therefore she wouldn't have a gain.

l. **PART GIFT/PART SALE**
    1. Between Individuals: Recipient's Basis = the greater of (1) the Transferor's Basis or (2) what Transferee has actually paid or is deemed to have paid
        a) Father buys land for 120k. Value goes up to 180k. He transfers to Daughter for 120k so 60k will be gift, 120k will be purchase.
            a. Daughter's basis then = 120 b/c it's the same for both (1) and (2).
            b. Tax implications to Father at sale: AR=120k (what he got in $), AB=120k
                i. 100% of Basis goes to the Sales side of transaction. Here, gain is 0.
        b) Father buys stock for 100k. Value goes up to 150k. He transfers to daughter for 120k.
            a. Daughter's basis = 120k b/c it's bigger than 100k.
            b. Tax implications to Father at sale: AR=120k, AB=100k (entire basis assigned to sales side of transaction) so Gain = 20k.
    2. Between Individual & Charity § 1011(b): Difference w/ charitable organization is that 100% of the basis does NOT go to the sale side. Must determine Basis for Sales side of transaction.
        a) Donor's Basis for sale = Original Basis *(Amt Rec'd/FMV)
        b) Recipient's Basis when sell = Amt Paid + {Original Basis * (1-[Amt Rec'd/FMV])}
            a. Buys stock for 100k and when worth 150k transfers to Suffolk University for 120k?
                i. Tax implication to Donor at sale: AR=120k, AB = 100k*(120/150) = 80k so Gain = 40k.
                ii. Suffolk's Basis = amt paid + gift.
                    1. 120k + 20K = 140k Basis.

→ Property Acquired b/w Spouses or Incident to Divorce

m. §1041 – No gain or loss is recognized in transfers of property b/w spouses and former spouses if incident to divorce.
    1. Transfer to Spouse: Spouse's Basis = Transferor's Basis
        a) H buys land for 4k and sells to wife yrs later for FMV of 7k.

a. His realized gain would be 3k BUT no gain/loss is recognized because b/w spouses, her basis= his basis of 4k, if she immediately sells to another party for 7k then -3k gain
b. What if property declined in value to $3k - H has a realized loss of 1k but he does not have to recognize that loss. When she later sells she will recognize the loss.
c. If W transfers property w/ 5k basis worth 7k in return for his property, they exchange bases. No gains or losses.

➔ **Property Acquired From a Decedent**

n. §1014 – Recipient's basis = <u>FMV of property on the date of decedent's death.</u>
   1. EXCEPTION – if decedent receives property by gift and **<u>within one year</u>** leaves prop to <u>original donor</u>, basis will be <u>decedent's basis</u> not FMV.

➔ **Amount Realized (what to include = everything you received)**

o. §1001 – the total amount of money received in the transaction plus the FMV of any property received in the transaction.
p. <u>Stock as Compensation</u> = EE's basis is FMV of stock; for ER, AR=FMV, AB=what they paid – but ER can write off as ordinary & necessary biz expense under § 162.
q. <u>Sale of Mortgage w/ Property</u> = Must include mortgages assumed or taken subject to property in Amount Realized - unpaid balance of the mortgage must be included in the TP's income if sell the mortgage.
   1. If dealing w/ a **Recourse Mortgage** and <u>amount unpaid is greater than FMV (i.e. bank isn't going to get all it's money back)</u>:
      a) AR = FMV of Prop. It will be deemed a sale for FMV.
      b) Bank can either go after the outstanding amt or forgive. If forgive, it is a <u>cancellation of debt</u> and includable as income.
   2. Example
      a) Mortgagor buys land for 100k. borrows 80k from bank and pays 20k cash. Nonrecourse mortgage (Mortgagor's Cost basis = 100k)
         a. When land has appreciated to 300k, mortgagor takes out second nonrecourse mortgage of 100k. Does mortgagor have income when she borrow this 100k? No, still has to repay,
            i. If 100k used to improve land, cost basis in land is now 100k +100k = 200k.
            ii. If 100k used to buy stocks, basis in land is still 100k (Basis in stocks is 100k).
         b. Principal amount of mortgage is 180k. Mortgagor sells prop for 120k cash subject to both mortgages while its still worth 300k, cost basis = 100k, AR=300k. Gain =200k
         c. If she gives land to her son worth 300k subject to both mortgages. Part gift – Part Sale. He is deemed to have paid amt of mortgages which =180k. gift part =120k.
            i. Tax Consequences to Son: his basis = 180k(the greater paid) AR=180k (amt of mortgages), so Gain=0
            ii. Tax Consequences to Mother: AR= 180 (amt of mortgs), AB = 100k so Gain of 80k.
         d. If gives to spouse, no loss or gain. Spouse's basis = her basis of 100k. if he pays off mortgage then 280k will be his basis.
         e. If land value declined form 300k to 180k and mortgagor transfers land to bank. AR=FMV of 180k + any outstanding debt. Since amt of loan was only 180k, stays at 180k. AB=100k. so she has a gain of 80k. (Crane)
         f. If land went down to 170k, AR = FMV of land + any outstanding debt. Since loan for 180k, need to add 10k to AR. Bank may cancel her debt and take 170k. if so she needs to count 10k as gross.
   3. **Pro Rata application of Basis**. Investor bought 3 parcels of land, each worth 10k for a total of 30k. sold one parcel in yr1 for 14k and a second in year 2 for 16k.
      a) Have to take each piece separately. So for first parcel, would recognize a 4k gain, for second, 6k gain.
   4. **Gift Tax**. Relative bought condo for 20k, gave to Gainer when worth 30k. Relative paid 6k gift tax on transfer. Gainer sells to Shelterer for 32k.
      a) **Gainer AB: [FMV-Donor's Basis]/FMV * Gift tax Paid = Amt to add to Donor's Basis to get AB.**
      b) Ordinarily would be a 12k gain BUT must <u>take into acct gift tax paid.</u>
         a. Use §1015(d)(6) to determine increase in basis. Comes out to 2k.
         b. So AR=32k, AB=22k, so Gain =10k
      c) Basis of Shelterer (buyer) will be what she paid for it = **32k**

5. **Part Gift/Part Sale**. What if Relative acquired prop for 8k but subject to a 12k mortgage. Relative paid 3k tax on gift to Gainer. Shelterer took <u>subject to mortgage</u> and paid 20k cash?
    a) G's basis is donor's basis so must determine what that is.
        a. Donor's basis = 8k+12k =20k
        b. G's basis is the greater of R's basis or what G paid for it. 20k is greater than 12k so G has a 20k basis. Sold it for 32k(20k+12k) mortgage so 12kgain
    b) Buyer took prop subject to mortgage and paid 20k for it. Basis? Basis =32k.

r. **Net Gift**
1. <u>Going to be treated as Part Gift/Part Sale Transactions</u>
2. <u>HYPO</u>: Parent purchases property for 10k, now worth 100k, give as gift to child who pays 25k gift tax. Net gift $25k gain
    a) Who's legal responsibility is to pay the gift tax? Donor.
    b) Third party is discharging legal obligation. Applying *old colony trust*, this means donor will be deemed to receive value of discharged obligation.
    c) So really this is a Part-Gift Part-Sale.
        a. From sale part, donor has rec 25k. can allocate 100% to sales side. So donor is going to report 15k gain (Basis of 10k, AR is 25k).
        b. Son's Basis is 25k (greater of donor's basis or what Son paid.

VII. Chapter 7 – Life Insurance Proceeds and Annuities

→ Life Insurance Proceeds

a. §101 - <u>Proceeds from Life insurance policies</u> are excluded from the gross income of the recipients.
1. Exclusion applies only to payments made by <u>reason of the death of the insured</u>.
2. You can take out a life insurance policy on someone else (i.e. Football team on player, can exclude the proceeds if player dies).

b. §101(g) Accelerated Death Benefits
1. Allows for payments on the life of a <u>terminally or chronically ill</u> individual.

c. **EXCEPTION:** if life insurance policy is **SOLD**, different rule applies.
1. Exclusion is limited to the <u>consideration paid plus any additional premiums</u>.
    a) NOTE: Full amt of <u>proceeds</u> can be excluded if sale is between:
        a. Spouses, Corp and Shareholder, Partnership and Partner
    b) Example: Jock owned a paid-up two year term $1 million policy on his life which he sold to Pro (Employer) for $20,000, Pro named beneficiary of the policy
        a. Pro can exclude $20,000 in <u>basis</u> under 101(a)(2) and report $980,000.
        b. If Jock is a shareholder of Pro, will be able to exclude face amt of 1mil 101(a)(2)(B).
    c) Examples (100k policy purchased for 40k).
    d) Insured sells policy to <u>Child</u> for $60k (FMV); on Insured's death, $100k proceeds are paid to Child.
        a. Daughter's exclusion will only be 60k - the consideration paid (40k gain).
        b. Mother would have had basis of 40k, sold for 60k, (20k gain).
    e) Insured sells policy to <u>Spouse</u> for its $60,000 (FMV); on Insured's death, $100k proceeds are paid to Spouse.
        a. No gain b/w spouses under §1041 as the husband gets her basis and will collect $100,000 under §101(a)
        b. Result to wife? 40k basis but does not need to report 20k gain. When she dies and he gets 100k. 101(a)2a. Full exclusion.
    f) Insured is <u>terminally ill</u> and sells the policy for its $80k (FMV) to Provider who collects the $100k of proceeds on Insured's death.
        a. 20k taxable. 101(g)(2) – if person terminally ill, and <u>sells to a provider</u>, amt paid will be treated as paid on death of insurer. Company can exclude 80k.
2. §101(d) <u>Installment payments</u>
    a) If the benefits are paid in installments rather than a lump sum, the **interest** portion of the installments **is income** to the beneficiary (101c)
    b) Excludable Amount each year = Amt of policy lump sum/life expectancy
    c) Live beyond life expectancy = keep collecting and excluding 4k/year. DIFFERENT THAN AN **ANNUITY**, only for **LIFE INSURANCE**.
3. Cash Surrender Value

a) If the **insured** elects to take the cash surrender value of the policy, that value might exceed his basis. In that case, he would have taxable income on the excess because it is not paid by reason of his death

→ **Annuity Payments**

d. An annuity K is one in which the TP invests a fixed sum, which is later paid back, with interest, in installments for a set period or for life. That part of each annuity payment that represents the TP's investment in the policy is exempt as a return of capital. The interest portion is income under §72.

1. Amt of exclusion = total payment for year*(Investment in K/Expected return for life) §72(b)
   a) The expected return is calculated by either a fixed K or by reference to the life expectancy of the investor; The life expectancy is determined from actuarial tables.
   b) The amt that exceeds this return of capital portion is then taxed as net income.
   c) Example:
      a. In the current year, T purchases a single life annuity with no refund feature for $48,000. Under the contract, T is to receive $3,000 per year for life. T has a 24-year life expectancy. Taxable 2k per year [3k-3k*(48k/3k*24)].
2. Return of Capital/ Life Expectancy:
   a) 72(b) - if annuitant lives beyond life expectancy, the full amount of any subsequent annuity payment is TAXED.
      a. So if live 30 years into annuity payments above, taxed on full 3k payment.
   b) If annuitant dies *before* her life expectancy, the amount of unrecovered investment is allowed as a deduction on her last income tax return.
      a. If dies after only 9 years of payments, T got $18k on 48k. So, gets 30k deduction. 72b2
3. **Annuities v. Qualified Annuity Plans** –
   a) Everything is subject to taxation in a Qualified Annuity Plan b/c it hasn't been taxed yet.

VIII. Chapter 8 – Discharge of Indebtedness

a. General Rule – If there is a discharge of debt, the amt of that discharge will be income. § 61(a)(12)
   a) When the 3rd party forgives it, or some other party pays it for you, have income.
2. When you borrow money, no tax consequences.
3. When u cancel debt by performing svc=income.
   a) Bonds are debt instruments so If purchases any bonds at a price less than the issuing price or face value, the excess over the purchase price is income.
   b) Difference b/w Amt borrowed and lesser amt that you pay back is income.
   c) For the Loaner of the $, the discharge is a loss???

b. **Exceptions:**
1. Insolvent debtors (FMV assets< liabilities) - §108(a)(1)(b)
   a) If insolvent both before and after transaction, entire amt of cancelled debt will be excluded.
   b) If discharge renders you solvent, will have to report excess of assets over liabilities.
2. Gifts - If a personal or family relationship is shown and the debt cancel was intended as a gift, no income is recognized by the debtor
3. Contributions to capital - Shareholder's forgiving a debt owed to him by his corp is looked upon as a contribution to capital and is not income to the corp
4. Compromises of disputed claims- If a cancellation or reduction of debt is in reality a compromise of a disputed claim rather than a fixed debt, no income is recognized
5. **Contested liability** - Occurs when TP disputes amt and parties settle on a different amount. Technically there is no discharge of debt but rather a *redetermination* of the debt owed. Amount of debt from gambling cannot be known until there was a settlement because chips are not property until they are turned in §108
6. Purchase money debt - Buy property and the seller provides financing and later go back to original seller to renegotiate, and you are not insolvent or bankrupt, the renegotiation shall be treated as purchase price adjustment §108(e)(5). Must be real estate.
   a) **If debt is between original buyer and seller of prop and seller is also the party that finances the transaction, 108(e)(5) applies**. Essentially, if company compromises the debt, its as if the parties have renegotiated the deal. Reduction, not a cancellation of debt
7. Bank Buys back property
   a) (Recourse loan) When someone buy off of loan by taking back property, Seller has income that is the sum of the sale income (AR-AB) and the discharge of indebtedness income.
   b) (Non-Recourse loan) TP deemed to have been paid value (FMV) of the loans.

IX. Chapter 9 – Damages and Related Receipts

→ **Damages in General**

a. "In lieu of" test - You must determine <u>in lieu of</u> what you got what
   1. If settlement/damages are profits that would have been income, then the damages should be income. If it was not income, then it is excluded such as a forced sale and have basis that you can recover. To that extent you get only get basis back, you exclude under §1001

b. <u>Recovery of a Loan</u> – Not income since it is a return of capital.

c. <u>Lost Profits and Punitive Damages</u> constitute INCOME
   1. <u>Injury to Good Will</u> - Excess of basis in good will is income

→ **Compensation for Injuries or Sickness**

d. §104 (a)(2)Gross income <u>does not include</u> damages, whether by judgment or settlement, because of personal injuries or PHYSICAL sickness and medical recovery specifically:
      a) Note if <u>already previously deducted</u> expenses, can't take new deduction for damages. i.e. excluded your med expenses, then suit settles, can only deduct the excess that you didn't already deduct.
      b) You have to pay expenses in order to be able to deduct. If no out of pocket expenses, no deduction
   2. Amts rec'd from Soc Sec and Worker's Comp Benefits from work related injury. § 104(a)(1)
   3. Old age benefits from Social Security - Under §86
   4. Amt of damages other than punitive **104(a)(2)** – These things are excludable.
      a) Amts rec'd as damages on account of personal physical injury or physical sickness – lost wages, etc.
      b) Emotional Injury - not excludable and shall not be treated as physical injury even if there are physical manifestations, **HOWEVER** – damages recovered for emotional distress incurred on account of physical injury are excludable
         a. Any damages for suicidal tendencies as a result of losing the use of her legs is Excludable – b/c physical injury led to emotional distress.
         b. Injury is a fan's squeaky voice causing anxiety would NOT be excludable.
      c) **Punitive Damages** excludable ONLY when rec'd in Wrongful Death Action. § 104(c)
      d) Pension or annuity for personal injury or sickness arising form military svcs § 104(a)(4)
      e) Amts rec'd as disability from injuries resulting from terrorist or military actions. § 104(a)(5)
   5. Accident or Health Insurance Benefits § **104(a)(3)**
      a) Benefit pmts are not taxed if you <u>own your own insurance policy</u>. Pd by employer, different story.
         a. If you pay your own medical insurance, it is all tax-free even if it exceeds how much you paid.
         b. If employer provided policy, any excess $ over out of pocket expenses is income.
            i. There is a limited exception in §105(c) you can exclude for disfigurements etc.
         c. The amount of medical expenses deemed to be paid by each policy is proportionate to the benefits received from each policy.
   6. <u>Structured settlements</u> (Revenue Ruling 79-313)
      a) All <u>payments received pursuant to a settlement agreement for personal injuries</u> are excludable from taxable income. If the TP had received a lump sum payment, all <u>future income</u> generated is taxed.
   7. <u>Interest</u> on a recovery/award IS taxable.
   8. <u>Purchase Annuity</u> = Award/Expected Return * yearly payout = taxable annual income.

X. Chapter 10 – Separation and Divorce

→ **Alimony**

a. Included in payee's Gross Income §71 and excluded from Payor's Gross Income §215(a) as § 62 deduction.

b. **Requirements** for a payment to be considered alimony - A payment to a spouse under a divorce or separation instrument is alimony if:
   1. Payment is in cash or check
      a) <u>Promissory note</u> is not cash for purposes of Alimony
      b) <u>Transfer of property</u> in lieu of payment is not alimony.
   2. Payment is pursuant to a divorce or separation agreement.
   3. Instrument does not say that it is "non-deductable" or "non-includable" – language of doc controls.
      a) Payment instrument does not designate the payment as a nonalimony payment (must make and affirmative statement that it is not alimony)
      b) By treating payment as property settlement—treated as a gift [§1041]
   4. Parties cannot live in same household at time payment is made – only applies if the spouses are legally separated under a decree of divorce or separate maintenance
   5. Parties do not file a joint return.
   6. No liability to make payment after death of payee spouse

a) Has to say this in the document or in the local laws.
b) Can be a payment to the estate separately in the doc and the portion paid in lifetime is alimony.

7. The payment is not treated as child support

c. Payments can be made to a 3rd party – see indirect payments below.
d. **Alimony Recapture Provision Under 71(f) -** if inordinately large amts of alimony are paid in the first or second year, in relation to year 3, an amount is RECAPTURED in year 3.
   1. Provision applies to "front-loaded" alimony payments, which look too much like a property settlement, and should be treated as such. Don't make parties amend prior tax forms [from years one and two], but will "recapture" or impose adverse tax consequences only to year three
      a) Recapture amount determined in year three will have to be included in *payor's* taxes as gross income and *payee* will get a deduction [exact opposite of how normal alimony payments are treated]
   2. How it works (look for downward fluctuation, fluctuation can go up):
      a) If payment in second year exceeds payment in third year by more than 15k, there is a recapture of that excess in the third year.
         a. RY2 = y2-(y3+15,000)
      b) If alimony in first year exceeds average of payments in second year and third year (after reducing 2nd year excess payments) by more than 15k, that excess is also recaptured in third year.
         a. RY1 = y1-{[(y2-RY2)+y3)/2]+15,000}
      c) In year 3 Payor reports INCOME of RY2+RY1 and Payee Reports DEDUCTION of RY2+RY1
      d) Only look at years that are payments of Alimony (i.e. if first year they live in the same house, it's not alimony, but it can be later. The first year is then the first year that alimony was paid – y2).
   3. Exceptions
      a) No recapture in third year if payment in third year is reduced b/c spouse dies or payee remarries.
      b) If fluctuations in payment not in control of payor. § 71(f)(c)(5)
         a. If the fluctuation is due to the death or remarriage of the payee spouse then no recapture.
      c) Contingent payments, ie payments subject to fluctuations not subject to rule IF made for at least 3 yrs. i.e. fixed % of income.
      d) Temporary support is another exception to the recapture provision. §71(b)(2)(C)

→ Indirect Payments

e. Payments of an indirect nature made to a third party may be treated as alimony.
   1. A payment of cash to a third party under the terms of a divorce or separation instrument may constitute alimony.
   2. If payments are made in satisfaction of a legal obligation exclusively that of the payee spouse and are applicable with respect to property in which the payor spouse has no legal interest, such indirect payments qualify as deductible alimony.
      a) For example, cash payments of rent made to landlord or Payment of mortgage (unless the payor still owns the property-must transfer title), tuition, etc.
      b) Insurance Policies: Payments directly to the policy are alimony where the Payee is the beneficiary and the policy is on the life of the payor.
         a. If payor purchases a policy and transfers it, payments aren't alimony (giving property)
         b. But if payee buys the policy with money that payor gives, it's alimony.

→ Property Settlements

f. §1041 - No gain or loss shall be recognized on any transfer of property b/w spouses or former spouses but in the case of the latter only if transfer of property incident to divorce.
   1. For spouses – no other requirements
   2. For former spouses - Transfers shall be treated as incident to divorce if:
      a) Take place within a year of divorce OR
      b) Otherwise relate to the cessation of the marriage (even if after a year)
         a. Transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to the divorce or separation instrument **and** the transfer occurs not more than *6* years after the date on which the marriage ceases
         b. Any transfer not pursuant to divorce or written instrument or outside 6 yrs may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage, must show factors for why transfer was hampered and couldn't do it within 6 yrs such as legal or Biz impediment or disputes concerning value of property.

3. Gain (including recapture income) or loss will not be recognized to the transferor, and the transferee will receive the property at the transferor's basis (whether the property has appreciated or depreciated in value)
4. Basis is equal to the FMV on the date of the transfer. Using property to pay a debt is treated as a sale followed by taking the cash and paying the debt with it.
5. THE REASON FOR THE TRANSFER IS IRRELEVENT (even if to satisfy debt owed to spouse).

→ Child Support

g. §71(c) Person who is recipient does not report as income, and payor does not get deduction from GI.
   1. Instrument must fix the amount.
      a) If total amt paid is reduced on the happening of some event, the amt of the reduction will be deemed as the portion paid for child support. (i.e. support is 10k per year and upon the marriage of child is reduced to 6k, 4k will be deemed to have been child support so 4k neither income nor deduction.)
   2. If payment isn't enough to cover both alimony & support, the payment will first apply towards the child support. All Child support payment must be paid before any future amounts may be considered as alimony
   3. If **ALIMONY** payment reduced based on a contingency relating to the child, the reduction is presumed to be child support and not alimony:
      a) Reduced 6 mo before/after the date the child is to turn 18, 21, or local age of majority.
      b) Reduced on 2 or more occasions which occur not more than 1 year before/after a different child of the payor spouse attains a certain age between the ages of 18 and 24, inclusive. The certain age referred to in the preceding sentence must be the same for each such child, but need not be a whole number of years. NOTE: Consider all ages b/w 18 and 24 (don't just whole ages); (ex—try 18 and 1 day, 2 days, 3 days, etc. if whole ages don't work)

XI. Chapter 11 – Other Exclusions from Gross Income

→ Gain Resulting from Sale of a Principal Residence

a. For sales or exchanges of residences after May 6, **1997**, married TPs may exclude up to $500,000 of gain upon the sale of their residence and single TPs may exclude up to $250,000 of their gain §121(b)(1-2).
   1. TPs must have owned and occupied the residence as their **principal residence** for 2 out of the last 5 years prior to the sale. §121(b)(3)(A).
      a) Aggregate time used as residence
      b) BOTH must USE for 2 years; but EITHER can OWN to meet this criteria.
      c) Cannot be your summer home. Must be principal residence (you can only have one)
   2. The exclusion applies to only one sale or exchange every two years but pre-May 7, 1997 sales are not considered. §121(b)(3)(B).
      a) Can take exclusion as often as every 2 years!
         a. Neither spouse must have utilized
   3. For married TPs, the exclusion is allowed if (1) either spouse meets thee ownership test, (2) both spouses meet the use test **and** (3) neither spouse is ineligible for exclusion because of a sale or exchange of a residence within the last two years. §121(b)(2)(B-D).
   4. TPs may elect out of this exclusion provision for any sale or exchange §121(f). (i.e. if know selling another place that will have a higher gain and meets the criteria, may opt out to use for the second sale)
   5. **Exception**: if 2yr ownership and use requirement not met b/c subsequent sale is job-related, health related, due to unforeseen circumstances, a portion of the exclusion applies.
      a) # months lived in residence / 24 months * Annual Exclusion = Excludable Amount

b. 121(c)(2)(B)

c. Old Rule §1034 – if selling principal residence and buying a new one w/in 2 years for at least the same price, could defer reporting GAIN.
   1. Under Old §121 – TP would be allowed a one time exclusion of up to a 125k if older than 55 when selling property.
   2. One-Time Exclusion
      a) An individual on a one-time basis may exclude from Gross up to 125k of Gain from the sale or exchange of a principal residence IF:
         a. The TP is 55 before the sale
         b. He has owned the prop and used it as a principal residence for 3 or more of the 5 yrs preceding the sale.
         c. NOTE: TP not eligible if exclusion previously used by spouse.
         d. If buy a house within 2 years, subtract gain from sale from AB for the second house. (AB=AB-GAIN from sale).
         e. If I don't trade up, I can defer only a portion (price-AR).

d. Don't forget that if took any depreciation deductions, must consider that into the basis when figuring out the gain to exclude.

e. Sale of a remainder interest qualifies, but not if related §121(d)(8)(b)

   1. Estate planner sold a remainder interest in Planner's principal residence for $300,000 (FMV) to Planner's son. Planner's basis in the remainder interest was $125,000. Does Planner have any gross income?

      a) Remainder of interest does apply for exclusion but does not apply here when it is sold to a related party. 267b - -what constitutes a related party. Can't use the exclusion again. The parent would have to recognize 175k of gain.

f. What result in (a) after one year of marriage TP pursuant to their divorce decree deeded ½ of the residence to Spouse and Spouse lived in the residence while TP moved out and one year later, they sold the residence for $500,000 (basis of 100k)?

   1. Gain is 400K, so each have gain of 200K and each can exclude it individually…statute provides that spouse who gets property pursuant to 1041 transfer can add other spouses ownership to their own. *If the sale is incident to divorce, a spouse gets to tack on the length of use by the other spouse so it is as if she lived there for ten years.*

→ **Income Earned Abroad**

a. In General, a US citizen or resident alien (green card or >183 days in US) is taxable to the US on his or her worldwide income. So if a US citizen working in a foreign country, income going to be taxable – perhaps even in both countries.

   2. §911 is an exclusion available to foreign earned income for qualified individual.

      a) Up to 80k per year § 911(a)(1)+ Housing Cost Amount § 911(c)(1)
      b) Look at 911(b)
      c) Housing Cost Amount limitation § 911(c)(2)(A)
         a. "Housing cost amount" (§ 911(c))--housing costs are excludable as long as they don't exceed (.16) ($80K) = $24,000
      d) To calculate exclusion =
         a) earned income exclusion limit = 80K
         b) housing costs = (rent x months)→ 3000 x 12 = 36,000
         c) **HC =** if housing costs are greater than 24,000, use 24,000 (if less than 24K, use this number)
         d) HC - (.16)(80K) = **11,200 (if HC were over 24k)**
         e) exclusion = 80K + 11,200 = 91,200

   3. 911(d) – you have to be a **qualified individual** for a housing (utilities and insurance) cost exclusion if your taxed home is in a foreign country and you have to satisfy one of two tests:

      a) Your tax home is in a foreign country (i.e. principle place of biz > 1 year) OR
      b) Bonafide residence Test - be there for an entire (an uninterrupted period) tax year (or plan to stay for an indeterminate amount of time with no fixed return date); OR
      c) Physical presence Test - physically present in a foreign country for 330 days within 12 consecutive months

   4. § 911(f) – Tax imposed equal to taxable income plus amount excluded

      a) TI w/ exclusion + Exclusion = TI-Bracket (i.e. if 22k is TI and § 911 exclusion is 90k, then figure out the tax bracket using 112k; but apply the % to the entire 22k).
      b) Corbett says to do this way:
         a. Calculate the tax as if there is NO exclusion = X
         b. Calculate the tax ON only the exclusion = Y
         c. X-Y = Tax Liability.

→ **Interest on Municipal Bond – figuring out if the bond purchase is better than some interest rate**

a. Interest on municipal bond is not subject to taxation.

   i. Purchase bond which yields 4.875% interest, purchase price of $1000. (yields $48.75 per year)
   ii. 0.04875 / 55 (assuming 35% fed and 10% state) = 8.863.
   iii. You would want a yield of 8.8% or higher to make savings better than the bond.

XII. Chapter 12 – Assignment of Income

→ **Income from Services**

a. Person who performs the services will be taxed on the income generated from those services.

   1. Don't have to receive $$ for it to be income, just have to control it.
   2. Exception: Income generated from performance of services is not taxed where TP

      a) Rejected it *before* earning it (performing the services) **and**
      b) Did not try to exercise any dominion or *control* over it.

a. Can't tell them to divert it to a 3rd party, but can say to direct it to charity of employer's choice (but not if you are on the board of directors that will make the decision)
b. Can a shareholder make a timely rejection of dividend income?
   i. One who performs svsc can so long as they do it before they perform the svcs and do not exercise control. Rejection of dividend has to be made prior to the recordation date
   ii. So what would timely constitute for a shareholder?
      1. Usual rule is RECORD date however,
      2. If shareholder owns more than 50% OF STOCK needs to be before Declaration date.

3. Exceptions from Revenue Rulings:
   a) Under circumstances where TP is named executor of an estate, he or she may decide to waive his or her compensation and serve on a gratuitous basis without facing tax consequences.
      a. If it is your intent to serve on a gratuitous basis, must make a formal waiver within 6 months of appointment.
      b. OR Waiver may be implied
   b) Amounts received for services performed by a faculty member of a student of a school under a clinical program and turned over to university are not includible in the recipient's income.
   c) If required by your K to give the $$ earned from speaking engagements over to your employer, it's not taxable to you (though it is to your employer).

→ Income From Property

a. Person who owns property that produces income is going to be taxed on the income produced from that income
   1. Power to dispose of income is EQUAL to ownership of it.
      1. TP assigned a portion of his income interest from a TRUST to his kids. Transferring the Ownership, so taxable to kids since kids now own portion of underlying property.
      2. TP signs P&S w/ texaco to sell her gas station. Before title has been transferred, she assigns 50% ownership to her kids and retains 50%. The fact that they got their shares after the P&S is significant b/c they had no power to prevent the sale.
         a. Since kids didn't have control of the property when the TP agreed to sell it, all capital gain must go to TP.
   2. Inventor develops an electric switch which she patents. Who is taxed if:
      d) Inventor gratuitously transfers patent to son who sells to buyer? *Son b/c he owns it.*
      e) Inventor transfers all her interest in the patent to Buyer for a royalty contract and then transfers the contact to gratuitously to son? *Son b/c he owns the property (contract).*

XIII. Chapter 13 – Income Producing Entities

a. **TRUSTS**
   1. Trusts - Both an aggregate and separate and distinct entity. With respect to the income generated from the trust property, could be taxed to benny, trust or settlor/grantor.
      a) If grantor never set up trust and instead assigns dividends of stock to his child, he owns prop so will be taxed.
      b) If parent makes gift to child, child gets taxed b/c he owns it.
      c) If parent creates trust, child, grantor or trust could be taxed.
         a. If child receives it, will be child so long as grantor doesn't retain too many controls.
         b. If trust keeps payment, trust so long as grantor doesn't't' retain too much control.
      d) If income used to support spouse under §677, taxable to grantor.
      e) If grantor has reversionary interest exceeding 5% of the value of the trust, grantor taxable
         a. UNLESS reversionary interest only occur by reason of death of a minor lineal decedent **b4** reaching 21.
   2. Grantor Trust Rules
      a) Generally if retain too much interest in the trust, then grantor will be taxed.
         a. Examples:
            i. Power to change where the funds go §674
            ii. Power to revoke § 671
            iii. Reversion (see above for exception)
            iv. Power to direct sale of trust corpus to any person including grantor for any price. Look at §675
            v. Payments to grantor's spouse § 677a

- b) Parents set up trusts for kids education. If there is some K that the parents have to pay for kids education or some law that they must pay, then the parents would be taxed. (Can't use the rule to discharge your debt).
  - **a.** Where parents have express contracts w/ schools saying they are not going to pay, that the children have trusts for that purpose so don't come looking to them for the $$$, courts have found there was no contract b/w schools and parents.
  - **b.** Can't just assign your earnings or accts receivable to go to a trust to shelter (even if the benefit is for someone else)
  - **c.** You CAN transfer your income producing property to the trust and then you won't be taxed on the earnings (so long as you don't maintain the control).
- c) §673, §674(a), §675, §677, §678

b. **PARTNERSHIP**

1. Partnership - Not a separate and distinct taxable entity – does not pay a separate income tax. Taxes really distributed to partners per partnership agreement. Recognized entity but not a taxable one.
   - a) If have a valid partnership, then each will be responsible for their respective shares.
   - b) Standard of Partnership is whether the parties **intended in good faith** to come together to form a valid Biz.
   - c) **Two Types of Partnerships**
     - **a.** Capital Intensive
       - ***i.*** Person shall be recognized as a partner if he has a Capital Interest whether derived by purchase or by gift (704e).
     - **b.** Services Oriented
       - ***i.*** No capital interest necessary
       - ***ii.*** Individual must be performing essential svs of the Biz
   - d) § 704(e)(2) - in case of a partnership interest created by GIFT, the distributor's share shall be includable in his gross income except to the extent that there has not been reasonable compensation for SERVICES rendered to the partnership.
     - **a.** So if Mom transfers prop to a partnership w/ her 3 kids so that they all have a .25 interest and then she renders 20k of svcs. 20k will be deducted from the income and the remainder will be split 4 ways. She will be responsible for the 20k she didn't charge for.
   - e) Inconsistent division w/ share of partnership: 704(e)(2) – your donative share has to be consistent with the capital interest.
2. Not a valid partnership if -
   - a) In a Scvs oriented partnership, the "Partner" cannot perform the services.
     - **a.** Like a lawyer making his doctor son a partner in his law firm.
   - b) Retaining sole ownership of property but let income produced go to partnership.
     - **a.** Like keeping the bonds and transferring the interest coupons or keeping the bldg but transferring the leases.
   - c) Individual retains the right to make all necessary Biz decisions.

c. **CORPORATIONS**

1. Corporations -Taxable entity. Reports all of its income, takes all the deductions to which it is entitled and then computes its tax liability.
   - a) Earnings taken out of corp. in form of DIVIDENDS. Corp not given deduction for dividends.
   - b) Used to be that dividends were taxed at ordinary income. Now taxed at only 15% to shareholders.
2. *Overton v. Commissioner* - The husbands want the dividends that they receive to be taxed at the wives' brackets. They have all the voting power and wives can't sell they control the dividend distribution. When it is distributed then it will go to their wives and it will all stay in the family. At this time there was no filing of joint tax returns. This was a sham to get earnings out of the corporation. The court ignored the facts that the wives were holders and treated the dividends as going to husbands.
3. *Johnson v. Commissioner* - Player makes contract with PMSA and PMSA licensed its rights to EST who made payments to the player. The team pays its compensation under the contact to EST because he has assigned his contract that he executed with the team. EST remitted 95% to PMSA and 5% to the player.
   - a) He did this because the corporate tax rates were much lower and he would then liquidate the corporation and it will be taxed as a capital gain at that point.
   - b) Who gets taxed? This is like Lucas v. Earl. He (his services) produced the income so he will be taxed. There are situations where the corp will bear the burden. Situations where that will be

recognized on p.306 (personal services corp.)– 1) must be employee of corp and 2) must be a contract that says corp. has right to control employee. .

XIV. Chapter 14 – Biz Deductions

a. Biz Expenses §162
   1. Statutory Definition - "all the <u>ordinary and necessary</u> expenses paid or incurred during the taxable year in carrying on a trade or Biz" are deductible.
   2. Questions to ask
      a) Was the expense "ordinary and necessary?"
         a. preserve, protect existing earning capacity
      b) Was the expenditure a current expense or a capital outlay?
      c) Was the expense for Biz or personal reasons?
   3. Applicable to EXPENSES, not CAPITAL EXPENDITURES
      a) <u>§263: Capital Expenditures</u> **-** any amt paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. (recovered w/ depreciation, amortization)
         a. Difference: Expenses are used this year and are gone
      b) Capital expenditures can include <u>acquiring assets, substantially improving a capital asset, OR an intangible asset that allows a long term benefit to the TP</u>. Incidental long term benefits are not considered. All other expenditures will be considered expenses.
      c) <u>Normal repairs</u> on property are considered expenses BUT overhaul of property may rise to the level of additional capital expenditure. For example, putting on new roof is a capital expenditure while patching the roof is a repair. There is no bright line.
   4. Allows deductions for <u>expenses for the production of income</u>
      a) Exp incurred in the production or collection of income
      b) Exp incurred for the **management, conservation or maintenance** of property held of the production of income
      c) Exp incurred in connection with the determination, collection or refund of any tax (cost of litigating)
   5. If you don't submit for a reimb from ER, then paying ER's oblig as gift (you can't deduct it)

b. "**Ordinary and Necessary"**
   1. Not usual and customary for someone to pay the bills of their former employer.
   2. Ordinary is whether the expense will be considered usual or customary within that particular industry.
   3. Necessary means appropriate and helpful to carry on the Biz.

c. **Expenses v. Expenditure**
   1. Repairs are things that will keep the place in usual operation status, not enhance prop's value.
   2. In a takeover, expenses incurred are not generally deductible since there are future benefits.
      a) If future benefits are merely incidental, that is okay and will still be considered an expense. (advertising, asbestos removal from bldg., EE training costs)

d. **"Carrying On"**
   1. Expenses incurred b/f purchasing the property (travel expenses, meals. Lodging) are not incurred in "carrying on a trade or Biz" b/c they are only in the process of *acquiring* a Biz and not *carrying on* Biz.
   2. **<u>§195—Start Up Expenditures</u>** [exception] - If TP is searching/trying to acquire a Biz, expenses paid or incurred *prior to the start of the Biz* are called start-up expenditures and may be deducted *but only for* the Biz TP was trying to acquire and which TP *actually acquired*
      a) Start-up expenditures may be deducted over the next 60 months (5 years)
      b) If TP doesn't end up operating Biz for 60 months, TP can deduct the rest of the expenses in the month TP ends the Biz (under §165—Losses)
      c) <u>If TP doesn't end up acquiring a Biz, TP cannot deduct anything</u>
      d) **Note:** you can deduct up to $5000 from a start up Biz in the year of which you actually acquire the Biz.
      e) **Note:** <u>Generally, cannot deduct the expenses of looking for employment</u>. Also, TP cannot deduct expenses of getting <u>elected or re-elected</u> [only deductions TP can make is when there is a recall and someone is challenging your election]
         a. Unless fee to agency finding the job is contingent on success of finding the job and so they don't pay until the EE starts working, the Fee is not deductable.
         b. If you are currently in a trade or Biz, <u>moving around</u> in that trade or Biz is deductible regardless of success.
   3. Personal investments of earnings or other $$ is not § 195 deduction (i.e. doctor acquiring real estate); if was real estate developer, the would be "expanding" and it's deductible..

→ **Reasonable Salaries**

e. §162 **-** "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 Biz, including—reasonable allowance for salaries or other compensation for personal services actually rendered;
   1. Regulation provides that reasonable is determined either at year one or as the compensation is paid out (year by year) depending on whether the arrangement was a free bargain.
      a) If the arrangement was a free bargain between employer and employee, then reasonableness is determined at the time the arrangement is entered into.
      b) If it was not a free bargain, then reasonableness is determined year by year compared to the services performed that year.

f. **"**Reasonable Salaries"
   1. (minority j/d) Independent investor std– if independent investor would approve.
   2. (majority j/d) Compensation if reasonable may be deducted as an ordinary and necessary Biz expense. Courts use the Multi-factor test to determine if salary is reasonable. Factors include:
      a) 1- the type and extent of the services rendered
      b) 2 - the scarcity of qualified employees
      c) 3 - the qualifications and prior earning capacity of the employee
      d) 4 - the contributions of the employee to Biz venture
      e) 5 - the net earnings of the employer
      f) 6 - the prevailing compensation paid to employees with comparable jobs
      g) 7 - the peculiar circumstances of the employer's Biz

g. **Contingent Fee Agreement**. **-** will be considered reasonable if freely entered into even if the amt of compensation is unreasonable when measured by other standards. If not free bargain, can only deduct the portion deemed to be reasonable.
   1. In a corp setting, the rest is going to be considered a dividend which is not deductible by the corp.

h. Problem, Page 359
   1. EE is the majority shareholder (248 of the 250 shares) and president of Corp. Directors adopted a resolution establishing a contingent compensation contract for EE. The plan provided for Corp to pay EE a nominal salary plus an annual bonus based on a % of Corp's net income. In the early years of the plan, payments to EE averaged $50,000 annually. In recent years, Corporation's profits have increased substantially and, as a consequence, Employee has received payments averaging more than $200,000 per year.
      a) if the 200k is reasonable in amount then the corporation can deduct that full amount. What if only part of the amount is reasonable $150k then how will the 200k be treated. The entire 200k will be treated as a deduction provided that the contingent compensation agreement was part of free bargaining. If not then 150k is all that the corporation can deduct. The other 50 will be considered a dividend. From his perspective it is just 200k of ordinary income. Dividends are at a lower rate so he would likely argue that it is unreasonable.

→ **Travel away from home**

i. §162(a) allows for deductions for Biz expenses including: "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 pursuit of a *trade or Biz*
   1. What is deductible?
      a) Meals—only 50% deductible
         a. TP must be away from home long enough to require lodging in order to get a meal deduction as well
      b) Living—100% deductible
      c) Incidentals (e.g. dry-cleaning)—deductible
      d) On a day the traveler is there for pleasure, the meals and lodging are not deductible.
      e) **Not overnight** – travel expense is ded, but not meals/lodging.
      f) CANNOT be Lavish or Extravagent
      g) ONLY TP's expenses, not his family's can be deducted.
   2. General Rule: Person's tax home is their principal place of Biz. When they are away from their principal place of Biz, they are away from home.
      a) If you live in Manchester but work in Boston, the IRS says that Boston is your home
      b) If have two Bizs and two homes, the one which takes up most of TPs's time and generates more money will be his Princ.Place of Biz.
      c) A married couple filing joint returns can have different tax homes.

d) Pro ball player has tax home where he gets salary, if that is only source of income.

j. <u>Away</u> when temporary location work is realistically expected to last (and does it fact last) for one year or less.
   1. Can deduct for originally expected < 1 year time if ends up being more than 1 year unexpectedly.
      a) TP supposed to go to branch office for nine months, but after eight months it is extended to fifteen months? *The first eight months will have been deductible b/c Temporary thought the time would not exceed nine months (i.e. will not last more than one year). However, all expenses incurred after the eight months are not deductible b/c now the period Temporary has to stay in Branch city is known to exceed one year.* If family moves there for the 9 months then only will be able to deducts Temp's expenses

k. <u>Commuting Expenses</u>
   1. If personal choice where to live, then not deductable.
   2. Daily commute is personal and NOT deductable.
   3. If TP has one or more regular work locations away from the TP's residence, the TP may deduct daily transportation expenses incurred in <u>going b/w the TP's residence and a temporary work location</u> (Ex: Court) in the same trade or Biz, regardless of distance
   4. If a <u>TP's residence is the TP's principle place of Biz</u> w/in the meaning of §280A(c)(1)(A), the TP may deduct daily trans cost for going between the resid and another work loc in the same trade/Biz, regardless of whether the other work location is regular or temporary and regardless of the distance.

l. <u>Meals Associated with Lodging</u>
   1. <u>Professor who has two positions</u> at two different law schools (one in CA and one in FL)—he may deduct ½ living expenses at one of those locations but he may not deduct meal expenses because he does not have duplicate meal expenses

m. <u>Traveling expenses (transportation, etc.) are either deductible or non-deductible</u>, they cannot be partially deductible.
   1. Therefore if Biz is the primary purpose for the travel, then the travel is deductible.
   2. If the primary purpose is for personal reasons, even if conduct some Biz on the trip, the travel is not deductible.
   3. <u>The primary purpose of the trip is determined by</u> how many days the traveler spends working and how many days the traveler spends for fun. Whichever one is more is the primary purpose.
      a) <u>If trip is for both pleasure & work, can only deduct work expenses</u>
   4. If the traveler only stays longer (a Saturday night stay) in order to get <u>cheaper traveling tickets</u>, then the primary purpose will remain work. Different rules pertain to meal and lodging.
   5. Under § 274(m)(1): a TP can travel on a <u>luxury cruise ship</u> as long as it is in relation to her Biz BUT amt deductible cannot exceed twice the amt of transportation per diem allowance under the federal rules per day. So the TP will be responsible for traveling expenses above the per diem per day.

n. <u>Traveling to places **outside of the US**</u> has different rules for traveling expenses:
   1. <u>Travel expenses are partially deductible</u> so divide the air fair between the percent of days worked and the percent of days there for personal reasons.
   2. % that is work is deductible while the % of air fair for time there for personal reasons is not deductible. <u>The primary purpose of the travel must still be for Biz to get any deduction at all.</u>
   3. This special rule does not apply if the travel does not exceed one week or the portion of the time for personal use is less than 25% of the total time on such travel.
      a) If you are gone <u>**more than a week and over 75% is Biz**</u> then the whole trip can be ded.
      b) Under § 274(h), a <u>Biz convention outside the North America area</u> is not deductible unless the txpyr establishes that the convention is related to an active conduct of trade or Biz. In addition, the TP must show that it was as reasonable to have it outside the North American area as it would be to have it within.
         a. For example, a teacher can't go to a convention for investing but could go for an ABA meeting.
         b. The term "North American area" means the United States, its possessions, and the Trust Territory of the Pacific Islands, and Canada and Mexico. [§274(h)(3)(A)]

→ Necessary Rental and Similar Payments (Disguised Sales)

a. §162(a)(3): TP can either buy property to be used in his Biz (in which case the TP gets a basis in the property and the TP can recover investment through depreciation) OR TP can rent property (which allows TP to deduct the rent each year)
   1. <u>Deduction does not apply to property that the TP is renting but in the process of purchasing</u> [installment payments]. This subsection is trying to distinguish a real lease from a capital exp.

→Education as a Biz Expense

a. Under the regulations, Education is deductible if it falls into either one of the first two categories and neither of the last two.
   1. Category 1 – DEDUCTABLE IF DOESN'T FALL IN CATEGORY 2
      a) Education maintains or improves skills required in the TP's trade or Biz (being attorney is generally defined. If I switch from tax lawyer to IP lawyer, I am not changing trade of business)
      b) Ed is required as a condition of the retention of an existing employment relationship
   2. Category 2 – NOT DEDUCTABLE IF DOES EITHER OF THESE:
      a) Qualifies TP for new trade or Biz
      b) Constitute minimum entrance requirements for some new trade or Biz
   3. NOTE:
      a) A practicing attny could deduct going back for his LLM but if went from law school to LLM then can't since not in the trade yet.
      b) Specialization is not considered a new trade.

b. Travel cannot be the education 274(m)(2)

➔ **Miscellaneous Biz Deductions** <u>(Business meals, e.g. take client to lunch)</u>

a. *Note* that the most important part of this section, arguably, is found in §274(d), which requires *substantiation by records or other evidence* in order to get the deduction or credit
   1. TP must demonstrate:
      a) The *amount* of the claimed deduction
      b) The *time and place* of the deductible event (e.g. meal)
      c) The *Biz purpose* of the expense
      d) The *relationship* b/w the TP and persons entertained
      e) TP or employee must be there § 274(k)

b. §274(a) must be *directed related to or associated with* the active conduct of the TP's trade or Biz (Note: 50% of meals are only deductible) = requiring <u>discussion of Biz going on</u> *during the meal* (i.e. directly related to) or *immediately preceding or following* the meal or entertainment (i.e. associated with)
   1. This also has been interpreted as requiring the discussion of a <u>specific Biz matter</u>
      a) Can't just take client out to dinner for good will—must actually discuss specific Biz matters (or have just discussed matters right before going to meal)
   2. <u>Entertainment facilities</u> (clubs dues, yachts, summer homes, etc.) are not deductible even if the primary purpose is for trade or Biz
      a) *Note* however if TP takes clients these facilities and spends money on meals, those expenses are deductible
   3. <u>Tickets</u>, etc. **-** Only deductible up to 50% of **face value** not if overpaid for them from concierge § 274(l)
   4. <u>Advertising</u> is an example of a Biz expense (if in the Biz)
   5. <u>Union dues or professional dues (ABA, etc)</u> are Biz expense.
   6. Cannot take a deduction for <u>polictial contributions</u>
   7. Cannot take a deduction for <u>clothes</u> UNLESS it is a **True Uniform**. §162(e) Not adaptable to everyday use.
      a) Drycleaning of uniform Biz expense
   8. Note: If ER reimburses EE for taking clients to lunch then EE doesn't get the deduction. ER does.

➔ **Depreciation**

c. §167(a) In order to get a Depreciation deduction, Property needs to be: <u>Used in the trade or Biz OR held for the production of income</u>.
   i. Inventory and property held for sale to customers are not allowed, nor is prop held merely for personal use.
   1. In Improved realty, only the improvements can apply.
      b) Cant take for land b/c land doesn't wear out.

d. §168 – Provides the Mechanical Rules for Depreciation
   1. Must be <u>**Tangible**</u> Property (Real and Personal); Intangible property (goodwill) depreciation is taken under 197.
   2. REMEMBER to reduce your <u>Basis</u> by the amount of depreciation taken up to the sale! If you choose not to depreciate, still need to subtravct from the basis. § 1016(a)(2).
   3. In order to compute, need to know 3 things:
      a) <u>Depreciation Method</u>
         c. The 200 Percent Declining Basis Method - Under this method, the 200% DB is applied but must then switch to the *straight line method* for the first taxable year for which using the straight line method will yield a larger deduction

i. **The % than the one used for straight line method -** If property is depreciable over five years, under the straight line method the % to be depreciated each year = 1/5 (i.e. 20%). So under the DB method, the % would be 40%

d. 150 Declining Basis Method used when property has a 15 or 20 yr. recovery per

e. **Straight Line Method**

i. This method is applied in the following cases: Nonresidential real property, Residential rental property; Property that the TP elects to use this method (can always opt to use it)

b) Recovery Period [168(c)] - the period of time you are going to recover the cost of the item. You have to know the: Classification of property 168(a)(d) – to know the class life and you will know the recovery per.

c) Convention:

f. ***Mid-Month convention***: 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

i. Applies to: nonresidential real property and

ii. residential rental property

g. ***Half-Year Convention***: treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year

i. Personal property will be deemed to be placed in service in the middle of the year that you place to in service. So January 1 then it will be June 1.

ii. This is the standard convention used for all property except that listed under mid-month convention

iii. **This convention means that in the year you acquire property AND the year you dispose of the property, you will only get *half a deduction***

	Method	Recovery Period	Convention When deemed to have placed in service
Personal Property	200% DDB moving to S/L	3/5/7	½ year
Real Property (only for structure, not land)	straightline (S/L)	27.5 res-rental 39 non-res rental	Mid Month
Intangible (s. 197) Amortization		15 year recovery period	

e. § 179 – Allows to expense what otherwise would have been recovered by depreciation. For **NEW tangible personal property for use in biz.**

i. Up to 100k for 1st year (adjusted for inflation)

1. This is a § 62 deduction, most likely

ii. Then recover the rest by depreciation

iii. Must use in the year of purchase

iv. LIMIT: If property totals over 400,000 that falls under § 179, limited to taking deduction of amount over 400k.

1. Ex if 475k, must reduce by 75k so that 100-75k is all you are allowed (25k). If have 500k, then get no deduction! -- Purpose is to help small business

v. Cannot create a loss. Can only use to bring TI to zero.

f. If property not used solely for biz would have to apportion and depreciate only that portion used for biz.

4. On January 2 of the current year for $300k Depreciator purchases new equipment for use in her Biz. The equip has a 6-yr class life and is 5-yr property under §168(c). D is single, calendar year TP, and she uses the equip *only* in her Biz. Compute the depreciation deductions w/respect to the equipment in each yr of its use and Depreciator's adjusted basis for the property each yr.

a) D elects to use straight-line method for equipment and all other property in its class placed in service during the year and elects out of §168(k). *Under straight-line method, TP would take 1/5th (20%) of the basis each year for deduction, since property has a life of 5 years under ACRS [in this case that amount = $60,000 (i.e. 300,000/5)]. However, mid-year convention only allows ½ the allowed amount in the year of purchase. So in year one, TP will deduct $30,000, dropping her basis to $270,000, and then will deduct 60,000 in subsequent years.*

b) D uses the accelerated ACRS method and elects out of §168(k). *% used under accelerated ACRS method is 40% which is double what % would be under straight line method (20%). Year one, 40% of basis = $120,000 but b/c of the mid-year convention, TP can only take $60,000 in depreciation deductions in year one. This drops TP's adjusted basis to $240,000. In year two, TP takes 40% of new adjusted basis (240,000) which is $96,000. New adjusted basis = 144,000 (240-196). In Year three, TP will take 40% of new adjusted basis (144,000) which is $57,600, leaving new adjusted basis = $86,400*

h. **Note: You can switch over from double declining to straight-line method in the year in which you get the bigger deduction. Using the straight-line method all you have to do is divide the AB by the remaining Recovery period ex: Yr 2 – 144,000/3.5 (remaining years)** = 41,143 but here you should use the double declining method because it is greater ded. (57,600).

c) Same as (b), above, except D disposes of the equipment on December 1 of year five. **<u>In year you dispose of property, must apply the mid-year convention, so the TP will only get ½ allowable deduction amount in the year that she disposes of property.</u>**

d) Depreciator uses the accelerated ACRS method and *does not* elect out of §168(k). *Doesn't apply anymore (expired*)

e) What difference from (d), above, if the year is 2004 and Depreciator also elects to use §179? Assume no inflation. *TP under §179 could deduct upfront $100,000, reducing her basis to $200,000 and then could have collected depreciation for this amount (even in year one).* 20% of 200k = 40k. Year 1 – 40k dep ded ; AB=160k.

f) The equipment has a 6-year class life and D elects to use the §168(g) alternative depreciation system for the equipment and all other property w/in class placed in service during the year. *This kind of depreciation is spread out over a longer period of time. In this case, property will be depreciated over its class life which = 6 years. So year one, applying mid-year convention, depreciation = $25,000 [(300,000/6)/2]. In year two, depreciation = $50,000, etc.*

5. **<u>Luxury Car</u>** worth 25k for Biz and for personal use. There is no 179 election made.

g) 280F(a)- Must opt out of 168, which TP hasn't done here. So will be 280F + 168(k) deductions - per 168, must be placed in service before 1/1/2005.

i. Luxury automobiles limitation (everything over 12,800) -Amt of depreciation for a luxury auto <u>may not exceed</u> -

j. under §280F(a) [ASSUMING 100% biz use]

i. 1st yr = 2560 (use these numbers even though they have been updated)

ii. 2nd yr = 4100

iii. 3rd yr = 2450

iv. 4th yr and all subsequent yrs = 1475 – now 1775

g. Examples.

6. Deprec. purchases a piece of real prop for 130k of which 100k is attributable to the bldg and 30k to the land. Deprec. Immediately rents the prop. What is D's depreciation in following situations:

h) Bldg is an apartment building? – Placed into service today (11/9) it will be deemed placed Nov 15 b/c mid-month convention. Straightline method. So will get deduction for rest of year which is 3 ½ months left in yr. So take 100(dep amount)/27.5 (rec. per) = 3636 for entire year. So divide 3636/24(half months) = 151.5 then multiple by 3(half months) =455

i) **Bldg is office building – Rec. per. would be 39 yrs b/c non-residen commercial prop**

j) <u>Doesn't matter whether building is used or New.</u>

k) Deprec elects alternative depreciation system with respect to the above 2 bldgs? - 168(g) 40 year rec per- stated in statute b/c residential and non-resid. Using S/L method.

l) **<u>Certified historic structures</u>**? – 47(a)(2) authorizes a **<u>tax credit for rehabilitation of certified historic structure</u>**

a. Tax credit equal to 20% of rehab. So get 20k credit.

b. The remainder is covered by the depreciation. Reduces TP's basis.

m) 100k is spent to rehabilitate the office bldg which is not cert historic but built **<u>PRE 1936</u>**? – 47(a)(1)

a. **<u>10% Credit for Restoring Historic Building that doesn't qualify for the certified</u> credit**. Rest will be depreciation.

XV. Chapter 15 – Deductions for Profit-Making, NonBiz Activities

a. §212 Expenses for the Production of Income - **<u>(MID)</u>**

   a) Investment related expenses allowed under this section are deductible from adjusted gross income as miscellaneous itemized deductions subject to 2% of AGI limitation.
1. There shall be allowed as a deduction all the **ordinary** and **necessary** expenses paid or incurred during the taxable year for:
   a) The production or collection of income
   b) The mgmt, conservation or maintenance of property held for the production of income; or
      a. <u>NOTE: If want to take deduction for maintenance of property – NEED to show that it is held for the production of INCOME</u>.
   c) In connection with the determination, collection or refund of any tax.
      b. NOTE: If you pay someone to do your taxes, it is deductible under this §212(3).
2. Things to Note:
   a) Production of income expenses are investment expenses and <u>tax planning and compliance expenses</u>.
   b) Production of income expenses must meet the same criteria for deductibility as previously discussed for trade or Biz expenditures with the exception that the <u>expenditure does not have to relate to a trade or Biz. (CAN BE PERSONAL, NOT BIZ SO LONG AS HELD FOR PROD INCOME)</u>
   c) To be deductible, production of income expenses must be <u>ordinary and necessary, reasonable, cannot be capital expenditures, cannot relate to the generation of tax-exempt income, and cannot frustrate public policy.</u>
   d) Investment expenses include <u>safe deposit box rentals, rent and royalties, investment counsel fees, subscriptions, legal and accounting fees related to investments</u>.
   e) Expenses of attending <u>conventions, seminars, or similar meetings for investment purposes</u> are NOT deductible.
3. *Bowers v. Lumpkin*- **Ordinary and Necessary**
   a) Facts: TP incurred <u>litigation expenses to protect her title to property</u> and claimed deductions under §212(2) b/c if she lost the litigation she would have lost the property. Court says that the litigation was a capital expenditure b/c she was actually *acquiring* property (not *maintaining/conserving*) in litigating over the title.
   b) TP cannot take deduction but <u>can add the cost of litigation to basis</u> (b/c it is a *capital expenditure*) Expenses incurred in defending title to property are added to BASIS of property. Cost of attys must be added to the purchase price to get BASIS. Part of acquisition cost.
   c) same meaning as in IRC §162—in other words, *necessary* (appropriate and helpful), *ordinary* (experience), and expenses (as opposed to capital expenditures)
4. *Surasky v. US* – **Relation b/w expense and production of income**
   a) Surasky and others attempted to form committee to enforce a change on a corporate board. They were successful to some extent, and attempted to deduct the battle to do so. Held: **Proximate cause is not required to show a relation to the production of taxable income.**
   b) NOTE: Revenue Ruling 64-236 indicated that the IRS will allow expenses for <u>proxy fights</u> if proximately related to the production or collection of income, or the management or conservation of income producing property. IRS refuses to follow Surasky under its no proximate cause premise.
5. *Meyer Fleischman* – **Origin of the claim Test (DIVORCE)**
   a) In a battle in a divorce, Fleischman deducts <u>legal costs for defending himself</u>
   b) Held: Legal expenses incurred in a suit to set aside an antenuptial agreement are not deductible because they flow from the <u>**marriage relationship and not from a profit seeking relationship**</u>
   c) Gilmore Case
      c. TP in a divorce owned property where he was a Biz employee and wanted to protect it. Court held that the fight arose from divorce [family relationship], so he loses. Court does not look to impact
   d) "<u>**Origin of the claim" test**</u>
      d. Most consistent under §23(a)(2)
      e. Check to see if expenses come from family relationship (nondeductible) or profit seeking venture (deductible)
      f. Alimony expenses, however, are deductible
6. <u>Alimony</u> - a person who is getting alimony (or trying to get alimony) *may deduct expenses* (i.e. litigation expenses incurred in getting alimony) §212(1) – PAYOR cannot deduct, but PAYEE can deduct.
7. PROBLEMS, page 490

e) Spectacular buys 100 shares of Sound Company stock for $3,000, paying her broker a commission of $50 on the purchase {no deductions here, commissions are just added to basis. Fourteen months later she sells the shares for $4,000 paying a commission of $60 on the sale.

- **g.** She would like to treat $110 paid as commissions as § 212 expenses. Why? Can she? *This is a capital expenditure and gets added to her basis. She should prefer the immediate deduction b/c it provides an immediate tax benefit as opposed to having the amount added to the basis. So $50 commission in purchasing stock will be added to her basis, giving her an adjusted basis = $3050. When she sells the property, the commission on the sale will reduce her amount realized (i.e. 4,000-3050-60= $890). Unfortunately, her capital gain has been reduced by $60. [Note if she was able to deduct it under § 212, it would be an immediate deduction against her gross income (which is taxed at a higher rate) rather than adding the expense to her basis in the property and therefore reducing the capital gain (since capital gain is taxed at a lower rate). She would rather reduce higher taxed income than capital gain income.*
- **h.** What result in (a) above, if instead she sells the shares for $2500 paying a $45 commission on the sale? *Here, the commissions paid will just increase her loss on the property so she will get a tax benefit one way or the other. The loss is deductible b/c incurred in transaction entered into for profit under § 165—loss =$595 (3050+45-2500)*
- **i.** Spectacular owned only one-tenth of one percent of the Sound Company stock but, being an eager investor during the time she owned the stock, she incurred $500 of transportation, meals and lodging expenses in traveling 1000 miles to New York City to attend Sound's annual shareholder meeting. May she deduct her costs under § 212(2)? *The expense must be reasonable in relation to the investment so the IRS would need to determine whether her presence was really required at the meeting or whether something important was occurring at the meeting or whether she was just taking a vacation—<u>must 455 show an objective reason why a stockholder is attending the meeting and reasonableness of particular stockholder in going to meeting (interest in stock). If being there will make a difference, then the expenses are deductible.</u>*
- **j.** What result in (c) above, if instead Spectacular owned 10% of the total outstanding Sound <u>stock</u>, worth $300,000? *Now she owns a greater % and has a greater ability to put pressure on the corp so her presence at the meeting might truly make a difference and would be deductible. Equally important is how much shares are worth—may be more reasonable for her to attend but if she goes to nyc for vacation and wants to write off trip—no good even though she owns considerable share of stock.*
- **k.** What result to Spectacular if she incurred the expenses in (c), above, to <u>attend a seminar</u> on investments? *Must show <u>primary purpose</u> first. Section 274(h)(7) provides that for § 212 expenses, a TP/individual is not allowed deductions—only allowed for expenses actively connected to your trade or Biz (§162). Therefore she cannot get a deduction even if she satisfies the requirements of § 212 unless the seminar is in connection with the active conduct of your trade or Biz.*
- **l.** Spectacular owns 10% of Sound's stock worth $300,000 and she incurs $10,000 in legal fees and personal costs investigating the operation of the Biz after the Biz has some serious setbacks. Is the $10,000 deductible? *Proximate cause test applies. If there are serious problems, she may convince a court that the expenses are close enough to being related to the conservation of income producing activity that she should be able to deduct them. These are misc. itemized deductions.*

f) After reading the Fleischman case, consider in what situations:

- **m.** Payor Spouse may deduct attorney's fees incurred in getting a divorce. *Payor Spouse's may NOT deduct attorney's fees incurred in getting a divorce. If terms of property—cannot deduct attorney's fees but may add fees to basis if payor is successful in keeping property. However, any expenses paid in getting tax advice regarding the tax results of the divorce are deductible under 212 (3).*
- **n.** Payee Spouse may deduct attorney's fees incurred in getting a divorce. *Payee Spouse may deduct the attorney's fees incurred in getting alimony §212(1). In terms of property, payee spouse cannot deduct attorney fees but can add fees to basis if payee is successful in obtaining title to property. There are only two expenses attributable to divorce that you can deduct: 1) getting alimony (payee spouse not payor spouse) b/c that is producing income*

under 212(1) and 2) § 212(3): tax advice for tax results of your divorce agreement. Both are misc itemized deductions.

- **o.** Payee Spouse's attorneys' fees incurred in getting a divorce are deductible by Payor if Payor pays them. *If payor pays creditor (i.e. attorney) and such payment satisfies the alimony requirements, then he must report it as alimony which means it would be deductible. But if it is not treated as alimony, then payments to attorney are not deductible by payor. The issue is whether the indirectly payment is qualified as alimony.*

g) Planner consults his attys with respect to his estate plan. They decide to make various inter vivo gifts and draft his will. To what extent, if any, are Planner's legal fees deductible under § 212(3)? *The Tax Court allows a deduction even for general tax planning advice (doesn't have to be associated with a tax controversy), but only the portion of the fee incurred for the tax advice, not the atty fees incurred to create an estate plan. Misc itemized ded.*

8. *William Horman* - **<u>Conversion of Personal Property to Biz Use</u>**
   a) Property owner moves out of residence and decides he's going to rent it out. Tried for a while but was unsuccessful. After he's moved out and is holding it out for rent – wants to take depreciation deductions and deduction for maintenance of property held for the production of income under 212.
      - **p.** Ct allows deductions BUT – he also wanted to take a deduction under 165(c) for the loss sustained in any transaction entered into for profit.
      - **q.** Ct said no b/c he would have needed to actually collect rents. Dif standard from 212.
         - ***i.*** <u>If property starts off as personal, not able to take deduction for loss unless actually rented it.</u>

   b) <u>If want to take deduction for maintenance of property – NEED to show that it is held for the production of INCOME</u>.
9. Conversion of per prop to rental Biz
   a) Ex: TP purchases a house and uses it as his residence (i.e. non income producing property and no exp are deductible) but after awhile, TP ceases to use it as a residence, moves out, and then either rents it unsuccessfully or rents it successfully. Are TP's expenses deductible?
      - **r.** Clearly if TP rents prop successfully, it is an income producing prop and therefore any maintenance exp and repairs are deductible under §212. If rented, TP may take depreciation deductions and he will be able to deduct the loss if he sold the prop for a loss after renting it out *successfully*.

   b) What if TP doesn't rent out property successfully?
      - **s.** Under §212(2), a *good faith effort to rent out the prop* is enough to permit deductions for <u>maintenance and repair</u> exp. This rule requires that the prop *be held for the production of income* but does not specifically require actual income to be produced in order to get deductions
      - **t.** Under §168, depreciation deductions will also be deductible during this period if the TP showed a *good faith effort* in trying to rent the prop out and the prop was being held for the production of income (even though it wasn't making any)
         - ***i.*** **NOTE:** that while under §168 the TP usually takes depreciation deductions based on his adjusted basis in the prop, if prop has declined in value from the time the TP first acquired the prop, his basis for deprec will be his basis in the prop FMV *at the time of conversion to rental purposes,* **which number is less**.
         - ***ii.*** Ex: If TP bought property for $100k and when he coverts it, it is worth $80k, his depreciation basis will be $80k. It cannot be $100k b/c he lost $20k when he was using it for personal purposes which is not deductible.
      - **u.** Under §165, for the TP to deduct a loss on the property, the prop must have *actually been converted into income producing property* (i.e. TP must have received income from prop). TP will get no deduction, unlike other sections, for making a good faith effort to rent—must have actually produced income to deduct losses.

   c) If TP has produced income after the conversion from personal to rental prop, then he only gets to deduct the loss on the prop *after conversion*, not the loss incurred during TP's personal use of prop
   d) *Note*—had the TP originally bought the prop for investment purposes but never made any $, he would have been allowed the entire loss [only when prop is converted from personal use to investment must prop actually produce income for loss to be allowed]
   e) He has to show that he had entered a transaction for profit. If he used the prop for personal purpose, he will not be deemed to have entered a transaction unless he actually Rents It.

10. *Lowry* **- Post Conversion Appreciation**

   f) Prop was started as personal used prop. The TP never attempted to rent out prop but argued that he should still be able to deduct maintenance exp and take depreciation deductions while he held property under the theory that prop would increase in value over time, so he was holding the prop for the prod. of income (the increase in value).

   g) Ct found for TP and held that TP may take such deductions as long as he has a sound Biz reason for not renting it out and he has actually moved out of the premises. Can only take 212 deductions and depreciation deductions if not used as personal residence

11. Problems on p.474

   h) Recall the Morton Frank case in Chapter 14.

      v. Should Frank's expenses have been deductible under § 212 or § 165(c)(2)? *In Morton Frank, Frank was trying to acquire property that would produce future income. The court held that acquiring such property is a capital expenditure and does not fall under § 212 b/c under § 212, Frank must already have the property. Under § 165(c)(2), once Frank decided on a certain Biz and entered into the transactional stage and did market studies and what not, if he then abandoned that Biz, he could deduct those expenses as a transaction entered into for profit but he must be at the transaction stage to be able to deduct such expenses. Just looking around at Bizes is not enough.*

      w. If Frank had decided to buy the newspaper and incurred capital expenditures to begin operations, but then abandoned his plans, would he have been allowed a deduction? *Under 165(c)(2), he would have been allowed a deduction for those expenses b/c he actually entered into a transaction (acquired a Biz), entered into for profit. Once abandons transaction, can deduct expenses.*

      x. If Frank entered the Biz and elected to use § 195 but ceased operations within the 60 month period, to what extent could he take a § 165(c) loss? *Under § 195, Frank would take deductions in the year he ceased operations for the rest of the deductions he would have been allowed over the 60 mo period.*

   i) Homeowners purchased their vacation residence at $180,000 ($20,000 of which was allocable to the land). When it was worth $160,000 ($20,000 of which was allocable to the land), they moved out and put it up for sale, but not rent, for $170,000.

      y. May they take deductions for expenses and depreciation on the residence? If so, what types of expenses would qualify? *If they are just trying to liquidate the asset, than they would not get to take any deductions. If they are holding it for an extended period of time to get a <u>substantial increase</u> in its worth (i.e. appreciation), then they fall under the Lowry case and all depreciation deductions after conversion plus any maintenance and repair deductions will be permitted. They just need to try to get a substantial increase from value at time of conversion to take the exp and ded. If he is willing to accept any offer—then he is not really holding for production of income and he should not get the deduction. However, if they are holding for income and sell the property at a loss and didn't try to rent it out, the loss will not be deductible b/c they never tried to rent it out. [in order to deduct a loss, the property must have actually been income producing]*

   j) Assume instead that they rented the property and properly took $10,000 of depreciation on it. What result when they subsequently sell the property for:

      z. $145,000? ***Because the FMV at the time of conversion was lower than their basis in the property, they have a dual basis for purposes of loss and gain.*** *For a gain on the sale, the basis is still $180,000 (their original basis) but for loss, their basis is $160,000 (FMV on date they converted it). The $10,000 in depreciation deductions comes off the building's basis b/c land is not depreciable. If reduce the basis by $10,000, it leaves a building basis of $150,000 for gain and $130,000 for loss plus $20,000 on each for land (i.e. $170,000 and $150,000 respectively). When they sell the property at $145,000, they have a loss of $5,000 b/c we apply the loss basis ($150k since sale price is lower than loss basis).*

      aa. $175,000? *If sell it for $175,000, they have a $5,000 gain b/c we apply the gain basis (since the sale price is higher than the gain basis).*

      bb. $165,000? *If they sell it for $165,000, they have no gain or loss b/c the sale price ($145k in property) is in between the loss basis ($130k) and gain bases ($150k).*

   k) What result in (b)(2) above, if the property had been Homeowner's principal residence, they had owned and used it for 4 of the prior 5 years, and the depreciation was taken after 1977? §121—

Depreciation taken after 1997 is deductible from the basis. Therefore any amount attributable to depreciation of the building is included in the gain as taxable income. "Recapturing depreciation." Therefore, they must report $15,000 gain on the sale as income even if within $500,000 exclusion.

XVI. Chapter 16 – Deductions not limited to Biz or Profit-Seeking Activities

a. J Simpson Dean –
   1. Deans owned corporation, which lent them $2,000,000 in exchange for interest-free notes. Commissioner alleged the interest on the notes was income to the Deans.
   2. Held: an interest free loan from a controlled corporation to its officers is not income. Cannot impute income where a deduction would have been allowed.
   3. Note: Code now imputes interest in all interest-free or no-interest loans, eliminating this tax advantage

b. §163 - - **<u>Interest is deductible unless it is personal interest. The following is interest is deductible</u>**:
   1. *Trade or Biz Interest*: interest on money borrowed for the individual's trade or Biz
   2. *Investment interest*: Interest on the money borrowed to purchase or carry taxable investments (i.e. stock, bonds, etc.)
      a) Limitation on deduction: Under §163(d), TP cannot use deduction on investment interest to create a loss and it cannot be used against another activity—it other words, if TP is taking loans to make investments, TP can only use the interest deductions to reduce his investment income to $0 and that's it. Any unused deduction will be carried over to another year
   3. *Qualified residence interest*: Interest on debt that is secured by principal residence and which debt is considered to be acquisition indebtedness (money used to purchase; limit of acquisition indebtedness is $1million) or equity (limit is $100,000)
      a) Qualified residence [§163(h)(4)(A)] = primary residence AND one other residence (which TP designates for this subsection and which the TP uses as a residence, under definition of residence used in §280A(d)(1))
      b) <u>Acquisition Indebtedness</u>:
         a. This refers to interest paid on money borrowed to *acquire*, *construct*, or *substantially improve or refinance a qualified residence*
         b. Limit on indebtedness = **$1 million**
         c. *Note*—if TP refinances the acquisition debt, the new debt will be acquisition debt to the extent that the debt was to pay off the existing debt (i.e. if refinance for more than original acquisition debt, that additional debt will not be treated as acquisition debt).
      c) <u>Home Equity Indebtedness</u>
         a. This refers to interest paid on a debt, which can be used for any purpose, but is secured using the *equity* in the qualified residence (i.e. FMV-amount of acquisition indebtedness)
         b. Limit on indebtedness **= $100,000**
      d) Grandfather Debt
         a. If case of pre1987 indebtedness—such indebtedness will be treated as acquisition indebtedness and the $1million limitation won't apply

c. **Problems on p. 502 - -**
   1. TPs purchase a home in 1998 which they use as their principal residence. Unless otherwise stated, they obtain a loan secured by the residence and use the proceeds to acquire the residence. What portion of the interest paid on such loan may TPs deduct in the following situations?
      a) The purchase price and FMV of the home is $350,000. TPs obtain a mortgage for $250,000 of the purchase price. *This loan is acquisition debt so all interest paid on loan is qualified b/c less than is 1 million (principal). Entire interest is qualified.*
      b) The facts are the same as in (a) above, except that TPs by 2000 have reduced the outstanding principal balance of the 1998 mortgage to $200,000 and the FMV of the residence has increased to $400,000. In 2000, TPs take out a second mortgage for $100,000 secured by the residence to add a fourth bedroom and a den to the residence. *This second loan is still qualified as acquisition debt b/c it was taken out to make substantial improvements. The second loan does not exceed the value of property, and together, the two loans do not exceed 1 mil. Therefore, the second loan is qualified and therefore all the interest on that loan is deductible as well as the first loan*
      c) The facts are the same as in (b) above, except that the TPs use the proceeds for the $100,000 mortgage to buy a Ferrari. *This is no longer acquisition debt b/c it was not used for substantial improvements of the residence. Instead, it qualified under home equity debt which can be used for any purpose, up to 100,000, as long as the home equity debt, together with other mortgage, doesn't exceed the equity in the property. Here, it does not (400k(FMV of prop) -200 (acquisition debt) =*

$200,000 (equity) > $100,000) so the $100,000 is qualified as home equity debt and the interest may be deducted.

d) The facts are the same as in (a) above. By 2010, TPs have paid off $200,000 of the $250,000 1998 mortgage and the residence is worth $500,000. In 2010, TPs borrow $200,000 on the residence, $50,000 of which is used to pay off the remaining balance of the 1998 loan and the remainder is used to pay personal debts. *The interest from the $50,000 used to pay off 1998 acquisition debt is deductible as acquisition debt b/c they are using the proceeds to refinance and pay off the existing acquisition indebtedness. Interest from $100,000 of the remaining $150,000 can be deducted as home equity indebtedness since it can be used for any purpose, including paying off personal debt. The interest on the last $50,000 is not deductible. So ¾ of the interest of the loan is deductible. If used $150,000 to make an addition, all of it would be qualified b/c now acquisition indebtedness.*

e) The facts are the same as in (a) above [$250k debt], but additionally, towards the end of 1998, TPs' financial prospects improve dramatically and they purchase a luxury vacation residence in Florida for its FMV of $1,250,000. They finance $950,000 of the purchase price with a note secured by a mortgage on the Florida house, use the house 45 days of the year, and elect to treat the residence as a qualified residence. *So now they have two mortgages: $250,000 on principal residence and $950,000 on qualified second residence (vacation residence). This is all acquisition debt but 1,200,000 exceeds the $1 mil limit. So 250k from first residence and $750,000 of second mortgage is deductible. With the last $200,000 (950,000-750k)), interest on $100,000 can be deducted for home equity loan. The interest on the last 100,000 is not deductible. So interest on $850k of the second mortgage will be deductible.*

XVII. Chapter 21 – Capital Gains and Losses

a. In order for a transaction to be LONG-TERM, must be **<u>for more than a year</u>** – one year and one day.

b. If have a NET CAPITAL GAIN, that may be taxed at a preferential rate.

  1. **<u>Net Capital Gain = diff between Net Long Term Capital Gains (NLTCG) – Net Short Term Capital Losses (NSTCL</u>**) § 1222(11)

c. Diff capital gain tax rates -

  1. 28% **-** max rate of tax for **Collectibles**, i.e. antiques, stamp collections, wine collections, etc.
  2. 25% **-** max tax rate for **Unrecaptured Gain**.(depreciable property) § 1250 gain
     a) So if took 20k in depreciation for a bldg you owned and originally bought for 100k. AB is 80k. If sell for 125k, Gain is 45 k.
        a. Portion reflected in depreciation deduction (20k) is the unrecaptured gain and will be taxed at 25%. The rest will be taxed as regular income.
  3. 15% **-** clearly the most popular rate
  4. 5% **-** if you're an individual who doesn't have very much income – what benefit has congress given you? Max of 5% for cap gains for those who are in a 10% income tax bracket.

d. NETTING CAP GAINS

  1. First want to net longs together, then shorts. Then net longs against shorts.
  2. NLT
  3. **Do not add losses in Gross Income, only Gains.**

e. **<u>Deduction of losses</u>** – SECTION 62 DEDUCTIONS!!

  1. <u>Can deduct up to the amt of gains +$3k. If leftovers, carried over to next year.</u>
     a) The $3k will be taken out of Net Short Term Cap Losses first. If no NSTCL or if no greater than 3k, no short term losses will carry into the next year.
  2. Deduct the losses from Gross Income to get AGI.

→ Capital Assets

f. In order to have a Capital Gain, must have 2 things:

  1. A Transaction that is treated as a **sale or exchange**
  2. of a **Capital Asset**.

g. **Capital assets** means any piece of prop tangible or intangible, real or personal, provided that prop does not fall into one of the 8 groupings identified in §1221(a)

  1. Inventory or prop held for customers in ordinary course of Biz
  2. Depreciable prop or real property used in a trade or Biz
     a) if sell a bldg or land that you used in your Biz, it will not be a capital asset.
  3. A copyright or musical composition if held by TP who's personal efforts created that property or for whom the prop was created **-** -- not cap asset so cannot have a gain; **<u>PATENTS</u>** are capital assets.

4. Accts or notes receivable as required by ordinary course of Biz. counts as ordinary income and will be taxed as such.
5. Gov't publications?

h. *Mauldin* Case
1. He sold plots of land for grazing cows. He argued capital asset because it was an investment. The gov. said that it was inventory b/c Biz. Issue was whether the sale of certain lots constituted ordinary income or a capital asset. Must ask why the property was held - - If held by TP primarily for sale to customers in the ordinary course of his trade or Biz, then taxable as ordinary income AND not capital gain.
    a) A substantial part of TP's income was derived from selling lots. He even listed his nature of Biz as real estate. For these reasons, will be taxed as ordinary income.

➔ Sale or Exchange Requirement

i. *Kenan*
1. Decedent dies and leaves property in trust. When bene turns 40 she is to get 5 million and the trustee has the option to give it to her in cash, stock, property or a combination. The stock in the trust appreciated from 2 mil to 5 mil.
    a) Bene has a right to 5 mill as opposed to right to a specific stock. Here there is a 3 million gain to the trust. The basis is 2 mil (the date of death) because that is when the property was left to the trustee. And trustees have a 5 million claim against them because of bene's right to 5 mil.
    b) This is a capital asset because it is stock and there is a sale or exchange because they gave the stock to the bene to fulfill an obligation that they owed her SO the Trust has a 3 million LTCG.
    c) **Held: when the trustees gave the bene the stock it was an exchange b/c they were fulfilling a claim that the bene had against them for 5 mil.**
2. Hypo: Had it been that she was assigned the stock-Then there would have been no implications to the trust and in this case her basis would have been 2 million. If she sold it for 5 million then all that gain would have been hers.
3. Hypo: What if she said that she wanted 5 mil cash instead of stock. Trustees would have sold stock and still got a 5 mil gain. Then she would have bought the stock on market for 5 mill then her basis would be 5 million. And she would have a Cost Basis because it was a purchase or taxable exchange.

j. *Galvin Hudson*
1. TP buys judgment of 75k for 11k. Debtor eventually settles for 22k. What are the tax implications? 11k of income but is it ordinary income or capital gain? Ct said ordinary income.
    a) Law has changed – now would be seen as a sale or exchange.
    b) Basis would be what TP paid for it.

➔ Holding Period

k. Holding period starts the day after the date of acquisition.
1. NOTE: <u>For long-term needs to run a day and one calendar year</u>.
2. Problems
    a) If you buy on 1/2/00 then holding period begins 1/3/05. Then end of holding is 1/2/05 and he can sell as a LT Gain on 1/3/05.
    b) Buy on 2/28/02. What is the first day that you can sell the stock for it to be long term. You can sell at March 1, 2003. Holding begins on 3/1/02 and ends on 2/28.
    c) <u>Acquire stock on 2/28/03.</u> What is the first day you can sell the stock to get long term treatment knowing that 2004 is a LEAP YEAR. <u>You can sell on 3/1/04.</u> The first day of holding is 3/1/03 the end is 2/29/2004. It is a full calendar year and if it is a leap year then that is still a full calendar year with the additional day.
    d) If shares of stock are purchased on jan 10 of yr 1 and then gifted march 1 of yr1, Donee can tack on donor's holding period. AND, donee gets donor's BASIS.
    e) If someone **<u>dies w/in a year of purchasing property</u>**, automatic long term gain.
        a. EX: Father purchases stock on 1/1/05 for $10 a share. 4/1/05 – father dies and now it is worth is $25 per share. Stock is left to son and is distributed by the executors of the father's estate. When son get the property on 7/1/05. Son sells the stock for $35 per share.
        b. What is the son's gain? $10 LT Capital Gain. Rule under 1223(11)

➔ Judicial Gloss on the Statute

3. *Hort v. Commisioner*
    a) Bank leased property from P and paid P 140k to get out of the lease. Was this ordinary income or a capital gain? P still owned the property so not a capital gain
        a. No disposition of a capital asset so no capital gain.

4. *Metropolitan*
    a) Hotel bought out Metro's lease. What tax consequences to Metro. What happens to the income rec'd? When sell all interest in property, it is deemed a sale. As such it is a capital gain.

→ **HYPOS:**

5. Unmarried TP has 100k of salary. He takes the std ded and a pers exemp. He had some capital transactions where he sells stock and gets a 30k long term capital gain and a 10k short term gain. NLTCG =30k and NSTCG=10k. Here there is no net capital loss so the NCG=30.
    a) What is TP's GI? 140k. (income from whatever source-gains derived from dealings with prop-statute says nothing about short/long term or capital gain).
    b) What is TP's AGI?=140k.
    c) Taxable Income is $131,800 b/c 140k - 5k (Std ded) and 3200 (PE)
    d) What is TP's tax liability?
        a. Usually you go to the rates and compute but here you take out the capital asset and do that computation separate. 131,800-30=101,800 101,800 (under 1(c) in the tax tables)= 23,010.5
        b. Then compute the NCG, since stock in 15% bracket: 15% of 30k - 4500
    e) Total Tax liability = 27,510.50 (23,010.5+4500)
6. LTCG =30k, STCG=10k, STCL=15k. So STCG minus STCL= 5k NSTCL=5k. So you have a 25k Net Capital Gain (30k NLTCG-5k NSTCL=25). This gets taxed as the preferential rates.
    a) Salary= 100k
    b) CG=40k
    c) GI= 140k – it is still 140k because from whatever source derived does not count losses.
    d) AGI= 140k-15k(capital loss) = **125k** – Look at 165(f) – refers to 1211(b) for computing capital losses, 165(c)(2), 62(c)(3)
    e) TI – 125k(AGI)-5k(Std Ded)-3200(PE)=116,800
    f) Tax Liability= 25k (capital gain)tax at 15%=3750; 116,800-25k=91,800 – Tax Liability under 1(c) =20210.50
    g) Total Tax Liability: 3750+20,210.5=**23,960.50**
7. LTCG =30k, LTCL=15k, STCG=0, STCL=15k. NCG =0 because 15k NLTCG-15k NSTCL=15.
    a) Salary 100k
    b) CG=30k
    c) GI=130k
    d) AGI=130k-30 (15k LTCL-15k STCL)=100k - you can deduct capital losses
    e) TI = 100k-5k-3200=91,800
    f) Tax Liability – there was no net capital gain so you just go to tax rates 1(c)
8. LTCG=30k LTCL=20k STCG=10k STCL=25k. So NLTCG=10k and NSTCL=15k. There is no net capital Gain b/c the loss exceeds the gain. There is 5k left over.
    a) Salary-100k
    b) CG=40k
    c) GI=140k
    d) AGI= 140-43=97k (40k gain and 45k of losses) 1211(b)(1)- you can deduct only 3k over the excess over the capital gain and the rest will be carried over to next yr; 3k of the 5k loss is going to be deducted this yr and the remaining 2k next yr
    e) TI=97000-5k-3200=88,800. – Then go to tax rates to figure out tax liability.
9. LTCG=2000; LTCL=6000; STCG=1000; STCL=5000. So NLTCL=4000 and NSTCL=4000. Thus, NCG=0
    a) Salary=100k
    b) CG=3000
    c) GI=103k
    d) AGI=103-6k=97k - 1211(b)(1) - you can deduct losses up to the amount of gain plus and additional 3k. You have 11k in losses but you can deduct 6 so you carry over 5. Did the extra 3k come out of the LTCL or STCL? 1212(b) – It came out of the STCL. So the next year you would take 5k deduction=1k of STCL and 4k of LTCL b/c Short term capital loss comes out first.
10. 2004 RATES: Person has 32k salary and LTCG=10 (stk). Std ded=4850 PE= 3100. Only net capital gain gets preferential treatment. Here the NCG is 10k.
    a) Salary=32000
    b) CG=10k
    c) GI=42000 (32+10)
    d) AGI= 42000

e) TI=4200-4850-3100= 34,050

f) Tax Liability: 34,050-10=24,050 – This is TP's tax base. TP is now in a lower tax break when you minus the NGG. TP is in the 15% tax bracket. And would not get a preference for his capital gain because already is in 15% tax bracket. So the first 5k is going to be taxed at %5k because 29050-24050=5 which is how much would put him over the next bracket. The reminder is going to be taxed at the usual 15%. So in order for him to get a preference then the 5k that would have been taxed at 15% would be taxed at the capital gain rate of 5% (because there is no 10% in Capital gain brackets)

   a. Total Tax Liability=**3250+250+750=4250** – Under 1(c), 24,050 = 3250; 5% of 5000= 250; 15% of 5000= 750

11. 20k LTCG (stock) 5kLTCL(stock) 5kSTCG(stock) 6kSTCL(stock)
    10k LTCG (princ. res.)
    a) LTCL is netted against LTCG of same kind
    b) STCL is netted against STCG of same kind
    c) **Then NSTCL is netted against highest tax rate.**
    d) So 10k for PrincRes is reduced by 1k STL.
    e) That leaves 9k taxed at 25% and 15k taxed at 15%

KIDDIE TAX - 1(g)

1) If child under 18 years, then a <u>portion of earnings</u> are taxed at parents tax rate
2) No PE (if you are a dependent, someone else takes your PE)
3) Limitation to SD (see § 63(b)(5)): the greater of $850 or 300 plus earned income. If the 300 plus earned income is greater than $5150, use $5150.
4) SD = greater of $850 or 300 + earned income ($500) [if this value is greater than $5150, then use $5150]
5) TI for the kid = INCOME (Earned and unearned) – SD – any other deductions appropriately
   i) EARNED INCOME is earned income + up to 1700 of the Unearned income = Taxed at kid's rate
   ii) UNEARNED INCOME is taxed at parents rate (less 1700).
      (1) BE CAREFUL → For Parent's income <u>straddling tax brackets</u>: if parents TI = $335,500, then of the $7800 (example) that is taxed at parents rate, the first $1000 is taxed at 33%, and the remaining ($6800) is taxed at 35%.
      (2) REMAINDER (EARNED INCOME) is taxed at Child's own rate.

SOCIAL SECURITY and MEDICAID

Section 3101 (er) or 3111 (ee)
Self-employed pays both

New tax 3101(b)(2) (wages in excess of …)

Unearned income medicare contribution 1411