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Big Picture

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= Adjusted Gross Income (AGI)
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x Progress Tax Rates
= Tentative Tax
- Tax Credits
= Tax Due

Taxpayer Venue Options

Venue	Tax Court	Claims Ct (Rare)	District Court
Judge	Tax Experts	Some tax experts	Generalist
Jury	NO	NO	YES
Appeal to	Local CTA	Fed Circ.	Local CTS
Procedural	Refuse to pay tax and sue	Pay tax/ sue for refund	Pay tax/ sue for refund

Hierarchy of Authority
- Code
- Treasury Regulations – just like the law, unless contrary to the code; binding on everyone
- Revenue Rulings & Revenue Procedures – not binding on the court, but binding on IRS and treasury.
- Private Letter Ruling - binding only to one particular case

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II. Gross Income

A. Benefits in Kind

i. In General

IRC61: Gross Income Defined
- GI means all income from whatever source derived, including: (1): Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains Derived from dealing in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony and Separate Maintenance Payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive Share of partnership gross income; (14) Income in respect of a decedent; (15) Income from an interest in an estate or trust.
- Glenshaw Glass – any accession to wealth is income.

Old Colony Trust Co. v. Commissioner (1929)
- Employer paid taxes on employees wage straight to the IRS
- Court: the money that the employer paid to the IRS is still taxable income – this is a change in his wealth!
- Note: Company paid salary portion of the taxable income. But where does the salary fall in the progressive system? In the 5% margin? 10% margin? This is an ambiguity.
- Tax on the tax argument doesn't hold up – as it turns out, if they paid you 100, then if you kept taxing the tax, they'd pay 67. If they paid you 167 outright, you'd pay 67 in tax at 40% rate.. It works out.

Haig-Simons Definition of Income

- Personal Income = Market value of rights exercised in consumption + change in value of the store of property rights between beginning and end of tax period
- **Income = Consumption + Change in wealth**

Economic Benefit Approach

- (The more practical approach): Income is the value of any economic benefit received by the TP regardless of the form of benefit.

Turner

- People called in radio contest and won tickets on a cruise. Tax FMV or what TP could afford?
- Court split the difference – they wouldn't have taken it had they not won it. Its not worth the full retail value to them.
- Today: no doubt it'd be retail value of tickets
  - use FMV because its administrable.
- Prizes
  - if you win a prize, see if the tax it costs is worth the thing itself to you.
  - Even if you take tickets and don't use them, you're taxed on their value.

ii. Fringe Benefits

General Point: we don't tax net *receipts*, we tax net *income*. This is why we allow deductions of business expenses and other things.

- Look to the two ends of continuum
- Tax Incentive (not for horizontal tax equity) --- Defining Income (horizontal equity)

IRC106 – Contributions by Employer to Accident and Health Plans

- GI != employer-provided accident or health plan coverage
- Health savings account is treated as coverage for medical expenses under accident or health plan
- Although this is income, 106 says this sort of income is excluded from GI – incentive for getting health insurance, even if the health insurance is worth less to you than it costs (35% less maybe?)
- On the continuum, this is probably towards a dead give away, not for horizontal equity

IRC119 – Meals or Lodging Furnished for the Convenience of the Employer

- Enacted after Benaglia
- GI != meals or lodging 1) *for the convenience of the employer* IF
  - meals: 2) furnished on the business premises, or
  - lodging: 2) required to accept lodging as a condition of employment 3) on business premises.
  - Note: even if it is compensation, if it meets these requirements, its excludable.
- Special Rules
  - employment K not determinative
  - fact that meals are charged or declinable do not matter in determination
  - all meals are for the convenience of the employer if more than half the employees to whom meals are furnished are for the convenience of the employer
- GI != lodging furnished to employee of an educational institution if
  - not inadequate rent, meaning exclusion doesn't apply to the excess of
    - lesser of
      - 5% of appraised value
      - average of rentals paid by non employees/students
    - minus the actual rent paid
  - Congress is trying to reduce the taxation on employees compared to non-employees – only tax them on the benefit they get over non-employees
- Business premises test is functional, not spatial
  - the lodging/restaurant must be considered a part of the business (house in Tokyo for business use; lodging across the street for 24/7 accessibility)
- 2 main arguments for this

    - living expenses – duplication of paying rent
    - meals/lodging – restriction of freedom of choice
- 119 vs. 61
    - 119 excludes from 61 certain things like income
- on the continuum, this is probably somewhere in the middle

<u>IRC107 – Rental Value of Parsonages</u>
- If minister of gospel (any religion), GI !=
    - rental value of home furnished for compensation
    - rental allowance paid as part of compensation (limited to actual amount used based on FMV, including utilities)
- On the continuum, this is a free give away

<u>IRC117(d) – Qualified Scholarship: Qualified Tuition Reduction</u>
- GI != qualified tuition reduction – employer pays part of tuition for employee (or relative/dependents) at employer or other organization for education
- Can't discriminate in favor of highly paid employees

<u>IRC129(a) – Dependent Care Assistance Programs: Exclusion</u>
- GI != employer's providing dependent care assistance program
    - 5k per year in the year it was provided

<u>Benaglia</u> (1937)
- Employee was general manager of several hotels. He and his wife were given lodging and meals at the hotel so that he could be an effective manager. He also wrote a letter that ambiguously required food and lodging with his salary, but it wasn't clear whether it was actually supposed to be part of the job description or part of the salary.
- Note: 119 doesn't exist...
- An effective manager has to be on the premises at all times. As such, his residence (with his wife) was purely for the convenience of the employer – the advantage to the TP is merely incident to his duty as an employee.
- Dissent: He managed two hotels, can't be that necessary to live there. Further, the letter said that the compensation included living quarters!
- Under 119, still have to ask whether its for the convenience of the employer.

Policy consideration
- Fringe benefit exclusion destroys horizontal equity – what an employer provides to one employee isn't taxed, but another TP who has to buy it himself (lunch) is taxed.

<u>Kowalski</u> (1977) p. 18
- NJ Troopers argue that their meal-allowance payments for eating at diners on the highway are covered under 119
- 119 excludes meals furnished by employer on business premises, not cash given for meals.
    - Presumably, having the choice of food gives you the sort of freedom that makes it income, not for the convenience of the employer.
- So if not under 119 exclusion, then you argue whether its even income under 61 (but doesn't really work here)

Note: exclude income in kind, deduct cash income.

Note: 16th Amendment gives Congress right to tax EVERYTHING that Constitution considers income.

Christey v. US	§162(a): the cost of meals that they were required to eat at public restaurants adjacent to highways while on-duty
American Airlines v. US	No b/c the vouchers they were given could be used at any time (food for flight attendants)
Adams v. US (Business Premises Test)	Rejected a literal reading of §119 and imposed a functional rather than a special test: the company had built this house specifically for its president and was expected to entertain “after hours”
Linderman v. Commissioner	No, there were no significant duties tied to the house

	and he was not on call 24 hours a day
Dole v. Commissioner	The house was a mile away; the FMV of the rental was taxable b/c it was not on the business premises

iii. "Non-Statutory" Fringes

IRC132 – Certain Fringe Benefits

- GI !=
  - 1) no-additional cost service
    - employer point of view
    - employer regularly sells this and employer doesn't incur any substantial additional cost in providing service to employee
      - ex. open seat on a flight – no one was going to use it anyways, so why not (but you can't fly standby free anymore, so Congress just made this an exception to the cost thing)
  - 2) qualified employee discount,
    - products or services
    - discount can't exceed
      - property: gross profit percentage at which property is offered to customers, or
        - gross profit percentage = [excess of aggregate sales price of property – aggregate cost to employer] / aggregate sale price.
      - services: 20% of the price at which services are offered by employer to customers
    - If discount is more of these, then the excess is taxable income.
    - Qualified property/services – offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services
  - 3) working condition fringe,
    - if i paid for it myself, could i have deducted it myself?
    - Me: is this the same as if you paid for it, were you reimbursed?
  - 4) de minimis fringe,
    - value of property or services is so small as to make accounting for it unreasonable or unadministrable
    - eating facilities
      - operation of eating facility for employees is de minimis if
        - located on or near business premises, and
        - revenue derived normally >= direct operating costs of facility
      - no discrimination for this to apply
  - 5) qualified transportation fringe, 6) qualified moving expense reimbursement, 7) qualified retirement planning services, or 8) qualified military base realignment and closure fringe
- First two only apply to high paid folks if no discrimination
- Not just employees, but also their family, dependents, etc.
- Policies
  - want employees to sport employer's work
  - uniformity – set out what exactly is and isn't income

IRC162(a) – Trade or Business Expenses: In General

- Deduction of all *ordinary and necessary* expenses paid or incurred in *carrying on any trade or business*, including
  - salaries or compensation for personal services tendered
  - traveling expenses (including meals/lodging) while *away from home* in the *pursuit of a trade or business*, and
    - not away from home anymore if gone for over a year.
  - rentals or other payments for the trade or business in which TP has no title or equity

iv. Imputed Income

Its a benefit in-kind, that you do yourself, instead of paying someone else to do it – the income is imputed on to you, despite the fact that other people have to pay for it. We don't tax this, however.

Arguments to tax imputed income
- any source derived – each person can be their own source

To make things more fair, Congress allows deductions for things
- Child care credit, for example
- this is a backdoor remedial measure

2 sources of imputed income
- capital
  - difference between buying and renting – buying house for 100k, no tax. Put 100k in the bank, 10% interest, and pay rent of 10k, you pay tax on the interest, even though they are economically the same.
- Labor
  - A makes 100 and spends 50 for services. B makes 50 and does own services. A is taxed for 100 and B is only taxed for 50, even though they are economically the same!

B. Recovery of Capital

Note: 3 ways to account for cost:
- immediately deduct expenses of income producing expenses
- capitalize the investment – postpone the profit until realized
- depreciated assets – deduct annually the asset's cost

i. Introduction to Basis

Gross income includes *gains* derived from dealings in property - §61(a)(3)
- Congress can only tax income; previous investment can't be taxed again upon sale of the property

Capital Recovery
- Basis is what you paid, and you aren't taxed on it later – you are able to recover your capital.

IRC1001 – Determination of Amount of and Recognition of Gain or Loss
- Gain = Amount realized – Adjusted basis
- Loss =Adjusted basis – Amount realized
- Amount realized = $ + FMV of property
  - AR != reimbursement of real property taxes if imposed on purchaser, not TP
- Entire gain/loss is **recognized** on sale or exchange of property

IRC1011(a) – Adjusted Basis for Determining Gain or Loss: General Rule
- adjusted basis = basis as adjusted in 1016

IRC1012 – Basis of Property – Cost
- Basis = Cost of property
  - cost of property != real property taxes

IRC1.61-6(a) - Allocation of Basis
- when a portion of property is sold, basis must be allocated amongst its parts
- Flat rate
  - Ex. 100 shares for $50. Sell 30 for $100. Basis = 5k. Basis on 30 shares is 1.5k. AR = 3k.
    - G = 1.5k.; Basis left for the 70 shares is 3.5k (50 per share)
- If you buy staggered and sell in a lump, rule is FIFO
  - Y1 = 10 at $10 and Y2 = 10 at $20. ... Y4 = 10 at $40. Y5 sell 20 at $50
  - AR = 1k. B = 10*10 + 20*10 = 300 => G = 700
- If you can identify the specific stock you sold, then you don't have to do FIFO – this fits in with the goal that you want to postpone tax, meaning you want to recover capital early.

        - Same example.
        - AR = 1k. B = 10*40 + 10* 30 = 700. => G = 300
- Example: Bought 26 acres of beach front property for 2.6M. Bought adjacent, non-beach property of 4 acres at 50k per acre (.2M). Sold 24 acres of non-beach property for 2.4M
    - Total basis is 2.6M + .2m = 2.8M. So basis for sold property 24/30 * 2.8M = 2.24M?
    - Or maybe since non-beach is 50k per acre, it should just be 24*50k = 1.2M?
- Building and Land
    - Must separately value the building (depreciable) and land (non-depreciable) when TP buys each in a single purchase. Annual depreciation only available to the extent of the basis in the building

ii. Damage Payments

IRC104(a) – Compensation for Injuries or Sickness
- GI!=
    - 1) worker's comp for personal injuries or sickness,
    - 2) non-punitive damages received on account of personal *physical* injuries or *physical* sickness
        - can include lost wages...?
    - 3) amount from accident or health insurance for personal injuries of sickness, other than those amounts received to the extent that the amounts 1) are attributable to contributions by employer not includible in employee's GI, or 2) paid by the employer
        - What happens in 104(A)(3) is if you buy your own insurance, the payout you receive will be excludable. If your employer pays for your insurance, you won't get an exclusion under 104(a)(3). You might get an exclusion under 105, but you won't get it here.
        - if you buy your own insurance then the payout that you receive is excludable but if you employer pays for your insurance you are not going to get an exclusion under 104(a)(3): (you could still get it under 105): the reason this is the case is it is mostly split by employee/employer:
            - In the case where the employer pays: it just says that it is not excluded you are going to have to look elsewhere to figure it out (105)
            - *Attributable*: means payout from a plan purchased by employer
    - 4) amounts received as pension, annuity, or similar allowance for personal injuries or sickness in armed forces of any country, and
    - 5) disability income for personal injuries incurred due to terroristic or military action
- GI = emotional distress and physical injuries as a result of emotional distress (headaches)

IRC105 – Amounts Received under Accident and Health Plans
- Inclusion: GI = amt received by employee through accident or health insurance for personal/sickness injuries *to the extent* 1) attributable to contributions by employer not included in GI of employee, or 2) paid by employer.
- Exclusions from (a) - GI != amounts in (a) if
    - to reimburse TP for medical care, or
        - gross income does not include amounts paid directly or indirectly for expenses incurred by him for medical care. If this is for medical care then it is excluded under 105(b).
    - 1) payment for permanent loss or loss of use of body part, and 2) computed w/r/t nature of injury, not period away from work.

IRC106 – Contributions by Employer to Accident and Health Plans
- employee's GI != employer-provided accidental or health plan coverage
    - if employer pays your insurance, you're not taxed on it.
- contributions to employee's health savings account is treated as employer provided coverage
- Point: If employer pays your insurance premium, you aren't taxed on that income.

Moral: There is basically no difference to the employee on payout (it will be excluded somehow), so he will certainly prefer the employer provided program because it saves him $400 on the premium.

Raytheon
- RCA paid Raytheon 410k in settlement of suit. 60K is for patent licenses, which are taxable. What about the other

350k?
- Test: What are damages in lieu of?
  - If **substitute for lost profits**, then taxable as income
  - **Destruction to the business** is capital recovery – disposition of property.
    - Good will – not a physical asset, but is intangible – reputation, relationships with customers, etc.
- So good will is capital recovery, what is the basis?
  - Raytheon didn't prove basis, so assume its zero, therefore its all taxable gain – burden on TP
- Proving basis of good will
  - purchasing good will when you buy company
  - home grown – advertising costs, etc.: things you've already paid tax on that contribute to good will. *You won't be double taxed*. If you deducted the cost, then it doesn't go in basis.
- Punitive damages are taxable

iii. Annuities

3 ways to allocate the capital/income
- pay lump sum of income at the end
- get the yearly exclusion ratio and apply it to each payment
- apply variable rate based on what you have received/what they have

Present value of money table on p. 827

IRC72 – Annuities; Certain Proceeds of Endowment and Life Insurance Contracts
- GI = annuity payments.
- Exclusion ratio
  - GI != such that x / amount paid to TP = amount first paid by TP / expected return
  - Ex. Want annuity payments of 1k per year for 2 years at 10% interest rate
    - using table on 827: 2 year discount is 826, and 1 year is 909, which means right now you have to pay 1735.
      - so if you pay 1735 now, you can get 1k in each of the next two years.
    - What is excludable?
      - Y1: x / 1k = 1735 / 2k => x = 867.5 is excludable as basis recovery, so you pay tax on 132.5
      - Same for Y2!
- If you die before getting all your investment back, the unrecovered investment is allowed as a deduction as a trade or business of TP
  - unrecovered investment = investment – aggregate amount received which was excluded from GI
- Expected return
  - use actuarial tables to see how many payments will be made, if there aren't a fixed number of installment payments
- If you die after your expectancy, then you are taxed on all your gain afterwards – all your basis was recovered in the estimated life expectancy.

Compare annuities to Bank Account
- Suppose you invest 1735 in bank at 10%, and you pay tax on the interest every year, and take out 1k every year (like in the annuity example

	Y1	Y2
Open Balance	$1735	909
Interest (Taxable Income)	$173.50	91
Subtotal	$1909	1000
Withdrawal	($1000)	(1000)
Ending Balance	$909	0
Basis Recovery	$826.5	$909

- in annuity payment, we paid tax on 132.50 each year, where as here, we first pay tax on 173.50 first, then 91 next.
  - **The key here is to see the difference in the timing of the taxable income. So the benefit from buying an annuity vs. a bank account is we have $41 less taxable income in the first year and $41 more dollars of taxable income in the second year. This is good because anytime you postpone taxable income, you are basically getting an interest free loan from the government.**
  - Why? - Annuities force you to keep a certain amount invested, so this is an incentive for that money to not be consumed.

Compare annuities to term life insurance
- Term life – bet against tying that year; whole – you get same amount of money, but premiums are higher

	Term Insurance			Whole Life Insurance	
Insured	**Premium**	**Benefit**		**Premium**	**Benefit**
Gramps	$1	$5		$200	$1000
Me	$1	$200		$5	$1000
You	$1	$1000		$1	$1000

- Note: proceeds of life insurance contract, paid because of death, are NOT taxable
- you never recover basis if you don't die
  - so, unlike annuities where you can deduct if you die early, in whole life insurance, if you die early, you don't get your basis back!

C. Realization

i. In General

Why have a realization requirement?
- **Liquidity** of appreciation of assets – if appreciation is in cash, should be income. If its in value, then you can't enjoy it until sold.
  - Many think that since stocks are liquid, they should just be taxed like cash
- **Valuation** every year is not administrable
- **Incentive** to invest in things that will increase in value – encourage saving (but bank turns around and invests too, so this is a weak argument)

IRC109 – Improvements by Lessee on Lessor's Property
- GI != income derived by lessor on termination of lease representing value attributable to buildings erected or other improvements made by lessee
- Note IRC1019 – if you exclude under 109, then basis is not adjusted – basis is what he bought it for, so gain is just whatever he ends up selling it for down the road less the original capital investment.

IRC1014(a) – Basis of Property Acquired from Decedent
- Basis of property acquired from decedent, if not sold, exchanged, or otherwise disposed of before decedent's death by decedent, is
  - FMV @ date of death
- NB: This section doesn't apply for deaths after 12/31/09! (1014(f))

IRC1019 – Property on which Lessee has Made Improvements
- Basis is not adjusted due to income derived by lessor and excluded under 109.

Effect of §109 & §1019: Lessor is not taxed on the value of improvements installed by tenants on leased premises until L disposes of the property: the gain is deferred not entirely excluded, allows L to convert rent (which is immediately taxable) into capital appreciation by "collecting rent" through T's improvements on their property

Cesarini

- Finder of a treasure-trove (found money) is in receipt of taxable income for income tax purposes to the extent of its value in the US for the taxable year in which it is reduced to undisputed possession
- Severance idea from Macomber
    - If Cesarini found a gold nugget, wouldn't be taxed until it was sold for cash. Same with finding out a painting you bought for 75k is actually worth 1M. You have no other chance to tax found cash, but a gold nugget, there is still an opportunity for realization.
- IRS revenue ruling: treasure trove is taxable income.
- Tax Procedure – why did they pay tax then sue for refund?

Venue	**Tax Ct**	**Claims Ct (rare)**	**Dist. Ct**
Judges	Tax Experts	Some Tax Experts	Generalists
Jury?	No	No	Yes
Appeal to:	Local Ct. Apps.	Fed Circ.	Local Ct. Apps.
Procedure:	Refuse to pay tax & sue	Pay tax & sue for refund	Pay tax & sue for refund

- Moral of the story
    - If you're confident – go to tax ct. If you have a sympathetic story and bad law, go to a jury! Why go to claims court? The appeals. The SC takes very few tax cases, so we get long lasting circuit splits. Not many cases are brought into the claims court however.

Haverly

- Principal got sample texts from publishers to do whatever he wanted with. He donated them to the school library and got a charitable deduction. He argues that its not gross income, however.
- Not a gift because taxpayer did not proceed from a detached and disinterested generosity nor out of affection, respect, admiration, charity, or like impulses
- He deducted the charitable gift, so that clearly shows that he took it as income – can't double dip.
    - Salary = 10k; books = 1k
    - Doesn't include in income, yet donates books and takes deduction: 10k – 1k = 9k. He double dipped!
    - Should be either 10k taxed
- If you take the deduction, then you acknowledged that its income.
    - Issue – where is the realization?
        - realization when he took the deduction
    - Problem – wouldn't there be realization if he just kept the books on their shelf?
        - Walker – IRC *could* tax this, but won't because of administrative difficulty

Eisner v. Macomber

- Company gave out stock dividends, not cash dividends with option to buy stock. - is a stock dividend income?
- A simple pro rata common on common stock dividend, in which the stockholder receives shares identical to those producing the dividend and has no option to choose cash produces no taxable income – **IRC305**
- Stock Dividends
    - gives out x shares for every y shares you have. So you get a higher number of shares, but control of the company doesn't change.
    - This actually reduces the value of the shares (normally a split which reduces price by half), which makes it easier to trade them.
- Continuum for company's actions

Tax Don't Tax

←----|--|---|--------------------------|------------→

Cash dividend Give SHers choice: cash or stock Stock Div. Retain Earnings

- Court seemed to have read a realization/severance requirement – cash dividends are severable, whereas stock dividends aren't.
  - Derived from capital != gain from capital
    - with cash dividends, you sever the cash from the stock. Stock dividends, you just have stock left.
  - Court read this as a constitutional requirement
- Holding: Stock dividends are NOT taxable income
  - nothing changes – all you get is a piece of paper
  - Walker: but cash dividends are the same – reduction in value of the stock but gain in cash...
- Bad Holding: The severability part is NOT good law anymore, Walker thinks.
  - We're only looking for administrative ease, nothing more.
    - Note: 1256 K is handled marked to marked – look at FMV at the end of every year.
- Bad Holding: income is gain from capital or labor..
  - too narrow – doesn't include found money
- this case is important for tax deferral purposes
  - if you taxed year to year, it'd come out the same, just not all paid at sale of the stock

Bruun
- Note: Overruled by IRC109!
- Lessor and lessee had an agreement saying they'd each improve the land and the resulting improvements belonged to the lessor. Lessee built a new building worth much more. Lessee then defaulted on the lease and the lease was canceled.
- Holding: you are taxed (realization) when lease is up and the control becomes yours again. If lessee defaults, you are taxed when default
  - other options: tax at beginning of K – not fair. Tax at very end on sale – this is possible, but the building will have depreciated already (which is good for TP)
- **Congress, though disagreed with the Court's decision in this case, and drafted §109, which states that you taxpayer will not have to take the value of the building into account until you sell it.** We are just going to treat this like appreciation.

Note: If you pay tax now, then your basis goes up! You increase your capital investment and don't have to pay tax again when you sell.

ii. Discount Obligations

What is going on: interest that is not paid as it is earned may be reinvested to earn more interest, which is why interest normally accrues at compound rate
- Present Discounted Value: is the value of how money to be paid in the future, it is determined by asking how much money would have to be put aside today; to fund the future payment.

Problem: Zero Coupon Bonds – you pay 100. Whereas a normal bond you'd get interest every year, then your principal back at the end, with ZCBs, you get the interest plus principal all at the end. This would provide for a huge tax deferment. BUT this is why we have IRC1272 7 1273.
- This excess is called oid
- So if you pay 100 now, for 133 later, the OID is 33 - 1273(a)

IRC1272 – Current Inclusion in Income of Original Issue Discount
- basically saying that you treat the OID just like you would a bank account – tax annually
- so you basically tax without realization (getting it in the end)
- Note: Exceptions for this OID taxing rule where not included in GI annually include US savings bonds, tax-exempt obligations, loans between natural persons (private loans between people)

IRC1273 – Determination of Amount of Original Issue Discount
- OID = Stated Redemption Price at maturity – issue price

- SRP at M = amount fixed by agreement including interest and other amounts paid at maturity (except interest based on a fixed rate, payable unconditionally at fixed periodic intervals =< 1yr.
- Issue price
  - if not for property, then price when publicly offered or when first bought
  - if in exchange for property, then the FMV of property

iii. Introduction to Capital Gains Rates

Problem – If you have IBM stock, and you sell it to buy Microsoft, you are taxed on the gain at sale. So the Microsoft purchase has to be worth the extra cost of tax you'd pay, else you should just hold on to IBM. This **lock-in** effect is one reason we have capital gains rates, lower than normal income tax rates. We don't want people making decisions based on income tax.

The code provisions below show another way to reduce lock-in
- basis step up (or down) at death under 1014 CREATES lock-in
- So we have 1022, which effectively will make it a carry-over basis at death for appreciated property, and FMV for depreciated property
  - but for things below 1.3M (or 4.3M for spouses), there is really no effect

IRC1014(f) – Basis of Property Acquired from a Decedent: Termination
- This section doesn't apply to folks who die after 12/31/09.

IRC1022 – Treatment of Property Acquired from a Decedent Dying After 12/31/09
- Treated as if transfered by gift
- Basis = lesser of
  - adjusted basis of decedent, or
  - FMV of property at decedent's death
- Basis increase (note: can't be increased above FMV at death)
  - Basis is increased by
    - in the case of an estate, by 1.3M
    - if surviving spouse, then add another 3M to make it 4.3M
- NB: So this "repeal" doesn't effect many things unless they have a really high FMV.
- If you give someone an inter vivos gift just so they can bequest it back to you for the 1.3M in basis add-on, thats fine, but it won't work if they die within 3 years - 1022(d)(1)(C)

D. Gifts, Etc.

i. Gifts

3 possibilities to tax gifts
- tax donor, no deductions. Don't tax donee.
  - Family model – gifts are a means to support your family – tax the donor.
  - Our system
- Donor gets deduction. Donee pays tax on income.
- Tax both – they each get some sort of value from this

IRC102 – Gifts and Inheritances
- GI != value of **property** acquired by: gift, bequest, devise, or inheritance.
- Value of **Income**: (a) does not exclude from GI
  - value of **income** from gifted property, or
  - where the gift IS income from property, the amount of such income
- employer to employee: (a) does not exclude form GI amount transferred by or for an employer to or for benefit of employee.
- Policy: Donor is paying tax on the gift, no need to tax the donee.

        - Rejects argument that donor gets benefit from gifting (pleasure, thankfulness, etc.)

Irwin v. Gavitt

- dude created a testamentary trust that gave P ½ of a remainder of the trust after his granddaughter got her crap
    - This income is to be applied so far as deemed proper by the trustees to the education and support of the granddaughter.
        - The balance to be divided into two equal parts and one of them to be paid to the testator's son-in-law, in equal quarter-yearly payments during his life.
        - But on the granddaughter's reaching the age of 21 or dying the fund went over to her, so the granddaughter was 6 at the time.
        - So, P (the son in law) gets this income from his part for a maximum of 15 years, until the granddaughter turns 21, then it goes to her.
- Issue: is amount received annually by P gift of property or income?
- Holding: This is income from property, so its taxable.
- Dissent – look, this is his gift, and statute says we're not going to tax gifts .
- 3 examples
    - G give 1k to S every year derived from 10k principal. Upon death 10 years later, G gives D 10k principal.
        - G taxed on 1k per year interest
        - Son isn't taxed on 1k (gift)
        - D isn't taxed on 10k (its principal on bequeath)
    - G bequests to S 10k. S invests and keeps 1k principle. After 10 years, S gives D 10k.
        - G is dead – no tax.
        - S is taxed on the 1k interest, but not the 10k bequest.
        - D isn't taxed on the 10k gift.
    - G dies and puts 10k in trust. 1k income is paid to S for 10 years. After 10 years, the 10k principal goes to D.
        - G is dead – no tax.
        - S is taxed on the 1k., according to Holmes in this case.
        - D isn't taxed on principal.
- S claims that the 1k is property, and he isn't taxed. But this wouldn't make sense in the scheme of things – SOMEONE has to pay tax on the 1k income!
    - Note: this isn't fair to G – G has no control over the trust, whereas he had control in case 2.
- Another possibility – more fair way is to split up the annuity aspect and the zero coupon bond aspect
    - Consider D getting a sort of zero coupon bond such that
        - 3860 now is 10k in 10 years. (from table). So tax her like she has a zero coupon bond with OID of 6140, split up and paid over the 10 years.
    - Consider S getting an annuity
        - His annuity must be worth 6140 – the amount left from the 10k total.
            - He got a stream of 1k payments for 10 years.
        - If he had received 6140 cash, he wouldn't have been taxed (gift) – this is his basis.
        - So use the exclusion ratio for annuities such that his 6140 investment paying 1k a year for 10 years would all work out.

IRC1015 – Basis of Property Acquired by Gifts and Transfers in Trust

- Table:

	FMV @ Gift > Donor Basis	**Donor Basis > FMV @ Gift**
Donee Gain @ Sale	Carryover Basis	Carryover Basis
Donee Loss @ Sale	Carryover Basis	FMV at time of gift as basis

Examples of 1015

- Ex 1: Donor Basis = 20; Gift FMV = 30, Donee Sale = 50
    - Always carry-over basis on left side, so Donee Basis = 20 and Donee gain = 30.
    - So upper left box
- Ex. 2: DrB = 20; GFMV = 30; DeS = 10
    - Always carry-over basis on left side, so DeB = 20 and DeL = (10)
    - so we're bottom left box
- Ex. 3: DrB = 20; GFMV = 10; DeS = 50

  - We're on right side. DeS is bigger than both DrB and GFMV, so we're top right.
  - DeB = carry-over = 20 and DeG = 30.
- Ex. 4: DrB = 20; GFMV = 10; DeS = 5
  - DeS is less than both DrB and GFMV, so Donee has a loss, so we're bottom right
  - DeB = 10 and DeL = (5)
- Ex. 5: DrB = 20; GFMV = 10; DeS = 15
  - We're inbetween, have to calculate both
  - if top right
    - DeB = 20 and DeG = (5) – this is impossible
  - so bottom right
    - DeB = 10 and DeL = 5 – this is impossible too!
  - Moral of the story – if DrB > DeS > FMV, then **no tax consequence** – you report it, but there is no gain or loss on the transaction – TI = 0
- So Point of all this
  - Planners can shift gain, but can't necessarily shift loss (unless donor ultimately ends up with a gain on it).
  - It seems that they are discouraging the transfer of unrealized losses. Congress seems fine with transferring unrealized gains, but there is a risk if you try and transfer losses.

Compare Inter Vivos transfers to bequests
- We pretty much always step up/down basis at death.
- If FMV @ death is bigger than decedent's basis, then bequest! (otherwise, if IV gift, it'll always be carry-over basis)
- If FMV @ death is less than decedent's basis, then DO NOT BEQUEST – FMV is bad because basis is lower
  - note: if you're in bottom right, its the same, but at least you know you're in bottom right from the get go
- If in between, like in ex. 5 above, better to IV gift because there is no gain.
- **Moral**: Don't bequest depreciated property, but there is a good reason to bequest appreciated property.

<u>IRC1022 – Treatment of Property Acquired from a Decedent Dying after 12/1/09</u>
- Meant to replace IRC1014
- Property transferred from decedent is treated as transferred by gift
- Basis is lesser of
  - adjusted basis of decedent, or
  - FMV at death
- Basis increase
  - increase the basis by 1.3M (add another 3M if bequeathed to surviving spouse)
  - basis can NOT be increased past its FMV at death.
  - Note: this is **aggregate basis increase** – this basis has to be distributed amongst ALL the bequeathed property!
    - So executor chooses which property receives what amount of basis increase.
- **Moral: If the decedent's property appreciated more than 1.3M (or 4.3M for surviving spouse) then you pay tax on the gains over that new 1.3M (4.3M) basis.**
- Note: there is an estate tax, but its being phased out.

<u>Reg 1.1001-1(e)(1): Part Gift/Sale Analysis Generally – Horizontal Division</u>
- When there is a part sale and part gift transfer, transferor has a gain to the extent that the AR by him exceeds his adjusted basis - we stick with <u>horizontal division</u>
  - Walker B = 40, FMV = 100, and sells it to Daughter for 50.
  - Walker: AR = 50, B = 40, G = 10
  - Daughter: AR = 100, B = 50, G = 50
  - So we divide the tax horizontally, 10 to him and 50 to her, where 60 is due.
- So TP might shift gain, but merely to another TP who will likely have carry-over basis, (unless inter vivos gift of depreciated asset and donee sells for loss)

<u>Reg 1.1011-2: Gifts to Charity – Part Gift/Sale Analysis for Charities – Vertical Division</u>
- For bargain sales to charity, do <u>vertical division</u> so that taxpayers can't shift all their gain to the charity (which is tax exempt)
  - Walker B = 40, FMV = 100, and sells it to Charity for 50
  - Divide property in half, so you have

        - Sale: B = 20, FMV = 50
            - Walker: B = 20, AR = 50, G = 30
            - Charity: AR = 50, B = 50, so G = 0
        - Gift: B = 20, FMV = 50
            - Walker: Not taxed on gift
            - Charity: B = 20 (not in the south-east quadrant since FMV > Donor Basis), AR = 50 so G = 30
- **Moral of the story: Instead of pushing 50 gain (in normal horizontal division) onto charity, we limit it to 30, using vertical division**

Duberstein
- Case 1 – dude sent clients to car dealership. Dealership gave him a car as a gift.
- Case 2 – dude resigned from job – job voted to give him a 20k gratuity.
- Gift is not
    - out of legal or moral obligation
    - for any anticipated economic benefit
    - in return for services rendered
- Gift is proceeds from a detached and disinterested generosity; out of affection, respect, admiration, charity, or like impulse.
- Most critical consideration is the transferor's intention, gaged by the circumstances
- There can't be any sort of "compensation" aspect to the gift

IRC102(c) – Employer Gifts
- There are no gifts in the employment context

IRC274(b) – Disallowance of Certain Entertainment, Etc. Expenses
- In response to Duberstein
- No deduction under 162 (Trade/Business expense) or 212 (Expense in production of income) by TP to any individual that exceeds $25.

IRC691(a)(1) – Recipients of Income in Respect of Decedents: Inclusion in Gross Income
- amount of GI not includible in the tax period of death is included for the year received of
    - estate of decedent, if given to estate by decedent
    - person who receives the amount, if right to receive is not acquired by estate
    - person who acquires from decedent by bequest, devise, or inheritance, if amount is received after distribution by estate

Reg 1.132-6(e) – examples of (and not of) de minimis fringes
- Look at code book on p. 1097

ii. Prizes & Awards

IRC74 – Prizes and Awards
- GI = prizes and awards
- GI != prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but ONLY IF
    - 1) recipient selected without any action on his part to enter/compete
    - 2) recipient not required to render substantial future services as a condition
    - 3) prize is transferred by payor to a charity
- Note: if you give it away to charity, you can't claim a deduction – Haverly double-dip
- Policy
    - Don't tax gifts – those are so family oriented
    - These could prevent against windfalls.
- Other options
    - we could just give people zero basis

NB: Look at facts and circumstances to see if its a prize or a gift.

iii. Scholarships and Fellowships

IRC117 – Qualified Scholarships
- GI does not include qualified scholarship to a degree candidate
- qualified scholarship is $ used for qualified tuition and related expenses
- qualified tuition and related expenses is $ used for tuition and fees for enrollment as well as $ needed for fees, books, supplies, and equipment for courses (NOT room and board)
- Scholarship exclusion **limited** to money NOT given for services (teaching, research, etc.)
- GI does not include qualified tuition reduction
  - qualified tuition reduction is amount of reduction in tuition given to employee for undergrad degree (includes grad school only for TAs and RAs)
- Scholarship can't earmark or designate its use for non-qualified expenses
- Note: athletic scholarships are income unless not dependent on playing sports

Ex
- A gets full ride to BU – 100k
- B goes to state school for 40k
  - A can argue B made 60k staying in-state – imputed income
- C saves and pays 100k at BU
- A gets benefit from tax, and B from shopping around. C gets screwed.

Who would pay the price if scholarships were taxed?
- Probably not students – schools would just have to pay more in scholarships to make it affordable for students.
- So government, in effect, is subsidizing education here.

E. Competing Claims and Offsetting Liabilities

i. Cancellation of Indebtedness

CoD Income
- You don't get taxed if you borrow money. Assets and liabilities go up, so you break even – not Haig Simons
- IF, though, you borrow 100 and settle debt for 70, then you still come out 30 on top – this is a gain, so you must pay tax now.

Kirby v. Lumber
- Sold bonds for 12M. Some time later, corporation repurchased the bonds for less than they sold them for. Difference was 137k.
- Debt – Company sells bond – purchaser loans money to company. When Company repurchases the bond, they settle the debt.
  - Can repurchase for less because the bond interest rate might be worth less than the market interest rate, so the tradeable bond is worth less in the market.
  - Also might sell for cheap if the company is doing poorly – price of a bond is just the expectation of being repaid.
- Empire case
  - In that case, they borrowed in deutchmarks, which had a US equivalent in dollars. When they repaid, they repaid the same amount they borrowed in deutchmarks, But the deutchmarks had declined in value.
  - So it would be fine to say there was a 50K gain on the currency transaction and a million loss on the business venture.
  - Court held that because money was lost in the general transaction, there couldn't be income.
  - Walker doesn't think this case is distinguishable...
- Test: Did the cancellation of debt free up assets?
- But, Kirby was codified in **IRC61(a)(12)**

IRC108 – Income from Discharge of Indebtedness

- GI != amount which would be includible by reason of discharge of indebtedness IF
  - Bankruptcy, or
  - occurs taxpayer is insolvent, or
    - still have to pay tax on income though – this is just for CoD income
    - might have to pay back after insolvency
  - qualified farm indebtedness, or
  - real property business indebtedness
  - Insolvency exclusion limited to amount of insolvency!
- Amount excluded applied to reduce the basis of the property
- Definitions
  - indebtedness of TP = indebtedness for which TP is liable or subject to which TP holds property
  - Insolvent – excess of liabilities over FMV of assets
- IF
  - debt to seller which arose out of the purchase is reduced, and
  - such reduction does not occur in
    - bankruptcy, or
    - purchaser is insolvent,
  - and, but for this paragraph, such reduction would be treated as income to the purchaser,
  - THEN such reduction shall be treated as a purchase price adjustment
    - if you have a purchase price adjustment (it turns out to not be worth as much and you re-negotiate), then the money saved is not taxable income
- Educational loans
  - GI != amount which would be includible by discharge if discharge was pursuant to loan provision that said it'd be discharged if the individual worked it off after school in a certain area.

Zarin

- Dude ran up HUGE bills at casino. He paid back 2.5M, and kept going. Finally, checks he wrote were drawn on ISF and casino sued for 3.5M. They settled for 0.5M, and IRS now wants to tax dude on the 3M as CoD income.
- Test: gain to the debtor from discharge is the resultant freeing up of his assets that he would otherwise have been required to use to pay the debt
- Argument for CoD
  - You would say this is a simple case, you borrowed money, you were obligated to repay it. The only reason we didn't include it as income when you borrowed it is because you were going to repay it
  - If he won 10M, he'd clearly have to pay 10M back
- Argument against CoD
  - Cash != chips; this isn't the same as if he went to bank, borrowed money, then gambled it away. He was pretty much guaranteed to spend the chips at the casino
  - Best argument against CoD: renegotiated purchase price adjustment
    - They renegotiated the price of buying the price of the chips.
  - He couldn't just take the chips, cash them, and leave – he was expected to dispose of them there
- This is a tough case to show COD income. The tax court says he does have COD income, the 3d Cir. Reverses
  - Third circuit: since they illegally loaned him too much gambling money, the debt was unenforceable, therefore no income since no legal debt.
    - Further, chips not property to which debt related
    - alternatively, court applied contested liability doctrine – if a taxpayer disputes the amount of a debt, a subsequent settlement is treated as the actual amount of indebtedness!

Gift and CoD

- If commercial setting, probably not a gift.
- If loan from parents, probably becomes a gift.

Price adjustment and CoD

- Car dealer says you can pick up car for 2k.
- You get here, and negotiate for 1k. This is price adjustment.

Ex. Suppose debts of 8k, 2k, 4k, and 6k. Assets are 15k (so you're insolvent). 8K debt is forgiven. You have income of 3k

- **your CoD income is not taxed only while you're insolvent.** Discharge of 8k in this case puts you at 12k of debt left – but you have 15k of assets – so this leaves you at 3k of income.
- Another way to look at it – you're 5k insolvent. If 8k is discharged, then you have 3k of CoD

ii. Illegal Income

Collins

- F: bookie punched in 80k tickets for bets on races himself, without paying. He paid back 42k and lost 38k.
- Unlawful taxable gains are GI, but loans aren't
- You must have intent to repay the loan for it to not be TI
- James test
  - a taxpayer has received income when she acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition
    - includes all forms of enrichment, but specifically excludes loans
  - Compare to loans
    - loans have the mutual understanding between borrower and lender to repay and a bona fide intent on the borrower's part to repay
- Court said that he owes tax on 80k of income, but can deduct 42k of that since he gave it back.
- Collins argument – he "borrowed" 80k, but only won 42k, so he had a net loss, therefore no income.
- Court disaggregates – 2 transactions: he took money (income), then lost it (gambling)
- He made a restitution payment – deduct this from the illegal income.
  - TP can take a deduction the year he repays what he took
- No worries about double penalty: criminal and tax penalties.
- Note: he can deduct his gambling loss only to the extent that he has gambling gains

F. Tax Expenditures and the Concept of Income

i. Tax Exempt Interest

IRC103 – Interest on State and Local Bonds

- GI != interest on State or local bond.
  - This section doesn't apply to
    - Private activity bond NOT a qualified bond (141)
    - arbitrage bond (148)
    - Bond not in registered form (149)

Policy – want to subsidize state and local governments

- TP 40% sees 10% corporate bond and 6% municipal bond the same – the federal government eats the $40.

Windfall problem

- If state makes it to 40% bracket is indifferent, then lower brackets won't buy – they don't save as much. If state needs to sell more bonds, however, then they can increase the interest rate to make it worth while for lower bracket folks. HOWEVER, then the higher bracket folks will buy them all up because they actually make money on them! State can't price discriminate against high-income TPs!

IRC141 – Private Activity Bond; Qualified Bond

- Private activity bond is a bond
  - which meets
    - private business use test, and
      - more than 10% of proceeds are to be used for any private business use
    - private security or payment test

            - if payment of the principal of, or interest on, more than 10% of the proceeds directly or indirectly
                - secured by any interest in
                    - property for private business use
                    - payments of such property
                - , or, derived from payments used for private business use
    - , or, which meets private loan financing test
- qualified bond
    - private activity bond if
        - exempt facility
            - more like airports, etc., instead of car manufacturers (meant to bring jobs to the state)
        - list on p. 120
    - this list is Congress picking and choosing what private activities they want to subsidize

IRC148 – Arbitrage

- bond issued whose proceeds are reasonably expected to be used directly or indirectly
    - to acquire higher yielding investments, or
    - to replace funds used to acquire higher yielding investments
- higher yielding investment
    - investment property which produces yield over term which is materially higher than yield on issue
        - security, obligation, annuity K, investment-type property, or residential rental property

ii. Tax Expenditure Budget

This budget is released annually which shows how much money the Federal Government is losing/subsidizing in each of its exclusions/deductions.

- Most focus is on subsidies provided through the tax code
- includes negative tax expenditures – tax penalties

iii. Alternative Tax Bases

3 ways to tax

- Consumption
- Wealth (property tax)
- income
- flat rate

Consumption Tax

- Leading alternative in the world
- We have a hybrid consumption income tax
- Consumption tax is regressive, instead of progressive

Consumption v. Income Tax Debate

Tax	Tax Base	Who's taxed Equally	Complaint
Income	Wages + Investment earnings or Consumption & excludes (change in wealth)	Tax earners equally	Discourages Savings
Consumption	Consumption	Consumers	It seems to be regressive (low income people spend more of their income than high income people)

Consumption tax can be considered like having an income tax, with a deduction for net savings

- Income = Consumption + Change in wealth
  - Consumption = income – change in wealth
- This would be an easier way of implementing a consumption tax, without re-writing the entire code.
  - But we kind of do have this aspect of our system – IRA's and 401Ks for example.

Income Tax discourages savings
* If you save and invest, you are still taxed in the investment income – this reduces your willingness to save.

****

III. Deductions

Calculation Recap

	GI (we've finished)
-	ATLD
=	AGI
-	BTLD
-	PE
=	TI
x	MTR
=	Tax (pre-credit)
-	Credits
=	Final Tax

3 categories of deductibility:

Capital Expenditures §263 (*no deductions now, but maybe later)*	Personal Expenses *(no deductions ever except exceptions)* §262
Business Expenses §162 (*Deductions Now)*	

Deductions are a matter of Congressional grace

A. Profit-Seeking Expenditures

i. "Ordinary and Necessary" Business Expenses

a. In General

IRC162(a) – Trade or Business Expenses: In General

- Deduction = ordinary and necessary expenses in carrying on trade or business, including
  - salaries for personal services actually rendered
  - traveling expenses (including non-lavish meals and lodging) while away from home in pursuit of trade or business
  - rentals required for use or possession for the T or B of property which TP has no equity or title in.
- Not "away from home" if away for more than a year.

IRC212 – Expenses for Production if Income

- Deduction = ordinary and necessary expenses
  - 1) for production or collection of income
  - 2) for taking care of property held for production of income
  - 3) for handling taxes

- This provision helps fill the gap for things in your T or B and things you do to make money.
- Not for hobbies

IRC262 – Personal, Living, and Family Expenses
- Deduction != personal, living, or family expenses
- First phone line is a personal business expense.

IRC263(a) – Capital Expenditures: General Rule
- Deduction != $ for new buildings/permanent improvements
  - this paragraph doesn't apply to
    - developments of mines
    - R&D under 174
    - list on 240-41

Ex.
- GI from practice is 100. Rent is 20.
  - Deductible under 162 – rent paid in T or B
- Buy building for 100k
  - Not deductible – capital expenditure under 263
  - why not deductible? This is just a conversion of wealth from cash to building.
- Buys a bike
  - not deductible – personal expense.

Welch (1933)
- Dude's co went bankrupt. He started a new one, and to build credit/good will, he repaid all his old debts.
- Assume this is necessary (low bar)
  - this probably wasn't even necessary!
  - Test: was it appropriate/helpful?
- Ordinary is the issue
  - whether life experience shows us that people in the group or community think its normal – it does not mean habitual or repeated
  - In this case, although men sometimes pay debts they don't legally have to, this action is extraordinary
  - life in all its fullness – look at facts and circumstances, like the test in Duberstein
- If he sold his business, this could probably count as basis.

Gillam (225)
- F: On flight to give business lecture in art, dude went nuts and hit people. He was arrested and acquitted under insanity. He deducted his fees, fines, and settlements
- Test: Ordinary != normal, usual, or customary to the person – the transaction which gives rise to the cost must be of common or frequent occurrence in the type of business involved.
- Dancer
  - Man was driving in car for business, and hit someone. Those legal fees were deductible: risk of accident is considered by employer just as much as having to pay gas.
- Walker: This is a close case
- Point: you can have personal expenses on a business trip.

b. Public Policy Limitation

IRC162(c)-(m) – Trade or Business Exceptions: Policy Limitations
- Deduction != (exclusive list)
  - illegal bribes/kickbacks
    - payments to government officials that are illegal bribes or kickbacks
    - payments to other people which subjects payor to criminal penalty
    - payments made by medical providers for getting Medicaid patients... or something.
  - lobbying/politics: no deductions for lobbying/politics, unless its for any local council or similar governing body
    - no deduction for lobbying state or federal government

        - fines or penalties paid to a government for violation of any law
            - payments to third parties (settlement in case, etc.) is deductible, as long as payment isn't akin to a fine
        - 2/3 of settlement or award from an antitrust violation suit
        - employee salary over 1M in publicly held companies for CEO, or other people whose salaries are reported to shareholders – Congress wants to see performance based pay
            - salary = amount that can be deducted under 162 but for this provision
            - doesn't include commission
            - doesn't include bonuses, if the goals are
                - limitations on 140
- So payor and payee pay tax – law isn't sympathetic.

IRC280E – Expenditures in Connection with the Illegal Sale of Drugs
- Deduction != expense in carrying on T or B if T or B consists of trafficking in controlled substances
- If you get caught your expenses for employees are not deductible, but the wholesale cost of the drugs is deductible - congress limits deductions to ancillary expenses, not cost of goods sold b/c that cuts too much into the concept of income. In this case, the cost of goods sold, your inventory, is crack, which is deductible.

Tellier (1966)
- F: Unsuccessful defense against criminal prosecution under securities act – deducted attorney's fees.
- No question that his fine wasn't deductible - 162(f)
- Necessary?
    - “appropriate and helpful for development of TP's business” - this is met
- Ordinary?
    - the point is to distinguish between those expenses that are currently deductible and those that are in the nature of the capital expenditures, which if deductible at all, must be amortized over the useful life of the asset.
    - Here, not capital asset, so ordinary.
- Public Policy Exception?
    - Just because money was spent because of wrongdoing doesn't mean the federal income tax is designed to punish the wrong doer more – wrong doers are taxed no more or less than other people.
    - ex.
        - upheld disallowance for deductions claimed for fines and penalties imposed for violating state penal statutes.
        - To allow a deduction would have directly and substantially diluted the actual punishment imposed
    - Conviction doesn't matter for deductibility
        - The tax code is not to enforce public policy unless Congress explicitly says so. But, it’s not for the court to pick and choose which public policy exceptions to enforce through the code.
- Hypo: State made bookie wages illegal. Still deductible income?
    - O&N under 162? Yes
    - Issue: 162(c)(2) - bribe, kickback, or “other illegal payment”?
        - Statutory construction – what does other illegal payment mean

Trucking Cases
- F: weight limits in PA were less than most other states, so many truckers just ate the fine. Deductible?

Per-Trip	Pre-Tax	Tax (40%)	AT (fine deductible)	AT (fine not deductible)
Additl Income	1000	(400)	600	600
Fine	(1100)	440	660	(1100)
Net	(100)		(60)	(500)

- So there is a risk that denying deduction could over-deter!
- But Congress disallowed fines under **162(f)** – doesn't want to appear to be subsidizing these violations

ii. Capital Expenditures

When an amount is capitalized, the amount is added to TP's basis – he has already paid tax on this!
- The expense can then be deducted over time through depreciation, or recovered as basis when sold.
- **Separate Asset Test:** if a expenditure creates a separate, identifiable asset w/ a useful life that will extend substantially

beyond the taxable year, the expenditure is probably a capital expenditure. Lincoln Savings & Loan

- **Future Benefits Test**: Even if a separate asset is not created, if an expenditure creates more than an insignificant future benefit, it is a capital expenditure. Indopco, Inc. v. Commissioner:
- Categories of assets routinely capitalized
  - Expenditures to purchase an asset, including financial assets such as stocks or bonds, real estate, tangible personal property, such as machinery and equipment, and intangible assets such as contracts and patents.
  - It also includes the costs of constructing an asset, such as a building.
  - Costs incurred by a company in raising capital by issuing debt or stock or of reorganizing a company's capital structure are capital expenditures.
  - Also, the costs of entering into a new trade or business or of acquiring the stock or assets of a new trade or business are capital expenditures.
- The most difficult legal issues, though, arise in connection with expenditures for operating or expanding an existing business.
- Courts sometimes ask whether the immediate or long-term benefits dominate. They also weigh the administrative costs of capitalization versus expensing. Courts are also more willing to allow deduction of recurring rather than nonrecurring expenditures.

IRC263(a) – Capital Expenditures: General Rule

- Deduction != $ for new buildings/permanent improvements
  - this paragraph doesn't apply to (meaning these are immediately expensible/deductible)
    - developments of mines
    - R&D under 174
    - list on 240-41

IRC263A – Capitalization and Inclusion in Inventory Costs of Certain Expenses

- Costs for inventory are inventory costs.
- In the case of other property, costs are capitalized.
  - Direct or indirect – so paying construction workers to build it – this is capitalized, not deducted immediately.
- Section applies to
  - tangible personal property produced by TP
  - property acquired for resale (as long as TP doesn't receive more than 10M per year)

Woodward

- F: Majority stockholders wanted to deduct legal fees for appraising the stock of minority shareholders who they were buying out because state law required them to buy out the stock of the people who voted against the action.
  - Purpose of the litigation isn't th issue – look to the origin of the claim. Appraisal is a substitution for negotiation of share price – therefore this should be capitalized.
  - **The real, simple inquiry here is: "whether the origin of the claim litigated is in the process of acquisition itself."**
    - if you paid a brokerage, you would capitalize the fee too – this is part of the investment in buying the stock.
  - its not just the cost of the capital asset that is capitalized, but its also the cost of acquiring that capital asset
- General rule: capitalize benefits that will be realized substantially beyond 1 taxable year.

Note: §263(a) codified the *Idaho Power* ruling, which generally requires capitalization of virtually all indirect costs, in addition to all direct costs allocable to the construction or production of real property.
* So if you hired construction workers to build your building, then you have to capitalize those salaries – not deductible!

INDOPCO (1992)

- F: Unilever has a friendly takeover of Nat'l Starch (INDOPCO). INDOPCO incurred expenses (investment banking and legal fees).
- Issue: whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that corporation as "ordinary and necessary" business expenses under §162(a).
- *Lincoln Savings* should be read to mean that the creation of separate and distinct assets well may be a s**ufficient but not a necessary condition** to classification as a capital expenditure.
- Aside: Unilever had these fees too! Is there deductibility for their fees? They would necessarily have to be capitalized – this is Woodward – Unilever is acquiring securities

- mere presence of some future benefit may not warrant capitalization, taxpayer's realization of a benefit beyond the year is undeniably important in determining whether tax treatment is immediate deduction or capitalization
  - INDOPCO's benefit beyond a year: having Unilever as a parent company.
  - Problem: they probably invested money to get most for their shares/assets, not to better harmonize relations with Unilever. Court doesn't seem to care, however, they're just looking at the end result.
- Generally, expenses incurred for corporate restructuring have not been deemed "ordinary and necessary"
- Old Test: "Separate and distinct interest" defined as "a property interest of ascertainable and measurable value in money's worth that is subject to protection under law and the possession and control of which is intrinsically capable of being sold, transferred or pledged separate and apart from a trade or business.
- New test is the future-benefits test: TP's realization of benefits beyond the year means you have to capitalize it
- Generally, expenses incurred for corporate restructuring have not been deemed "ordinary and necessary"
- The code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes.
  - So if you're benefit is later, then you can't get a deduction now

Staley
- Court allowed deduction of expenses in defending against a hostile takeover.
- Distinguish INDOPCO
  - If you are not friendly, you can deduct. When you become friendly, that means you appreciate the benefits to the company.

Reg 1.263(a)-4 and (a)-5 pull back on INDOPCO
- Still require capitalization for acquisition or creation of separate asset, but there is still a 12 month rule
  - if you have an expenditure that provides a benefit into the next year, but the benefit expires before the end of the following year (you buy in year 1 but benefit expires before the year 3, you're good)
  - de minimis exception – when acquiring intangibles, transactions less than 5k can be expensed.
  - Employee salaries are intangibles that can be expensed.
    - Along with most internal expenses...easier administrability. Obviously people on the inside are going to be working on things that will benefit the company more than a year later.
- Apply back to cases
  - Woodward – costs for litigation – if outside counsel, then capitalize. If in-house, then employee, and can be expeIRC165 - nsed.
  - INDOPCO – i-banking fees capitalized, but not employees fees.
  - Staley – treated the same.
- On the exam – just say "INDOPCO would hold ____, but we know that its been pulled back by revenue rulings."
- Chirelstein – INDOPCO was pulled back almost all the way, to go back to the separate asset test standard...
- The regs require that a taxpayer must capitalize only those transaction costs that "facilitate" the acquisition, creation or enhancement of an intangible that itself must be capitalized.
  - There are 2 significant exceptions, however:
    - (1) the first is a de minimis exception: generally if the transaction costs are less than $5K, none of them must be capitalized.
    - (2) overhead costs
      - one major issue after INDOPCO was whether or not salaries needed to be capitalized.
        - Treasury exempted all employee compensation from capitalization.

- Corporate Reorganizations:
  - The regulations are not as broad with respect to this type of capitalization as INDOPCO would imply.
    - The require capitalization of expenses to "Facilitate" takeovers and reorganizations, but carve out many exceptions.
      - Inherently facilitative costs are always capitalized:
        - So, things like appraisals, tax advice, structuring the transaction, regulatory or shareholder approvals, and the cost of conveying the property.
      - Other costs must be capitalized only if they occur after a bright-line date (the earlier of an agreement between the acquirer and the target, or, board authorization).
      - In no case must in house salaries be capitalized.

- Expenses incurred before the final decision to merge were deductible "investigatory" expenses of an ongoing business but the fees incurred after that date were incurred to "Facilitation consummation" of the merger transaction therefore must be capitalized.

- 7th Circuit drew a distinction between friendly and hostile takeovers:
  - Because the fees were not to facilitate a change in ownership, but to protect the existing structure, the court applied what it described as a longstanding rule that costs incurred to defend a business were deductible.

Repair versus Replacement
- You can deduct repair, but you can't deduct replacements.
- Repairs – its a repair if you're not substantially increasing the life span of the machine. You can't, however, just "repair" ever piece with a new piece.

Ex. You buy out the last 5 years of your bad coach's K. You must capitalize this because your benefit is spread over the five years!

<u>iii. Capital Recovery Provisions</u>

	For Business	**For Investment**	**Personal**
Losses	Deduction (above the line)	Deduction (below the line)	No deduction (except for casualty losses)
Bad Debts	Deduction (above the line)	Capital loss	Capital loss, but only if wholly worthless

a. Losses

<u>IRC165 – Losses</u>
- Deduction = loss not compensated for by insurance
  - basis for determining amount is the adjusted basis (1011) for determining loss from sale/disposition
- for an individual, deduction is <u>limited to</u>
  - T or B
    - fact specific question – look at frequency of transactions
  - transaction entered into for profit, not T or B, and
  - losses of property not for T or B, if arises from fire, storm, etc.
- <u>Wagering loss</u> allowed only <u>to the extent of wagering gains</u>
- <u>Theft loss</u> counts for the year the theft was discovered
- <u>Capital loss</u> (sale or exchange of capital assets) allowed only <u>to the extent of capital gains</u>
- if <u>capital asset becomes worthless</u> then the loss is treated as a loss from the sale or exchange of a capital asset

<u>IRC267 – Losses, Expenses, and Interest w/r/t Transactions between Related TPs</u>
- Deduction != loss from sale/exchange between relatives (defined in (b)) (doesn't apply to gains!)
  - Relationships
    - family
    - trust fiduciaries/beneficiaries
    - people owning more than 50% of companies, partnerships, etc.
- Constructive ownership
  - if you are a relative, then you are held to constructively own the stock
- If loss is previously disallowed to transferor, then the TP/tranferee who eventually sells at a gain, then the gain is recognized only to the extent that it exceeds the loss.

    - BUT you can't go into "negative" gains to claim an ultimate loss!
- Policy – we don't want loss shifting/tax sheltering in the family – there aren't arms length transactions here!

Ex. Brother has basis of 1k. He sells to sister for 800. Sister sells for 1.5k.
- Sister's AR = 1.5k
- Sister's B = 800.
- Is her gain 700? No – she can deduct the loss that brother would have been able to take, but for 267's disallowance of such deduction, so her gain is 700 – the 200 her brother wasn't able to take, which is 500.

Ex. Now suppose sister sells for 500 instead.
- Sister's AR = 500 and her basis is still 800.
- So she has realized a loss of 300. Add loss? NO – 267(d) only applies when there is a gain. So recognized loss and realized loss are the same here.

Ex. She now sells for 900
- Her AR = 900, Basis = 800, so she has gain.
- Can she deduct her brother's 200 now to claim a loss of 100? NO – you can only use the loss to wipe out gains!
- This is just like how we treat IV gifts – we discourage transfers of loss

Note: recognition != realization; there are times where you can realize something but not recognize it!

<u>IRC1091 – Loss from Wash Sales of Stock or Securities</u>
- if substantially identical stock is bought within 30 days before or after the sale of other stock, then <u>no deduction</u> unless the TP is a dealer in securities and the loss happened in the ordinary course of business
- Basis is just the basis as it was with that sold before, adjusted by the difference between purchase price of the new identical stock and the sale price of the old stock
- Policy – we want to stop the artificial creation of tax loss

Ex. T1 = buy 1 ABC @ 200; T2 = sell 1 Share ABC @ $90; T3 = Buy 1 ABC @ 80
- Look at T2 (sale), and go backward and forward 30 days – did he buy substantially identical stock?
- Basis of new T3 bought share is
    - intuititve: take the new basis and add the disallowed loss: 80 + 110 = 190
    - code: original basis (T1) + [price of newly bought one (T3) – price at which sold (T2)]
        - = 200 + [80 – 90]= 190

<u>IRC1211 – Limitation on Capital Losses</u>
- Corporation: losses from sale of stock allowed only to the extent of gains
- Individual: capital losses allowed to the extent of capital gains, PLU up to 3k
- Why is this fair?
    - TP controls when realization occurs, not IRS

Ex. House bought for 100k. Worth 180k. Burns down. Loss is adjusted basis of 100k, not the economic loss of 80k.

<u>Cottage Savings Ass'n</u> (1991)
- F: CSA gives out house mortgages. Basis in bundle of mortgages is 6.9M, but FMV is 4.9M. They want the tax loss, but if they sold the debt, then they'd appear insolvent
    - So CSA traded debt portfolios with another bank so they could both record losses, but keep their ledgers in tact. In fact, they didn't even tell the people who had to pay the debts about this – they just collected the other bank's debts and remitted the money to said other bank
        - the Regulation Committee said they could do this without noting a loss in their books
- Issue: has there been a sale or disposition here?
- Losses are only recognized only when realized, and a realization occurs only when the properties exchanged are "materially different."
- Test for "materially different" for realization purposes for disposition of property is whether the taxpayer got something different in kind or extent in their legal entitlements
    - Test for Regulation Committee might be economic in substance, but for tax purposes, its administrative

convenience:
    - The mortgages traded were for different people and entitlements, therefore they were legally distinct.
    - Arm's length deal between unaffiliated parties
- This case works for realization rules for both gains and losses – hair trigger realization requirement

Fender v. US (1978)

- Trust made large capital gains. To offset gains, trust sold bonds, which had declined in market value [basis: $435k; sale price: $225k], to a Bank at the end of calendar year. At the time of the sale, co-trustee owned 40% of Bank stock. Trust re-purchased the bonds 42 days later. At time of re-purchase, co-trustee owned 50% of Bank stock.
- H: this was not a deductible loss – a loss must arise from a bona fide sale
    - Trust made large capital gains. To offset gains, trust sold bonds, which had declined in market value [basis: $435k; sale price: $225k], to a Bank at the end of calendar year. At the time of the sale, co-trustee owned 40% of Bank stock. Trust re-purchased the bonds 42 days later. At time of re-purchase, co-trustee owned 50% of Bank stock.
- The bank would not have bought the bonds but for the fact that they knew they'd be repurchased – this was a pretend sale
    - no transfer of risk/reward, which is pretty much what capital ownership is
- Note: 267 doesn't apply – 42 days is more than 30
- Note: not "in the family"under 267(b) because only 40% common ownership at time of sale.

b. Bad Debts

IRC166 – Bad Debts
- Deduction = debt that becomes wholly worthless
    - if partial debt is recoverable, then Secretary may allow the rest to be a deduction
- TP not corporations,
    - (a) doesn't apply to non-business debt, and
    - if nonbusiness debt becomes worthless, treat it as a short-term capital loss
- non-business debt
    - debt acquired not in TP's T or B
    - debt whose worthlessness causes a loss in TP's T or B

So unlike losses, we have 2 categories (business/non-business) instead of 3 (T or B, for profit, casualty/theft)
- Not much in the category of investment "bad debts"
    - people don't make loans for investment outside of T or B

US v. Generes (1972)

- Taxpayer owned 45% of stock of corp, for which he'd originally invested $40k. He was also pres. of the corp, for which he received salary of $12k. Taxpayer loaned the corp. $300k, then when corp couldn't repay him, he claimed a business bad debt deduction, claiming he'd made the loans to protect his job and salary, rather than his investment.
- For determining whether nonbusiness or business bad debt, look at the dominant motivating factor (not significant motivation), not whether the business factor is significant.
    - Here, if he loaned money to protect his job, then its for T or B; if he loaned it as a shareholder to keep the company afloat, then non-business
    - No showing that taxpayer's dominant motivation for making the loan was his salary, so he can't deduct as business bad debt.
        - Note: earning a salary is a T or B
        - since he wasn't trying to further getting a salary, this was an investment in the business, which is non-business

c. Depreciation

IRC167 - Depreciation
- Deduction = depreciation for wear and tear of 1) property used in T or B or 2) property for production of income
- Basis is the adjusted basis under 1011
    - you depreciate the basis, not the FMV – so if you got a 2k machine for 1k, then you can only depreciate 1k of the basis.

    - Code just assumes that the cost to you is the initial value of the asset
- For property subject to lease, no portion of adjusted basis is allocated to lesehold interest, and the entire basis is taken into account for depreciation deduction w/r/t toe property subject to the lease
- Ex.
    - depreciable: wasting assets (building, machines, etc.) for T or B or investment
    - non-depreciable: non-wasting asset (land), wasting asset for personal use (artwork)
    - antiques are in a gray area

<u>IRC168 – Accelerated Cost Recovery System</u>

- determine depreciation deduction through
    - depreciation method
        - default: 200% declining balance method
            - switch to straight line method for 1st taxable year where straight line method w/r/t new adjusted basis gives you a bigger allowance
        - use 150% declining balance method for (same as above, but 150% instead of 200%)
            - 15 year or 20 year property not in (3)
            - farming business property
            - TP election under (5)
        - straight line method
            - non-residential real property
            - residential rental property
            - TP election under (5)
            - etc.
    - recovery period, and
        - look at table
    - applicable convention (treat property as being placed in service at middle point in the [applicable time span])
        - default: half-year convention
            - so you'd only deduct 50% of what you'd get for the full year, regardless of when you put it into service
                - therefore incentive to buy at end of year – more deduction than actual depreciation, but if you stock up last quarter, below, you go to mid-quarter
        - real property: mid-month convention
        - if aggregate bases placed in service within last 3 months of the year exceed 40% of the total bases, then mid-quarter convention
- (e)(1) – gives you a list of the classification of property having a given class life
- New traight line method only system for certain property
- Note: salvage value = zero – pro-taxpayer; IRS assumes that your property won't have any use at the "end" of its life

<u>IRC179 – Election to Expense Certain Depreciable Business Assets</u>

- TP can elect to treat 179 property <u>as an expense</u> not chargeable to a capital account – deduction in the year its placed in service
    - up to 250k
    - Reduce the 250k by the amount the cost of the property exceeds 800k
- Policy – want to help out small business who invest in depreciable assets.
- Ex. You spend 500k on asset with 5 year recovery period thats DDB.
    - You can immediately expense the first 250k
    - The other 250k you have to depreciate as normal. Looking at CCH XV, you get 20% (half year method, 5 year period, DDB), so you get another 50% depreciation deduction for a total of 300k your first year.

<u>IRC197 – Amortization of Goodwill and Certain Other Intangibles</u>

- TP allowed straight line amortization deduction by amortizing adjusted basis over a 15 year period
- Amortizable 197 property means a 197 intangible which is
    - T or B or 212 activity
    - but does NOT include intangibles created by TP or those NOT described in (D), (E), or (F) of (d)(1)
        - unless created in the acquisition of a T or B
- 197 intangibles are
    - goodwill, going concern, etc. (p. 206)

IRC1016(a)(2) – Adjustments to Basis

- for depreciation/amortization, basis is reduced by the amount deducted by the applicable method (if no method used, then straight line method is the default)
  - ex. so you have 1k with a 5 year recovery period. Under DDB, your first deduction is 400 (40% of 1k), making your new basis 600. If you turned around and sold it for 900, you would have a gain of 300, not a loss of 100. You are taking the deductions, which means your basis has been recovered to the amount of your deductions.

Reg1.167(b)-1 – Straight Line Method

- Cost/basis – Salvage value (zero) is deductible in equal amounts over the expected life of the property.
- [Adjusted Basis – Salvage Value (zero)] / (Remaining Useful Life) = allowable deduction for the year.

Reg1.167(b) – 2 – Declining Balance Method

- Uniform rate is applied each year to the unrecovered cost/basis

Steps:

- First look up the class-life from a list provided by treasure - 168(i)
- Now go to 168(e) to find the classification of the property (in years)
- now go to 168(c) to find the applicable recover period (in years) – this gives you the straight line method percentage

Ex. under straight-line method, if 1k asset with 5 year recovery method

- [1k – 0]/5 = 200. So you have a 200 deduction each year
- Y0, B = 1k
- Y1, B = 800, D = 200
- Y2, B = 600, D = 200
- Y3, B = 400, D = 200
- Y4, B = 200, D = 200
- Y5, B = 0, D = 200

ex. Double-declining Balance method

- for 200%, if the straight-line percent was 20%, then the rate would be 40% (200% of straight-line rate)

	DDB Depr	End of Year Basis
Year 1	400 (40% x 1000)	600
Year 2	240 (40% x 600)	360
Year 3	144	216
Year 4	86	130
Year 5	52	78

- You are supposed to switch to straight-line when that method would give a higher allowance, so
  - in Y1, straight line would give you 1/5 = 20% < 40%
  - in Y2, 1/4 = 25% < 40%
  - in Y3, 1/3 = 33.33% < 40%
  - in Y4, 1/2 = **50%** > 40%
    - So, in Y4, you switch over to straight line method, which would give you the following table:

	DDB Depr	End of Year Basis
Year 1	400 (40% x 1000)	600
Year 2	240 (40% x 600)	360
Year 3	144	216
Year 4	108	108
Year 5	108	108

- This way, we'll always reach zero.

Lets do 150% method now, where we have 1k over 5 years (20% straight line method rate) – double declining rate is 30%

	150% Depr	End of Year Basis
Year 1	300	700
Year 2	210	490

Year 3	163	327
Year 4	163	163
Year 5	163	0

- Y1: 1/5 = 20 < 30
- Y2: 1/4 = 25% < 30%
- Y3: 1/3 = **33%** > 30% - switch to straight line method, and you deduct 163 the rest of the way

Note: pg. XV has the list of depreciation tables
- The first year accounts for the half-year recovery thing.
- Since 15-20 year stuff is 150%, those years in the table are 150% of the straight line

Jet example: if you own a bunch of jets, but can't offset your depreciation deductions, you should sell the jets to someone with gains, like banks, and then have them lease it to you.
- However, if you're a non-profit, you have to use straight-line method, which isn't as attractive for this kind of shifting. Further you use class life, not the shortened schedule.

Note: new IRC168(k)
- provides a special allowance for certain property acquired in 2008
- allowance is in conjunction with 179

B. Business/Personal Borderline

i. In General

Child Care

IRC21 – Expenses for Household and Dependent Care Services Necessary for Gainful Employment
- Credit = % of employment-related expenses for 1 or more qualifying individuals
  - Phase-out: % = 35%, reduced by 1% (but not below 20%) for each 2k by which TP's AGI exceeds 15k
    - AGI = 15,000, Credit = 35% of expense
    - AGI = 15,001, Credit = 34% of expense
    - AGI = 16,000, Credit = 34% of expense
    - AGI = 17k, Credit = 34%
    - AGI = 17,001, Credit = 33%
    - So at AGI = 43,001, Credit = 20% and the phase-out flat-rates
- Qualifying individual
  - dependent under 13; dependent retards
- Employment-related expenses (you have to spend money which allows you to work, not just have fun)
  - $ of the following so TP can work
    - household services, care-giving
  - includes outside care too, if the qualified individual spends at least 8 hours everyday in TP's house
- Dollar limit - Amount shall not exceed
  - 3k for 1 individual; 6k for 2 or more
- Earned Income limit - Amount shall not exceed (you and your spouse have to actually be earning money with your time to get this credit)
  - un-married individual – that person's earned income
  - married, then lesser of each of their earned income
  - if spouse is a student of retard, then minimum earned income is either 250 or 500

Zero Bracket Amount and Child Care
- ex. Family: 2 parents, 1 kid. Wages = 15k / year. Child care = 1k/year.
  - Std Deduction = 10.7k
  - Personal Exemption = 3.4k * 3 members = 10.2k

  So total deductions they get is 20.9k = **zero bracket amount**
- So this IRC21 child care tax credit DOESN'T MATTER because the child care tax credit is non-refundable!

IRC129 – Dependent Care Assistance Programs

- GI != employer's providing dependent care
  - amount excluded shall not exceed 5k (2.5k for married-separate returns)
- Earned income limit – amount excluded shall not exceed
  - single TP – earned income for that year
  - married TP – lesser of one of couple's earned income
  - if student spouse, look to 21(d)(1) for earned income minimum of 250 or 500
- Congress is pretty confident that employer-provided child-care is work-related (helps TP produce income)

129 and 21

- You can have deduction under 129 AND credit under 21
  - but note that under IRC21(c) – the flush language after 2, the maximum amount creditable under 21 is reduced by the amount excludable under 129
- Steps
  - Start with 129 – see what is excluded
    - max is 5k
  - Then, whatever is excluded under 129 you reduce from the 3k or 6k allowed as credit under 21
    - 21(c) says that the amount of employment related expenses that can be creditable should be reduced by the amount of excluded income in 129
      - So if you have 2 kids or more, then the 129 deduction can never take your 21 credit down to zero
  - Once you figure out what is left over, then you figure out what percentage to multiply it by
- So would you ever ask the employer not to pay for child care?
  - He thinks probably not, as long as your MTR is greater than 20% (the phase-out). If you were under 20%, then you'd probably rather take the 3k/6k credit (saves you more money)

Pevsner (1980)

- F: She had to buy clothes to work in a high-end boutique, and there was no debate about whether these close didn't fit her out of work lifestyle.
- H: Use objective test, not subjective test – administrative ease and better horizontal equity.
- Bright line test: can you wear these clothes outside of work?
  - No reference is made to the individual TP's lifestyle or personal taste – instead, adaptability for personal or general use depends upon what is generally accepted for ordinary street wear.
- Who CAN deduct clothing?
  - Rodeo clown, work uniforms (burger king, UPS, etc.)
- You could argue that this is a working condition fringe under 132(a)(3)
- Note: courts are generally suspicious of employee's trying to deduct expenses that the employer won't reimburse.
- Notes after case
  - inherently personal standard – some deductions are disallowed as being inherently personal in nature
    - religious advice, etc.

Note: 35% credit versus 100% Deduction

- The 100% deduction saves you only the MTR of that deduction, whereas the 35% credit saves you 35% of what you paid.
  - So 100% deduction of 1k at MTR = MTR * 1k
  - 35% credit of 1k = 350.
  - So if MTR is less than 35%, you're better off with the credit.
- *Tax credit ignores the TP's tax bracket*

	35% credit	Deduction, if you're in 35% tax bracket	Deduction, if in 15% tax bracket
TI	No change in taxable income	Goes down by $1000	Goes down by $1000
Tax	Goes down $350	Goes down by $350	Goes down by $150

ii. Travel and Moving Expenses

IRC82 – Reimbursement for Expenses of Moving
- GI = reimbursement of moving for work

IRC132 – Certain Fringe Benefits: Qualified Moving Expenses Reimbursement
- GI != qualified moving expenses reimbursement = $ from employer for expenses which would be deductible as moving expenses under 217 if directly paid by individual. (Does not include expenses TP has already deducted!)

IRC162(a)(2) – Trade or Business Expenses: Traveling Expenses
- Deduction = O & N expenses in carrying on T or B, including traveling expenses (including meals and lodging) while away from home in pursuit of T or B
  - away from home – this is temporal, not spatial.
    - Home = tax home, not normal home
      - this is why commuting costs aren't deductible – home != tax home
    - for the purposes of meals only, the away from home requirement has a sleep over night requirement – Correll
- Easy policy for lodging – its clearly duplicative. Harder to substantiate the meals one, but you can say you have limited options in a foreign city
- Commuting costs
  - from home to work. And back generally NOT deductible – Reg 1.162-2(e)
- Note: if you're "away from home" more than a year, you're probably considered to have moved.
  - Based on expectation – if you expect to be gone for more than a year, then can't deduct. If you don't expect, then you can deduct, until you realize you're gonna have been there more than a year.

IRC217 – Moving Expenses
- Deduction = moving expenses for starting work in a new place of work
- Moving expenses =
  - moving household goods and personal effects from old to new place
  - traveling from old place to new place
  - does NOT include meals along the way
  - Include stuff for other people in the house if they are a part of TP's household and are moving from the same old place to same new place
- NO deduction unless
  - New work is
    - > 50 mi. further from old residence than old work was
    - if no old work, then > 50 mi. from old place
      - so it can be your first job!
  - and, either
    - during 12 months after move, full-time employee at least 39 weeks
    - in 24 month period full-time employee or performs services as a self-employed individual on a full-time basis for 78 weeks, where not less than 39 weeks are during 12 month period in 9a)

Moving expenses revisited
- there is a time test
- there is also a distance test
  - take your old residence
  - compare old residence to old principal place of work - A
  - compare that to the distance between your old residence and the new place of work - B
  - so if B is bigger than or equal to A plus 50 miles, then you get a deduction

Ex. A works in Boston. Takes a job in Dallas which requires 6 month training in SF.

- Boston to SF
  - Doesn't mean length of work requirement for time in SF
    - this is a temporary living expense
    - Where is the tax home?
      - Boston? No job there anymore...
      - SF? this is temporary
- Boston to Dallas
  - Can say that he was never a resident of SF under 217(b)
  - He won't have spent enough time in Dallas because he has to spend 6 months in SF, but you could argue that Boston was his previous residence and Dallas was his new one, and just have his stuff sent from Boston to Dallas
- SF to Dallas
  - no problem – thats easy
- How about the distance test?
  - SF was just training – you can argue that it shouldn't be an old principal place of business to kill the 50 mi test
  - So if Boston is former residence and SF is former PPB, then Boston to Dallas has to be 50 miles further than Boston to SF

<u>McCabe</u> (1982)
- Cop had to drive around NJ because he couldn't get a gun permit there. He claimed the additional expenses because of the tool he needed for the job
  - Cop wants to deduct difference in cost between going through NJ and going around, which he has to do because his work requires him to carry a gun
- Revenue Ruling 75-380 - in order to deduct additional expenses in commuting, taxpayer must establish the necessity for transporting work tools to and from work
  - PROBLEM: only get a deduction for the portion of the cost of the work elements by the mode of transportation used which is in excess of a different mode of transportation without the work element
  - I.e. you only get to deduct the cost of the weapon if it costs you more driving around NJ with the weapon, as driving around NJ w/o the weapon
- Court: where you live is your business. Its not his job's fault that he lives so damn far away.
- Arguments
  - Commissioner - <u>Flowers</u>
    - commuting isn't deductible
  - TP - <u>Fausner</u>
    - SC case – overrules revenue rulings - disallowed commuting cost when air pilot claimed deduction for car for taking his bags – because he would have driven the same route, he gets no deduction
- Dissent – but for the gun requirement, required by his work, he wouldn't have had to drive around NJ!

<u>Deductible Travel Expenses versus Non-Deductible Commuting Expenses</u>
- Away from home
  - Doctor has office in Med Plaza. Driving between home and Med Plaza is not deductible.
  - Driving from Med Plaza to hospital IS deductible.
  - If you drive to a place, for business, thats not your "<u>home office</u>," then you can deduct.
    - You can choose where you live based on where you work, but you can't really help that your work makes you drive to other places
  - Problem: Joe construction worker evenly bounces between construction sites – he has a <u>temporary work office, not a home office</u>
    - neither leg is deductible – how would you choose. Administratively, we either deduct both or none: Congress chose none.
      - But if he generally works in a metropolitan area, then strays away from it for work, then deductible.

<u>Hantzis</u>
- Wife going to law school in Boston and is working in NY for the summer. She wants a deduction for her summer costs in NY. She couldn't get a job in Boston, so she went to NY, but her husband is still in boston
- for living expenses to count as a business expense, you have to have business ties at both places for the temporary living thing to kick in.
  - The question is whether or not she has a <u>business</u> reason for maintaining a home in Boston. If she didn't then NY is

her home for tax purposes.
    - Husband is not a business reason
  - Doesn't matter that she was going back to boston for school - It just comes down to the fact that the IRS and the courts haven't been willing to treat education as "business." It's been treated as "pre-business"
- Courts are looking to allow deductions for duplication that is caused by business.
- Moral: <u>you must have a business reason for maintaining the home and a business reason for being wherever you are.</u>
-

<u>iii. Entertainment</u>

<u>IRC274 – Disallowance of Certain Entertainment, Etc., Expenses</u>
- **NOTE: this is a DISALLOWANCE provision. Never say that 274 allows a deduction; it DISALLOWS deductions allowed in 162.**
- Entertainment
  - Deduction !=
    - activity (entertainment, amusement, recreation) unless directly related to or directly preceding or following bona fide business discussion in the active conduct of TP's T or B
      - this is filled with holes, thats why we have the 50% rule
    - Facility used for activity
      - harsh rule – no deduction for, say, ski lodging
    - dues/fees for social, athletic, or sporting club
      - Congress is skeptical about what goes on at a country club
  - Business lunch is entertainment
    - this is a pretty toothless rule – of course you're gonna talk business at some point!
- Substantiation
  - NO deduction under 162, 212, part (a), or business gifts UNLESS TP provides adequate records
- Conventions
  - Deduction != convention outside of US unless directly related to T or B, considering 1) purpose of meeting, the organization, residences of the members, other factors TP brings up.
  - If a cruise, then ship deduction only if ship is registered in US and all ports of call are in the US
  - Reporting requirement in (h)(4)
  - Point: <u>attendance at conventions held out side North America isn't deductible unless directly related to trade or business and, taking into account the purpose of the meetings, the activities of the sponsoring organizations, its reasonable for outside NA as to have inside NA</u>
  - Note qualified NA nations: Virgin Islands, no dice; Caribbean islands ok if they comply with banking secrecy laws
- business meals
  - No deduction UNLESS
    - not lavish
    - TP is present
  - (1) doesn't apply to ...
- Entertainment tickets – skyboxes
  - if leased for more than 1 event, deduction =< face value of non-luxury box tickets covered by lease.
- Additional limitations on travel expenses
  - Deduction != water transport if expenses exceed 2 x aggregate per diem amounts for those days
  - deduction != expenses for travel as a form of education
  - deduction != expenses for family member UNLESS
    - family member is employee
    - that travel is for bona fide business purpose
    - would otherwise be deductible by family member
- **50% limit**
  - Deductible amount for food or entertainment activities shall not exceed 50% of the amount
  - exceptions

Ex. Employee goes to Chicago: 300 for hotel and 100 for meals. Employee is reimbursed in full.
- Employee
  - since reimbursed, not taxed on anything! (if sole proprietor, then he'd only get 50% of meals)

- Employer
  - 300 for hotel, fine, but only 50 for the meals because of 274(n)!

Note: 274 doesn't affect non-profits who are tax-exempt anyways, so it does nothing to discourage lavish spending.

Ex. A Las Vegas casino provides completely free meals to casino workers on the business premises and for the convenience of the employer. The employees have only 1/2 hour to eat and may not leave the building. Is the portion of the meal cost that is deductible for the casino 0, 50%, or 100%? Consider Code secs. 119, 132, 162, 274 and Reg. sec. 1.274-2(b)(1)(i).

- 162 – O&N? Yes
- 274 – excluded?
  - (a)(1)(B) – is the cafeteria a facility?
  - Entertainment?
    - No – food with clients is entertainment, not for employees.
  - 274(n) – 50% limitation?
    - No limitation if excludable under 132!
- 132(e)(2) – eating facility de minimis fringe
  - on or near business premises
  - revenue normally equals or exceeds direct operating costs (no free meals) – but there are free meals here!
  - BUT - employee entitled under 119 to exclude value of a meal provided at a facility shall be treated as having been paid to an amount equal to the operating cost
- 119
  - So, then we look to 119 to see if these employees would be able to exclude the costs of these meals if they had paid – and they would because the meals are eaten on the business premises, and are for the convenience of the employer.

<u>Moss</u> (1983)

- Eating every day at noon for lunch business meeting with your firm is not tax deductible
- just because it was the best time to meet, and was better for business, doesn't mean its deductible
  - ex. commuting and talking about work – can't deduct gas money
- in a law firm, an occassional luncheon meeting with staff might be an ordinary and necessary expense – thats about it though.
- <u>Sutter</u> formula
  - if a personal living expense is to qualify under section 162, the taxpayer must demonstrate that it was different from or in excess of that which would have been made for the taxpayer's personal purposes
- Problem here is the every day nature of it all

<u>iv. Gambling & Hobby Losses</u>

<u>IRC165(d) – Losses: Wagering Losses</u>

- gambling losses are deductible from gambling gains only.

<u>Groetzinger</u>

- If you are a professional gambler, then it is your trade or business – you get trade or business deductions etc.
  - only if you are involved in the activity with continuity and regularity and with the primary purpose of earning income or profit.

<u>IRC183 – Activities Not Engaged in for Profit</u>

- NO deduction if not engaged in for profit (hobby)
- Can't double count - (b)
  - (b)(1) – if you would have been able to deduct before, you can deduct it.
  - (b)(2) - whatever expenses are left after (b)(1) is subtracted you can deduct to the extent you have gains too.
  - Point: you can't deduct hobby losses past the extent of your hobby gains.
- If GI exceeds deductions for 3 / 5 years, then its engaged in for profit, unless Secretary says otherwise

<u>Plunkett</u> (1984)

- its about whether had the objective of making a profit, not whether he reasonably believed he would be making a profit.
- Subjective test – factors include
  - (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.
  - Note: Compare to other mixed motive things where we have bright-line rules (buying clothes for work, commuting, etc.)
    - he thinks this subjective test is bad – too hard to tell what would be covered.
- Court used the reasonableness to make a profit as an objective standard to see whether he could have subjectively had the objective of making a profit

Ex.

Ranch P/L	2005	2006	2007
Sales Income	100	300	600
Expenses			
Feed	200	200	200
Real estate tax	150	150	150
Total	350	350	350
Net Gain/Loss	(250)	(50)	250
Total Deduction	150 RE	300 (150 RE, 150 feed)	350 (150 RE, 200 feed)

- If there is an objective for profit, then 183 doesn't apply and he deducts the full 350 each year.
  - This is an above the line deduction at line 18
- If there is NOT an objective for profit, then 183 DOES apply
  - So he still claims the 100, 300, and 600 income.
  - (b)(1) – he deducts what he would have been able to deduct, the real estate: 150 each year
  - (b)(2) – he can deduct the rest of the 200 per year to the extent that there is sales income left over after the (b)(1) deduction.
  - In this case, the GI still shows up on line 18, but, if 183 applies
    - real estate taxes show up on line 6
    - the rest are miscellaneous itemized deductions, subject to the 2% whatever.

Moral: pet food: we don't want your pet food expense to be sheltering other income, so we only allow deduction for pet food to the extent that you make money on your pet operation.

<u>v. Education</u>

Deductible Education Expenses for T or B under 162
- Deductible if
  - the expense maintains skills required in employment or trade or business or
    - switching duties, but keeping the same type of work is the same T or B
      - ex. teacher goes from elementary to secondary or switching subjects
  - meets requirements to maintain employment
- Unless
  - meets minimum requirements to qualify for employment, or
  - qualifies for new trade or business

<u>Wassenaar</u> (1979)
- D tried to deduct expenses for his LLM. He went to school, worked at firms over the summer, and got paid on law review.
- you need to be established in your trade or business before you can use the "improving skills through education" deduction of 162(a)
- Moreover, you can't deduct educational expenses for entering into a new trade or business

IRC25A – Hope and Lifetime Learning Credits

- Tax credit for Hope plus Lifetime Learning
  - only one credit per student, but a TP supporting multiple students adds them together.
- Hope (per student credit)
  - Credit
    - 100% of tuition < 1.1k
    - 50% for in between 1.1k and 2.2k
  - Limits
    - allowed for 2 years only per student
    - student must be at least ½ time for at least one semester
    - only allowed for first 2 years of post-secondary education
    - not for students convicted of felony
  - eligible student
    - ½ of full-time work load
- Lifetime Learning (per TP credit)
  - Credit
    - 20% of tuition under 10k
  - Expenses
    - does not include tuition considered for Hope – you have to elect only one
    - only those which are used to acquire or improve job skills
- Phase-out modified AGI (applicable to aggregate of Hope and LLC)
  - The amount of Hope + Lifetime Learning Credit is reduced by x
  - x / (Hope + Lifetime) = (TP's modified AGI – 47k (or 94k)) / 10k (or 20k)
    - so x = (amount of credit you would have had) * (MAGI – 94k) / 20k
  - modified AGI = AGI increased by any amount excluded under 911, 931, or 933

Ex. W works full time. Tuition is 8k. Modified AGI is 104k.

- Options
  - Hope
    - 100% of first 1.1k and 50% of next 1.1k
    - so you can get a total of 1.1k + 550 = 1.65k
  - LLC
    - 20% of up to 10k = 20% of 8k = 1.6k
- Can't take both – 25A(c)(2)(a). So for each student you have t choose between Hope or LLC
- Phase-out
  - Example
    - (d)(1) – reduce 1.65k by amount under (2)
    - (d)(2)
      - (a) – excess of AGI over 94k = 104k – 94k = 10k
    - So ratio is 10k / 20k = x / 1.65k; so you are left with $825 credit
  - Generally
    - Phase-out begins at 94k and ends at 114k

IRC222 – Qualified Tuition and Related Expenses

- deduction = qualified tuition and related expenses
- Limitation
  - AGI < 65k, 4k
  - 65k < AGI < 80k, 2k,
  - else 0.
- Cliff effect
  - if you're at 65k, you could get 4k in deductions.
  - If you earn one more dollar, you lose 2k in deduction!
- No deduction allowed if they elect to have 25A apply.
- This is an above the line deduction!

vi. Interest

IRC163 - Interest

- Default: Deduction = interest paid or accrued on indebtedness (but this has been narrowed so far that it might as well not be a default anymore)
  - Limitation
    - amount shall not exceed the net investment income
    - Carry forward – amount not allowed in (1) is carried forward to the next year (carries indefinitely)
  - Investment interest = interest allowable as deduction paid on indebtedness properly allocable to property held for investment
    - != there are some things it isn't
  - Net investment income
    - excess of investment income over investment expenses
  - investment income (POINT: you don't get interest deduction if you get the capital gain rate – you either elect for the deduction and treat it as ordinary income or don't take the deduction and get the capital gain rate)
    - GI from property held for investment (not just the one bought with the loan), plus
    - excess of
      - gain attributable to disposition of property held for investment, minus
      - net capital gain = account gains and losses from property held for investment,
    - plus net capital gain
    - you can deduct the interest against that capital gain, but here's the deal: if you do that then you have to give up the preferential tax gain at 15% and treat it as an ordinary gain at your regular marginal rate. - 163(d)(4)(B)
    - Same deal with dividend income – flush language of 163(d)(4)
  - this is an election – you could wait and take the capital gain rate on this income, but he doesn't think it'd usually make sense unless you expect other investment income in the future that isn't a capital gain
  - investment expenses
    - deductions allowed which are directly connected with the production of investment income
  - Property held for investment
    - property which produces income, and
    - activity involving conduct of a T or B
      - not passive activity, and
      - TP does not materially participate
- Disallowance of deduction for personal interest
  - deduction != personal interest paid or accrued
  - Personal interest = interest allowable other than
    - T or B (other than the trade or business of performing services as an employee)
    - investment interest
    - qualified residence interest
  - Qualified residence interest
    - mortgage interest
      - amount borrowed can't be more than 1M
    - home equity loan interest
      - amount of indebtedness does not exceed FMV of residence less amount of acquisition indebtedness
      - aggregate amount of debt shall not exceed 100k

IRC221 – Interest on Education Loans

- Deduction = interest on qualified education loan
- Maximum deduction = 2.5k
- Limitation based on Modified AGI
  - amount allowable (up to 2.5k) is reduced by X
  - X / (allowable) = (TP's modified AGI – 55k (or 110k for joint)) / 15k (or 30k for joint)
  - so amount allowed = allowable (1 – (MAGI – 55k (or 110k))/ 15k (or 30k))
- Only for dependents (not allowed for someone who's PE is used by another TP)

IRC263A – Capitalization and Inclusion in Inventory Costs of Certain Expenses

- You must capitalize interest costs which are (so deduct the interest over the life of the building)
  - paid during production period, and
  - allocable to property which has
    - long, useful life
    - production period over 2 years, or
    - production period over a year and cost over 1M

IRC265 – Expenses and Interest Relating to Tax-Exempt Income

- No deduction for interest on loans used to buy tax-exempt obligations

My Notes:

- interest deduction – sometimes you are allowed to deduct interest paid on a debt when that debt is used to buy assets
  - if debt is used to buy
    - **business interest**: interest on debt is deductible
    - **investment interest**: depends, but generally deductible only to the extent that it is deducted from net investment income (income you get from the investment, less expenses) – this carries forward indefinitely to later years
    - **investment to earn tax-exempt income** – interest on debt used to buy things that whose purchase is already tax-exempt! This is controversial and congress has limited it
    - **personal interest** – interest on debt used to buy things for personal, nonbusiness things is generally NOT deductible.
    - **Home mortgage interest** – deductible – we want people to buy houses.
      - Acquisition indebtedness – deductible to an extent when buying a home (and the debt is secured by the home)
      - home equity indebtedness – deductible to an extent regardless of purpose, as long as the debt doesn't exceed the fair market value of the home and the debt is secured by the home
        - so you can take out a loan on your home, get deductions for your interest on the debt, and invest that money on things that give you consumer interest
        - problem: if you're overextended, not only does your credit go to shit, but you lose your home.
    - **Education loan interest** – certain taxpayers can make an ATL deduction of up to 2500 of educational loan interest

Business Interest

- Generally deductible if loan used for O & N business expense (employee salary, big truck for business, etc.)
- If for building building, then you capitalize the investment (and the interest paid on investment)

Investment Interest

- Loan used to buy stock – you get deduction limited to investment income; carries forward INDEFINITELY
  - investment income is for all your investment, not just the one you bought with the loan
- No deduction on interest from loans used to buy muni bonds under 265

Personal Interest

- Credit card interest – no deduction under 163(h)(1)
- Home loans– HUGE exception under 163(h)(2)
  - home equity indebtedness
    - loan you take out based on equity on your home – limit is up to 100k of debt
  - acquisition indebtedness
    - you can deduct interest on debt which is up to 1M to purchase a home
    - the 1M is in aggregate – if you have more than 1 home, your debt can't be more than 1M for them all (limit is 2 homes)
    - if its more than 1M, then you just pro rate the interest
  - House must be used to secure the loan
    - if home is used as security, then it doesn't matter what the purpose is!

Education loan interest

- exactly same phase-out as in 25A
- Much better phase-out than the step phase out of 222

- Phase out between 55k to 70k
  - before 55k, max flat deduction of 2.5k

Interest Type	Example	Interest Deductible?
Business	Pay employees	Yes
	Purchase vehicle	Yes
	Finance Bldg constr.	Capitalize
Investment	Buy Microsoft stock	Yes* linked to investment income
	Buy TE municipal bonds	No - 265
	Investy in passive activity	Maybe
Personal	General credit card interest	No 163(h)(1)
	Home mortgage	Yes w/ limitation
	Home equity credit used to buy car	Yes 163(h)(3) w/ limitation
	Interest on Student Loans	
Education loan	221 – phase out works just like §25A	Yes- \$2500 max deduction up to modified AGI of \$50K, then phase out to 0 when modified AGI reaches \$65K.

<u>Tax Arbitrage</u>

- Congress generally disallows deductions for interest on loans used to buy tax-exempt or tax-preferred assets (muni bonds)
- Suppose you have a 40% marginal tax rate TPer. Suppose they can borrow \$100 @ 10% interest. And they use that money to buy a municipal bond which pays 7% interest after tax.
  - Pre-tax
    - You pay 10% to get 7% - you're a loser
  - Would you borrow at 10% to buy that bond?
    - Without the deduction, you would definitely not do it, because you'd be losing \$3.
  - But, if the interest on the loan is deductable,
    - You would deduct \$10, which saves you \$4 after tax.
    - So after tax, the bond will only cost you \$6, but will return \$7!
    - Then, with the deduction, you have a \$10 pre tax on the loan, you would pay \$4 which means after tax your interest expense on the loan is \$6. So if the interest is deductible you switch from a \$3 loss to a \$1 gain.
- Ideally, the market would handle this and the interest rates on muni bonds would drop, but Congress doesn't agree - So we have IRC265
  - Congress doesn't want high income folks to borrow money and avoid tax.

<u>Knetsch</u> (1960)

- Investment
  - 10 30 year maturity annuity bonds (won't be paid out for 30 years) at 400k each – so 4M investment at a 2.5% rate
    - he isn't taxed on this 2.5% until he gets the money 30 years down the road (when he is 90)
- Loan
  - They loan him 4M at 3.5% to buy the bonds. He owes yearly interest of 140k.. To pay for this interest, he borrows against the bonds!
    - The bonds are accruing at 2.5%. He won't receive the interest til 30 years, but he can borrow from that interest.
- So work through it – MTR or 40%
  - Pre-tax
    - He pays 140k in interest and gets 100k from the annuity build-up loan
    - It looks like he is out 40k
  - Tax
    - no tax on 100k loan
    - He tries to deduct 140k interest he pays, which would reduce his tax by 56k
  - So after tax
    - He has 100k from loan
    - His interest expenses save him 56k, so he pays 140k – 56k = 84k

        - So he has 100k less 84k – he is up 16k!
- 265 doesn't apply – this is just tax deferred, not tax exempt
- Court denied deduction because this was a sham debt – it wasn't really a debt!
    - 2 prongs
        - there were no commercial economic substance of the transactions. No indebtedness was created by the transactions
        - no economic gain could be realized from the purchase of these bonds without consideration of the tax consequences
    - the 4M is meaningless – it could be 4MM; since he owes them 4M and he is borrowing from the payback of 4M, then it'll all even out in the end
        - no money is leaving the building – this is shammy
- Goldstein
    - F: she wins 140k in sweepstakes. She realizes high tax consequences, so she borrows 1M from bank at 4% rate for 2 years.
        - She secures the 1M by investing it in treasuries
        - these treasury bonds give her 3% interest.
    - Why would she do this? She prepays 2 years of interest in 1950, so she prepays $80K of interest in 1958. The interest on the treasury bonds will be paid $30K in 1950 and $30K in 1960.
    - Do the math
        - Suppose she did nothing
            - in 1958, she would have had TI of 140k.
        - With the deal, however, she has
            - 1958 – she had 140k income and 80k of interest payment – so her income is only 60k
            - 1959 – she had 30k,
            - 1960 – she got 30k again
        - So instead of paying tax on 140k at first, she pays tax on 60k, then 30k and 30k – she saves 20k
    - Suppose tax schedule is standard deduction up to 20k and 50% above.
        - If she had done nothing, she'd pay (140k – 20k) * 50% = 60k in tax.
        - If what she did worked
            - 1958: TI = 140k – 80k = 60k; therefore [60k – 20k (SD)] * 50% = 20k
            - 1959: TI = 30k; therefore [30k – 20k (SD)] * 50% = 5k
            - Same for 1960, 5k
        - So instead of paying 60k in tax in year 1, she pays 30k total.
- So Goldstein versus Knetsch
    - Goldstein had a real loan – it was even secured; Knetsch, the court said, never really had a loan
    - So as an alternative, the court looks at "economic substance" Is there any potential for pre-tax profit?
        - If no pre-tax profit, then likely they are doing it for tax benefit.
        - Was there any reason at all, aside from the tax benefit for Tilly to have undertaken this obligation?
    - Note: A smart lawyer would invest in corporate bonds, so at least there is a chance for pre-tax profit...

C. Personal Deductions

<u>i. Taxes</u>

<u>IRC164 - Taxes</u>

- deduction = the following state, local, and foreign taxes
    - real property
    - personal property (not foreign)
    - income, war profits, excess profits taxes
    - GST
    - environmental tax
    - 212 taxes for carrying or T or B
- Election: you can deduct sate and local sales taxes instead of state and local income taxes!
    - Specific items are listed in (H)
- Policy
    - income tax

    - In favor of deduction – money paid for state/local taxes is not in your consumption power
    - Against – you consume local services paid for by state/local taxes (fire, police, sewer, etc)
    - So Congress is subsidizing state and local government
  - property tax
    - Congress wants to encourage home ownership
- Note: These are all itemized deductions
  - How do you tell what is itemized and what is above the line? - IRC62
    - This section lists a number of deductions you take at arriving at AGI, which is "the line." So any deduction taken in §62 is above the line, if it's not listed in §62, it's itemized/below the line.

ii. Casualty Losses

IRC165 - Losses
- Deduction = loss not compensated by insurance.
- Basis = 1011 adjusted basis
- Deduction limited to
  - losses of property not connected with T or B or entered into for profit IF such losses arise from fire, storm, shipreck, or other casualty, or from theft
- Any casualty loss is allowed to the extent that the amount from each casualty or each theft exceeds $100
- If the personal casualty losses exceed personal casualty gains, such losses are allowed to the extent of
  - personal casualty gains + so much of such excess as exceeds 10% of AGI
- Policy:
  - Why only casualty? Any other "loss" is considered a usage loss
- "It is appropriate to allow the deduction only of those losses which may be considered extraordinary, nonrecurring losses, and which go beyond the average or usual losses incurred by most taxpayers in day-to-day living."
  - So we're concerned with **sudden, physical damage**
    - kind of arbitrary – fast moving insect swarm might get you a deduction, but not a slow moving one!
    - Must be sudden and unforeseen
- High bracket TP's are "insured" by the government more than low bracket ones
  - you save the MTR * Deduction!
- What can you deduct?
  - You deduct your BASIS, not the FMV – you don't get to deduct the un-capitalized gain!
  - see Reg. 165-7(b)
    - **Amount deductible in the case of any casualty loss shall be the lesser of either (1) the reduction in FMV as a result of the casualty (FMV before – FMV after) OR (2) the adjusted basis.**
    - **You cannot deduct any portion covered by insurance. So if a portion of the loss is covered by insurance, you can only deduct the rest.**
    - **This would be different if the property were used in pursuit of wealth, for business, etc.**
- **Limitations** – if you have established a casualty loss, (50.1k loss)
  - First reduce the amount by insurance recovered
    - here, lets say zero
  - (h)(1) – Knock off the first 100 of casualty loss
    - administrative convenience
    - here, becomes 50k
  - (h)(2) - So, after you knock off the first $100, and aggregate your casualty, we have to factor in this 10% of AGI floor.
    - **Only providing benefit for huge losses, which are compared to your AGI. (Assuming you're itemizing, and not taking the standard deduction)**

AGI	10% of AGI	Deductible Loss	Marginal Tax Rate	Tax Savings from Loss*
50,000	5,000	45,000	15%	$6,750
100,000	10,000	40,000	25%	$10,000
400,000	40,000	10,000	35%	$3,500

- Note: reduce your casualty loss by any casualty gain (overcompensated by insurance)
- If non-business asset, then treat the difference between FMV and basis as "consumption" - no loss for that.
- If business asset, then your basis is reduced over time for depreciation. So, if the FMV winds up being less than your basis then you've suffered an economic loss in excess over depreciation.

iii. Charitable Contributions

IRC170 – Charitable Contributions

- Deduction = Charitable contribution
  - **Limitation based on Income**
    - Deduction to church, school, hospital, political organization, and other charities is allowed as does not exceed 50% of TP's contribution base
    - If a corporation, then shall not exceed 10% of TP's TI
- Charitable contribution
  - contribution or gift for
    - the use of a State
    - charitable corporation, trust, or community chest, fund, or foundation
    - religious, educational, etc.
  - Charitable contribution includes gifts to:
    - A state, possession of the united states or a political subdivision of any of the above
    - A corporation, trust, or community chest, fund or foundation…organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes
    - A post or organization of war veterans
    - Fraternal societies, orders, lodges, but only to the extent that such fits rae used for religions, charitable, educational, etc
- **Gifts of appreciated property**: Amount of contribution shall be reduced by the SUM of
  - non LTCG gain if property had been sold at FMV today (so STCG), PLUS
  - if charitable contribution
      - of tangible property
        - if use is unrelated to the charity's purpose, or
        - which is applicable property
      - to or for use of private foundation
      - of any intellectual property
      - of taxidermy
    - gain which would have been long-term capital gain if property had been sold at FMV
- Substantiation requirement
  - No deduction of 250 or more without substantiation
- You deduct FMV of whatever you transfer
- Note: itemized deduction, so its either this or the standardized deduction.

IRC501 – Exemption from Tax on Corporations, Certain Trusts, Etc.

- Lists requirements to be tax-exempt

Hernandez

- The taxpayer has made payments to the church of scientology and has received services from the church in return.
- If there is a quid pro quo – you "donate" to charity in return for something, then not deductible.
  - There is an inherent reciprocity in the church's program. The church established fixed price schedules for auditing and training sessions in each branch church; it calibrated particular prices to auditing or training sessions of particular lengths and levels of sophistication; it returned a refund if auditing and training services went unperformed; it distributed account cards on which persons who had paid money to the Church could monitor what prepaid services they had not yet claimed; and it categorically barred provision of auditing or training sessions for free.
  - If this were considered charitable, then numerous forms of payments to eligible donees plausibly could be categorized as providing a religious benefit or as securing access to a religious service.
- Dissent
  - This is just like donating to other religions, where it pays for the cost of pews, breakfasts, etc.
- Hernandez is a difficult application of the rule that a charitable contribution is limited to the excess of the amount transferred to the charity over the value of any benefit received by the donor
- courts now think that charitable deductions must meet the Duberstein test – detached and disinterested
  - Here, doesn't look like detached and disinterested generosity

- In the end, IRS caved in on this issue, despite the outcome of this case: 170(f)(8)
  - States that in providing a receipt a donor should note if only "intangible religious benefits" were received. These are defined as a benefit "provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context."

<u>Gifts of Appreciated Property - 170(e)</u>
- The first question under 170(e) is reduction by the amount of gain that would have been long term capital gain if the property had been sold at FMV.
  - Basically, have you held the property for more than a year. If you did, it would have been long term capital gain when you sold it. If not, it would have been short term capital gain.
- Real Property – B = 10k for land; FMV = 100k, and you donate to BU
  - Don't worry about 170(e)(1)(A) or (B) because this isn't any of those things – so you get the full deduction of the FMV.
    - So its the same as if donor died and bequeathed it
    - Like double-dip – the gain is never income, yet you can deduct it (unlike Haverly)
  - So either give away 100k of property, or sell it, pay tax on 90k, and give the rest away.
  - Better to donate because you reduce from TI the tax you would have paid on the 90k and the donee gets 100k value instead of whats left after paying tax on the 90k
- Suppose its IBM stock
  - this is LTCG so (e)(1)(A) doesn't apply
  - this is not tangible personal property under (B)
- Suppose its an old textbook
  - So now we're in tangible property land under (B)
    - if its related to the purpose or function of the charity, then you can deduct the whole thing.
    - If its unrelated, then you can only deduct your basis.
      - How do we get there?
        - We start with FMV minus any short-term capital gain or ordinary income - (e)(1)(A).
        - We also then reduce the amount that would have been long term capital gain if you give to a private foundation or a public charity for which the item does not serve the purpose of the charity - (e0(1)(B)
- Note: if its a depreciated asset, sell first, then donate the money because you wouldn't get a deduction of the loss if you just donate it – you just get a deduction of the FMV.
- Services
  - not allowed to deduct value of your time, but other expenses, yes. It'd be like giving you a deduction for imputed income – this is the <u>Haverly</u> double-dip

RECAP of 170(e):
- The general rule is that your deduction is FMV, but it's reduced by the amount that would have been short term capital gain (held less than a year). Basically, it's reduced to your basis. It also might be reduced by the amount of long term capital gain in certain situations.

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IV. Computation of the Tax

A. Tax Rates

<u>IRC1 – Tax Imposed</u>
- Marrieds filed joint and surviving spouses
- Heads of households
- unmarrieds
- Marrieds filing separate
- Estates and Trusts
- Phase-out of marriage penalty
- This is a **progressive** system
  - at each margin, you're taxed at that rate. So if you add 100 more income, you'll never have to go back and recalculate the tax for the previous ones, but rather you just see what margin you're in.

B. Adjusted Gross Income and Taxable Income

IRC62(a) – Adjusted Gross Income: General Rule

- Above the line deductions
- AGI = GI – ATLD
- ATLD =
    - T & B deductions if the trade or business is carried on by the TP who is not an employee.
        - This is so that you get ATLD if you're not an employee but you pay for things.
        - If you are an employee (below) Congress doesn't want you to have ATLD if they don't reimburse you!
    - T&B for employees
        - reimbursed expenses
        - expenses of performing artists
        - school teacher expenses up to $250
        - expenses of armed forces reserves
    - losses from sale of property
    - retirement savings
    - alimony
    - jury duty paid to employer
    - moving expenses
    - interest on education loans
    - higher education expenses
    - health savings accounts

IRC63 – Taxable Income Defined

- Itemizers: TI = GI – Deductions (other than SD)
    - Not AGI because later on it says that ID are not ABTL or PE
    - So TI = GI – Deductions
        - Deductions allowed by this chapter other than SD are ATLD, ID, and PE
        - TI = GI – (IRC62 ATLD + ID + PE)
        - TI = AGI – ID – PE
    - So even though definition doesn't mention AGI, itemizers do calculate it
- Non-Itemizers:
    - TI = AGI – SD – PE
        - = GI – ATLD – SD – PE,
        - where AGI = GI – ATLD (IRC62 deductions)
    - SD = basic SD + additional SD
        - Basis SD = 10.7k (married/surviving spouse) or 7.85k (head of household) or 5.35k (else)
        - Additional SD
            - another 600 if spouse or TP is over 65
            - another 600 if spouse or TP is blind
            - If TP not married or not surviving spouse, then 750, not 600
    - Limitation for certain dependents
        - SD for individual, whom another TP can claim a PE for, shall not exceed the greater of
            - 500, or
            - 250 + such individual's earned income
- Itemized deductions
    - deductions allowable other than
        - deductions allowable at arriving at GI (not ABTL)
        - deduction for PE
    - So these deductions are just BTLD
- Election
    - without an election, no itemized deduction allowed
    - So you have a choice between ID and SD.
- After choosing, you still take away your PE.

Policy – why have ATLD and BTLD?

- ATLD is for everyone – supposed to be related to business stuff
- Dangerous shortcut to see if its ATLD or BTLD is looking at ToC, but on xxiii, they put moving expenses and others at BTLD when they are actually ATLD!

IRC67 – 2% Floorr on Misc. Itemized Deductions

- MID only allowed to the extent the total exceeds 2% of AGI
  - so if you had 2.3k of MID, and your AGI = 100k, then you get to deduct anything over 2k, which is 300.
- MID is any deduction OTHER THAN
  - interest under 163
  - taxes under 164
  - casualty or theft loss under 165(a) and (d)
  - charitable deductions under 170
  - health stuff under 213
  - 72(b)(3) annuity deductions
  - amortization deduction under 171
  - etc.
- Apply this BEFORE the dollar limitation of the second sentence of 162(a) (traveling expenses for T or B)
- If you had a business expense for which you weren't reimbursed, you could get a BTLD

IRC68 – Overall limitation on Itemized Deductions – Phase-out of ID

- If AGI exceeds X, the amount of ID is REDUCED by the LESSER of
    - 3% of excess of AGI over X, or
    - 80% of the amount of the ID otherwise allowable
  - where X is 156.4k (joint return)
- For this section, ID does NOT include
  - 213 medical stuff
  - 163(d) investment interest, and
  - 165(a) casualty or theft losses
- Apply this after the application of any other limitation on the allowance of an ID (so do 2% floor first)

Phaseout for Itemized Deductions

- NOTE: don't forget about the 2% floor you still have to apply FIRST (68(d))
- Applicable amount is 156.4k
- Your IDs are reduced by the lesser of
  - 3% of excess of AGI over 156.4k, or
  - 80% of amount of ID otherwise allowable
- ex. Married couple with AGI = 250k and IDs = 20k
  - Reduction options
    - (a)(2) - Reduction amount would be 80% of 20k = 16k.
    - (a)(1) - 3% of (250k – 156.4k) = .03 * 93.6k = 2.808k
    - So the lesser is 2.808k
- Phaseout of the Phaseout
  - You take 2/3 of whatever is lesser
  - if you're in (a)(1) land, then 2/3 of 3% of another dollar of AGI is 2% of AGI
    - so you lose 2/3 of 3 cents for every extra dollar of AGI
  - EMTR
    - 2/3 of $.03 is $.02. If you're in the 33% MTR, then you lose $0.007 for every dollar you earn, so your EMTR goes up 0.7%
- "Full" phase-out: say you have AGI = 1M, IDs = 20k
  - you get either (a)(2) – 16k or (a)(1) - $25,308
  - so you choose (a)(2), take 2/3 of it which gives you 10.7k
  - So you have 20k – 10.7k = 9.3k of IDs after the phase-out
    - just fall back to the standardized deduction, in this case!

IRC151 – Allowance of Deductions for Personal Exemptions

- PE is allowed as a deduction in computing TI
- Exemption amount = 3.4k
    - if a dependent is being claimed for PE for another TP, then no second PE for you.
- Phaseout
    - for TP with AGI greater than threshold amount, exemption amount is reduced by applicable percentage.
    - Applicable percentage
        - 2% points for each 2.5k (1.5k for separate filing) (or fraction thereof) by which TP's AGI exceeds threshold amount
    - threshold amount
        - List
- Phaseout of the Phaseout
    - the phase-out reduction is equal to 1/3 to what would have been the phase-out amount

Phaseout for the Personal Exemption

- Phaseout is a back door way of increasing the tax rate for higher bracket TPs
- ex. Married couple, no kids, AGI = 234.6k
    - MTR
        - SD = 10.7k; PE = 3.4k * 2
        - TI = 234.6k – 17.5k = 217.1k
        - So MTR = 33%
    - IRC153(d)(3) – Phaseout
        - For every 2.5k (or fraction thereof) of AGI over the threshold amount, PE is reduced 2%
            - Threshold amount for joint return marrieds is 234.6k
            - They are at the cusp in this example
        - If you add 2.5k to their AGI (now it becomes 237.1k), their PE goes down 2%: PE goes down 2% of 6.8k, which is 136.
    - IRC153(d)(3)(e) – Phaseout of the Phaseout
        - Reduce this 126 by 2/3 (for years 2006 and 2007)
        - So the PE phaseout is actually 136 * 2/3 = 91
    - SO PE = 6.8k – 91 = 6.709k
- Moral of the story: For every 2.5k of AGI, your TI goes up 91.
    - So you pay another 33% of 91 in tax, which is 30.3.
    - so for every 2.5k you earn, you pay another ~$30 in tax.
    - 30 in tax / 2.5k in income means your MTR is increased by 1.2%
    - Effective MTR (EMTR), therefore, is 34.2%!
- The phaseout is fully phased out at 357.1k (according to table on xii – but they don't do the phase-out of the phase-out)
    - At 357.1k, you have 50 2% stair steps
        - 357.1k – 234.6k = 122.5k, which is 49 2.5ks
        - BUT you never lose all of your PE, you just lose 2/3 of it!
    - So in the 234.6k and 357.1k range, each time you earn 2.5k, you have 91 more of TI.
        - So you're EMTR stays at 1.2% throughout this range
    - Once you're past 357.1k, you lose all the PE, and, therefore, you don't lose that 1.2% anymore
        - once you lost all the PE you can lose, the effect of the next dollar is to go back down to your regular MTR – **MTR bubble**
- ex. What if they had 2 kids?
    - Their base PE is 13.6k – so everything doubles
    - they get lose 182 of PE, not 91
    - Their EMTR is 2.4%, not 1.2%

IRC152(a) – Dependent Defined

- Dependent means qualifying child or qualifying relative.

Marriage Penalty and ZBA

- Low income people don't itemize because they don't pay tax up to their ZBA.
    - ex. Married couple with no kids: SD = 10.7k; PE = 3.4k * 2; so ZBA = 17.5k

- ex. Non-married individual: SD = 5.35k; PE = 3.4k; so ZBA = 8.75k
    - ex. 2 non-married individuals: 8.75k * 2 = 17.5k
    - THEREFORE, TODAY, NO MARRIAGE PENALTY
- In previous years, there used to be a marriage penalty: your ZBA as a married couple would be less than if you were two unmarried individuals.
- ZBA reasons
    - administrative ease – not everyone will do itemized deductions
    - help out the poor folks

C. Minimum Tax on Tax Preferences

<u>Basic Idea of the AMT</u>

- Calculations
    - First, <u>broaden the base</u> of income subject to tax
        - Calculate regular TI
        - Add back in tax preferences (TPIs) (these things are NOT deductible in the AMT)
            - state and local income taxes
            - property taxes
        - Add back in the PEs
        - now you have AMTI >> TI
    - Now <u>subtract out</u> the AMT exemptions
        - These are the "SD" for the AMT, but these numbers haven't been inflation adjusted
        - 44.35k for singles
        - 66.25k for married
    - Now we have the <u>taxable excess</u>
        - Tax it at the tax rate of either 26% of 28%
    - Now we have the <u>tentative minimum tax</u>
    - You pay whichever is greater
- Technically,
    - AMT = Tentative minimum tax – regular TI
    - then you add it back on to regular TI, but this just means its the tentative minimum tax.
- AMT does phase out

Regular Tax	**AMT**
Gross Income minus	We start with regular taxable income
§62 deductions =	Plus TPIs =
AGI minus	AMTI (greater than regular TI)
Itemized deductions, minus	Minus AMT exemptions
Personal exemptions = Regular Taxable income	= taxable excess
Multiply by regular tax rates	Multiply by AMT rates
= income tax	= tentative minimum tax
So you pay the greater of the two	

- Policy
    - Rich people find too many tax shelters – its not fair. So we have a minimum tax on these people
    - Apparently it doesn't work too well though...
- Problems
    - Doesn't give too much revenue since not inflation adjusted
    - Congress keeps patching the exemptions!
    - We'll probably just get rid of this, but tax rates will have to go up to make up for it.

Note: the numbers for the AMT are not inflation adjusted – Congress just patches these sections every year!

IRC55 – Alternative Minimum Tax Imposed
- there is imposed a tax equal to the excess of
  - tentative minimum tax over regular tax
- Non-corporate
  - tentative minimum tax =
    - 26% of taxable excess up to 175k plus
    - 28% after 175k
  - taxable excess is the AMT income for the taxable year as exceeds the exemption amount
    - TE = AMTI – Exemptions
  - Amount shall NOT exceed the sum of
    - amount determined under this section reduced by the lesser of
      - capital gain, or
      - sum of
        - adjusted net capital gain, plus
        - unrecaptured 1250 gain
    - PLUS 15% of adjusted net capital gain in excess of amount on which tax is determined
    - PLUS 25% of taxable excess in excess of something...
- Corporations
  - 20% of income that exceeds exemption amount
- AMT income – adjust by IRC56 and 58 deductions and increase through IRC57

IRC56 – Adjustments in Computing Alternative Minimum Taxable Income (AMTI)
- No deduction for
  - MID
  - SD and PE
- Exception

IRC57(a) – Items of Tax Preference
- These are added back in to regular TI to get AMTI

D. Personal Tax Credits

IRC32 – Earned Income
- Tax credit = credit % of the TP's earned income as does not exceed the earned income amount
- Limit – amount of credit shall not exceed the excess of
  - credit % of earned income amount, over
  - phaseout percentage of the **AGI** (or earned income if its greater) that exceeds the phaseout amount
- Credit percentage and phaseout percentage are in a table in (b)(1)
- The earned income amount and phaseout amount are inflation adjusted and on pg. (xi)
- Earned income
  - wages, tips, salary, etc.
  - **NOT investment**
- Phaseout
  - look at start and finish on table on xi
  - Phaseout percentage is in 32(a)(b)(1)
- This is a REFUNDABLE credit! You could have a negative tax withholding!

ex. Single parent with 1 kid. Earned income is 10k.
- Credit is equal to the credit percentage of what you've earned that doesn't exceed the earned income amount
- Credit percentage
  - 1 kid – 34%
- 34% of EI that doesn't exceed EI amount
  - EI amount is 8.39k

    - so we're giving credit for 34% of every dollar earned up to the EI amount (8.39k)
    - the 34% of the EI amount is the cap on the credit
    - Maximum credit, on pp. Ix is 2.853k
- ZBA for TP
    - SD for head of household is 7.85k
    - PE = 2 * 3.4k = 6.8k
    - so ZBA is 14.65k
- So since their income is 10k, they pay no tax because they're under the ZBA. Moreover, they get a check or 2.853k from the EITC

Phaseout
- For HoH phaseout begins at 15.39k and ends at 33.421k
- Phaseout percentage is 16%
- So for every dollar of EI above phaseout threshold amount, you lose 16 cents of your credit
    - So you could jump from a MTR of 10% or 15% and then jump into a 26% or 31% range!
    - note use AGI for the phaseout percentage, not necessarily EI (unless its greater)

Note: there is a child support element in this: the cap is lower if you have no kids, but you get more credit if you have 2 kids.

EITC Marriage Penalty
- ex. Two singles, each with a kid: each makes 13k and get a credit of 2.853k. So they get 5.706k in total.
- ex. Married, with 2 kids: EI = 26k; Threshold amount = 17.39k! So they start getting phased out of the maximum credit of 4,716!
    - Further Limitation
        - Credit percentage of EI amount: 40% of 11.79k = 4.716k
        - Phaseout percentage of [AGI – Phaseout amount]: 21% of (26k – 17.39k) = 1808
        - So you reduce the Credit (4176) by the Phaseout (1808) and get a credit of 2908

So on the phaseout, if you're single with one kid
- in the phaseout, for every dollar, you lose 15 cents for regular tax plus another 21 cents from the phaseout
    - these people are in an over 35%

The graph of the EITC to EI looks like

```
             ________________________
            /                        \
           /                          \
          /                            \
 Reaching EI amt                  After Phaseout threshold
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V. Choice of the Taxpayer

A. Taxable Unit

i. Marriage

There is no perfect system – someone is going to be penalized. Cohen proof:
- 3 tax schemes
    - A: Tax all units (single or married) at 10% up to 10k and then 20% above 10k
        - ends up with 2 singles saving money
    - B: Tax each person at 10% up to 10k and 20% above 10k
        - penalty when you have a non-working spouse
    - C: Tax singles as in B, but tax couples at 2x the single rate at ½ the income – income splitting
        - marriage bonus – single person is penalized

- 4 tax scenarios
  - 1: Single person who earns 20k
  - 2: 2 Singles each earning 10k
  - 3: H earns 20k, W earns 0
  - 4: H and W each earn 10k

	Scheme A	Scheme B	Scheme C
Single earns $20K	3K	3K	3K
2 singles each earn $10K	2K	2K	2K
Wife earns $20K, H earns 0	3K	3K	2K
H & W each earn $10K	3K	2K	2K

<u>Drucker</u>

- Court rejects the argument that these marriage penalties are unconstitutional. It doesn't prevent anyone from marrying. Congress has the authority to tax married people more if they want to.

	AGI	0 Bracket	TI	Single Tax	Married tax
Alex	$50K	8750	41,250	4,386 + 25% (41250 – 31850) = 6736	
Barb	$50K	8750	41,250	6736	
Single Total		17500	82,500		
Alex + Barb	$100K	17,500	82,500		13,472 (25% rate)
Cindy	$90K	8750	81250	15698.75 + 28%(81.25k – 77.1k)= 16,861	
Dennis	$10K	8750	1250	125 (10%)	
		17500	82500	16986	
Cindy + Dennis	$100K	17500	82500		13472(25% rate)

- So in this case, there is a marriage bonus for C and D, and the same tax is paid for A and B!

Marrieds versus Singles in the Tax Brackets

Top of Bracket	Single	Married	M v. S	
10%	7550	15100	2x	No Mar. Pen
15%	30,650	61,300	2x	No Mar. Pen
25%	74,200	123,700	1.67x	Mar. Pen
28%	154,800	188,450	1.22x	Mar. Pen
33%	336,550	336,550	1x	Mar. Pen

<u>IRC7703 – Determination of Marital Status</u>

- Determination of whether an individual is married shall be made as of the close of the taxable year
  - so theoretically you could get divorced and re-married every year to avoid marriage penalty...?
- Moral of the story: <u>Get married in January and have babies in December.</u>
- Gay marriage is not recognized for federal tax purposes

<u>ii. Divorce</u>

<u>IRC71 – Alimony and Separate Maintenance Payments</u>

- GI = alimony and separate maintenance payments set forth in a divorce or separation instrument
- this does NOT apply to the amount of the payment fixed to be child support
- Alimony is taxed to the earner.
- Note: <u>Child support</u> is not includible in GI to the recipient and is not deductible by the payor.

<u>IRC215 – Alimony, Etc., Payments</u>

- Deduction = payment of alimony or separate maintenance payment which is <u>includible in the GI of the recipient under</u>

71 (therefore child support is NOT deductible!)

Note: Parties can contractually reverse these tax consequences

IRC1041 – Transfers of Property Between Spouses or Incident to Divorce

- No gain or loss recognized of transfer of property from individual to spouse or former spouse
- Treat as a gift – transferee's basis is the adjusted basis of the transferor
- former spouse: transfer within 1 year of end of marriage or related to the cessation of the marriage
- This provision solved a lot of the problems created in the Farid-Es-Sultaneh decision
- TPs generally want this – defer tax
  - problem is that if the the recipient spouse has a low basis

Farid-Es-Sultaneh

- D sells shares to K, selling 12k shares at 19.23 per share. She got the shares from her husband, who had a basis of 16 cents per share.
- Commissioner – this was a gift, so her basis is 16 cents per share.
- Court – 2 assets
  - Doris transfers back her marital property rights which she gave up in exchange for these shares, meaning that this transfer of shares /marital rights is a realization event.
  - Problem: Husband was never taxed on the transfer of the shares – *someone* needs to pay tax on this appreciated value (gain) between the 16 cents per share stock (original basis) and the marital rights he received (amount realized).
  - Note: AR is always the value of what you received, NOT what you gave up! (in case you're dealing with an unfair trade where the two assets don't have an equal FMV)
- But regardless, we have IRC1041.
  - However, this is a pre-nup agreement, so 1041 wouldn't really cover it.

B. Assignment of Income

IRC1(g) – Tax imposed: Certain Unearned Income of Children Taxed as if Parent's Income

- For a child, tax imposed = the greater of
  - tax imposed without regard to this subsection, or
  - tax which would be imposed if child's TI were reduced by the net unearned income of such child + child's share of the allocable parent tax
- Child
  - 1) under 18, or 2) 18 or over and has earned income < ½ of the individual's support, and
  - either parent is alive, and
  - child does not file a joint return
- Allocable parent tax = excess of
  - tax which would be imposed on parent's TI if it included the net unearned income of all children, over
  - tax imposed by this section on the parent without regard to this subsection
- Net unearned income = excess of
  - AGI not attributable to earned income, over
  - sum of
    - amount of standard deduction for dependents plus
    - greater of 1) the amount of the SD above or 2) if child itemizes, then the amount of the IDs

Lucas v. Earl (1930) – Assignment of Income from Services

- TP Ked with his wife to have ½ of his salary go directly to her (this was before joint-return filing)
- Court: Intent of the tax statute is to tax salaries to those who earned them. You can't get around this by anticipatory arrangements
  - Fruits of TP's labor cannot be attributed to a different tree from that on which they grew
- Point: Income from services is going to be taxed to the earner

Blair (1937) – Assignment of Income from Property

- Life-tenant of a testamentary trust assigned his children dollar interests in the income of the trust. Donor retained

interest in unassigned portion of trust, but donees' interests were to continue for the duration of the life estate and were thus coterminous with the donor's
- Court: Donees are taxable – the entire property was assigned to the donees, so it is income to the donees.
  - The donor's fractional interests could never revest in the donor.
- Key factors
  - irrevocable assignment
  - father had no more control
    - unlike Earl, where he could just not make any money to cut off his (kind of loose)
    - also unlike Earl because that was wages – he controlled what wages he got, but this is a transfer of property
  - given away everything for that part of the trust (unlike Horst, where he kept part the bond)
  - long term interest
  - he gave away an equitable interest
- ex. B owns 100 shares of stock. He gives 20 shares to his son. Dividends on those 20 shares are taxed to the son.

Horst (1940)
- Father gave coupons from his coupon bonds to his son, before they are paid.
- Holding: Current interest payments on the TP's bonds were includable in TP's income despite his annual gifts of the coupons to his son.
  - Father was the "remainderman" on the income from the property, and the son collected an excludable gift at the end of the year.
  - Father could have just gotten the $50 and gave the son a gift of the cash, so treat it like that.
- Compare to Blair
  - He just assigned one coupon to his son, he has the corpus still, and has control.
    - If Blair had just given the gift annually, then it'd be the same result as this
  - Horst **carved out** an interest for his kids, he didn't sever his interest from the transfer.
- Factors
  - Less transfer of control here since he still had control over the bond and the coupons thereafter
  - Short term interest
  - recipient only has right to receive the money, no equitable interest
  - He gave one coupon, and retained discretion
    - power to dispose of income is the equivalent of ownership of it
  - Holder of coupon is the holder of 2 rights: 2) right to demand and receive payment on principal, 2) demand and receive interim income payments
  - he gave out this interest right before it was due
- Point: Horst tried to shelter the income from tax by giving it to his son for a lower bracket. He could have just given the whole bond to his son, but he didn't – presumably he wanted to maintain control of it. Can't have your cake and eat it too, it seems.
- Possibilities
  - If Horst only owned the coupon, and gave it to his son, then it'd probably be more like Blair – there is no carved out interest, but rather a complete severance of control.
  - If Horst gave the coupon to his son and the bond to his daughter, then who is taxed on the income from the coupon?
    - Can't tax daughter – she didn't give it to him.
    - Can't tax Horst – he has no control left
    - So tax son. Treatment of the son depends on who retains the bond and other coupons. This seems weird, but correct.
      - If father kept some control, tax father. Else, tax son.
- Compare to Gavitt
  - issue: whether annual income of a testamentary trust should be attributed to the income beneficiary or be excluded as a gift or inheritance?
  - H: tax the income beneficiary because they got the cash. Don't tax the remainderman.

	Blair (property – tax kids)	**Horst (income – tax Dad)**
What was transferred	Fraction of life interest in a trust.	Interest coupon from a bond just before the payment came due.

Differences b/w transfers in Blair and Horst	~ Complete transfer of control ~ Long Term Interest ~ Equitable interest was transferred	~ Less transfer of control ~ Short Term Interest ~ no equitable interest, just a right to income

Ex. He gives 19 year old daughter stock. Who pays tax on dividends going forward? Daughter does – its her property.

- Suppose she is 15, not 19.
  - Since she is under 18, under 1(g), we have the kiddie tax.
    - The first 850 plus the greater of 850 or expenses incurred in producing such income, which is usually just 1700, is not taxed at the parents rate
    - this unearned income is taxed at the parents rate.
- Suppose he K's with his daughter to split his salary with her.
  - This is not her income – Earl
  - This is taxable income to him, and his daughter receives it as a gift.
- Suppose he gives stock to his daughter and she immediately sells it.
  - He pays no tax. She has carry-over basis, so she pays tax on the FMV less his basis. This IS a shift of taxable income!
  - Like Blair

Old Exam Hypo: CEO gets the boot and a severance package that pays 1M per year for 10 years. CEO assigns half the interest in this assignable K right to her mother. Who gets taxed on that assigned to her mom?

- If this is payment for services, under Earl CEO still gets taxed.
- If this is just a property right, then we have Blair/Horst analysis
  - irrevocably assigns 50% - looks like Blair.
- Courts generally would apply Earl
- Note: Apply Earl, even if the performance of services is paid through property, and not cash!

Note: If claimed as a dependent, child cannot claim a PE (since the TP claiming him as dependent used his PE)

C. No/Low Interest Loans

IRC7872(a)(1) – Treatment of Loans with Below-Market Interest Rates: Gift Loans and Demand Loans

- If a below-market loan which is a gift loan or demand loan, forgone interest is treated as if
  - transferred from the lender to the borrower as a gift, and
  - retransferred by the borrower to the lender as interest
- Moral of the story: IRC7872 precludes the use of interest-free or low-interest loans between employers and employees to avoid employment taxes (social security tax) or limitations on interest deductions, between family members to shift income from high-rate TPs to low-rate TPs

Problem addressed:

- A puts 100k in bank, and gifts the interest to B. A pays tax on the interest; B has no tax consequence.
- A gives 100k loan to B interest free. B puts the money in the bank and gets the interest. B pays the tax on the interest!
- So A can shift the taxing of the interest just by making a loan!

Look to Applicable Federal Rates to see what market rate to use. Suppose we have 100k loan at 0 interest and the applicable rate is 5%.

		Lender		**Borrower**	
Code	**Character**	**Cash?**	**Tax Consequence**	**Cash**	**Tax Consequence**
7872(a)(1)(A)	Gift (lender to borrower)	Paying $5K	None	Receiving $5K	None (gift)
7872(a)(1)(B)	Interest (borrower to	Receiving	Taxable as interest	Paying $5K	Possible

	lender)	$5K	income under §61		Deduction (§ 163)

- Moral of the story: lender/parent, you have to pay tax on the interest you are missing out on – you can't tax shelter like this!

This also happens in employment –
- (a)(1)(A) – no gifts in employment, so we consider the employer to be compensating the employee.
- (a)(1)(B) – treat it as an interest payment.

		Lender		**Borrower**	
Code	**Character**	**Cash?**	**Tax Consequence**	**Cash**	**Tax Consequence**
7872(a)(1)(A)	Compensation (lender to borrower)	Paying $5K	Deductible as ordinary and necessary business expense	Receiving $5K	$5K more of income which is taxable
7872(a)(1)(B)	Interest (borrower to lender)	Receiving $5K	Taxable income	Paying $5K	Possible Deduction (163)

- This may not stop you from shifting tax, but it makes you pay the employment tax on the interest forgone.

D. Income in Respect of a Decedent

IRC691(a)(1) – Recipients of Income in Respect of Decedents
- GI = decedent's stuff on transfer if not includible in decedent's GI
- included in the GI of
  - estate, or
  - person who gets it
- Don't forget the step-up in basis on death.

****

VI. When is an Item Taken Into Account

A. Gains and Losses on the Disposition of Property

i. Deferred Payments

IRC452 - Installments
- Income from installment is taken into account using the installment method
- Installment sale – at least 1 payment is to be made after taxable year
  - does NOT include: dealer disposition or inventories of personal property
- Installment method – method where income recognized is proportion of payments received in that year which the gross profit (realized or to be realized) bears to total K price
  - So handle basis ratably per year
  - Income = Proportion of payments
- Election – you can elect out of this installment method rule
  - You would do this if, say, you had tons of losses and needed gains to offset them.
- Second dispositions by related persons
  - If A first disposes of property to related person B, and then, before A receives all payments from the first disposition, B second disposes of the property, then
  - AR for B's second disposition is treated as amount received by A at the time of B's second disposition
  - SO: Treat it as if the original TP had sold it, and recognized all the gain that would have resulted if the first TP sold it himself.
- EXCEPTIONS (total AR is at disposition, regardless of installments)
  - disposition of property under revolving credit plan
  - installment obligation arising out of a) publicly traded stock/securities or b) other property regularly publicly

traded

Theory: You have basis of 5. You sell at 15, with 5 installments of 3 plus interest. Possibilities:

- Recover basis first
  - First 5k of payments would be basis recovery. So you tax defer all your basis gain.
- Code: Spread basis over 5 years
  - So you recover 1 in basis for every installment payment.
- Basis last
- Tax gain at disposition
  - we don't do this because there are liquidity problems here – you have to pay tax on payments that you haven't received. The person paying the payments may not be able to sell the thing to guarantee payments, so you're paying tax on a not-for-sure future payment.
- Note: if you don't have interest on th installment payments, then the lender is still taxed under 7872!

Basis recovery method: Say sell for 15, with 5 annual payments of 3. Basis is 5.

- Equal installment payments
  - Income = proportion of the payment that is gross profit divided by total K price
    - Payment = 3; Gross profit = 15 – 5 = 10; total K price = 15
    - So 2/3 of every payment is income.
    - So 2/3 of 3 = $2 per payment is income.
- Unequal payments: 6 in years 1 and 2, and 3 in year 3
  - Proportion stays the same: 2/3
  - So you have income of 4, 4, then 2.

First and Second dispositions between related persons: Say initial sale is from TP to daughter for 15. Payments are $3 for 5 years. Daughter's basis is 15. She turns around and sells it at FMV of 15 immediately.

- Treat it as if the original TP had sold it, and recognized all the gain that would have resulted if the first TP sold it himself.
- So Dad recognizes gain of 10 at the time of second disposition. Daughter has no gain.
  - Note: if Daughter had sold for 20, she would have a gain of 5, and dad would still have a gain of 10.

<u>Burnet v. Logan:</u>

- If the sale price is contingent on future events (Ex. Your basis in a mine is 100. You sell it for 10% of your annual profit for 10 years.), then you use the <u>open transaction doctrine</u>
  - Court allowed TP to recover basis first in this case.
  - So in the example, if the profits are 20 per year, then the cost would end up being 200.
    - In the first 5 years, then, TP doesn't pay any tax. But then the last 5 years, he pays tax on the full 20 each year.
- **The Regs now provide today that**
  - **if the <u>period is certain</u>, but the amount is uncertain, you spread your basis over the certain period. So if you know you'll be receiving money over 10 years, spread the basis over 10 years.**
  - **if the <u>amount is certain</u>, but the time period isn't – say you will sell for 10% of profits until that equals 200, we won't know when that will actually happen. In this case, we prorate the basis across the total profit.**
    - **So, the total amount received is 200. We will take 100 of basis recovery and 100 of profit. So each time you receive a payment it would be half basis and half gain.**
  - **If we don't know either the period or the amount, you spread your basis over 15 years.**

<u>ii. Nonrecognition</u>

<u>IRC1001(c) – Determination of Amount of and Recognition of Gain or Loss</u>

- all gain or loss on sale or exchange shall be recognized.

General Rule: A owns GA and B owns yacht. They swap.

- A's gain is the difference between the FMV of the yacht and A's basis in GA
- B's gain is the difference between the FMV of GA and B's basis in the yacht.
- 1001(c) says that the general rule is disposition of property is both a realization and recognition.

- Exceptions
  - exchanges of like kind property (1031)
  - involuntary conversions (1033)
  - Sale or exchange of TP's residence (121)

IRC121 – Exclusion from Gain from Sale of Principal Residence
- GI != gain from sale of property if for the 5 years prior to the date of sale the property was the TP's principal residence for periods aggregating 2 years or more.
- Limitations
  - Gain excluded shall not exceed 250k (500k for couples)
  - You can do this every 2 years.
- So if your gain approaches 500k, sell your house!
- Note: you can't deduct losses from house – this is personal consumption!
- Old law: you could defer gain if you bought a new place within 2 years that had a cost basis at least equal to the amount realized on the old residence – you could just roll into a new place every 2 years!

IRC1031 – Exchange of Property Held for Productive Use or Investment
- No gain or loss if property held for T or B or investment if exchanged for like kind held for T or B or investment
- Exceptions
  - stock in trade or other property held for sale
  - stocks, bonds, etc
  - other securities
  - etc.
- Property received is treated as not like-kind if
  - property not identified as property to be received within 45 days before transfer, or
  - property is received after the earlier of
    - 180 days after transfer
    - due date
- Cash/Boot: if you get cash/boot along with the like-kind property,
  - and if there is a gain, then gain is recognized on that cash/boot
  - and if there is a loss, then no loss from the exchange is recognized
- Basis is the same as basis of that exchanged, adjusted
  - decreased by money received
  - and increased/decreased by whatever is recognized in the exchange
  - **Formula: New Basis = Old Basis – Dollars Received + Gain Recognized – Loss Recognized**
  - basis is allocated if you get other property too
    - basis to the other property is assigned at its FMV
- Livestock of different sexes are NOT like-kind.
- If transfer is between related persons
  - nonrecognition, and
  - within 2 years the tranferee disposes of it (or the TP disposes of something received from related person)
  - THEN no nonrecognition anymore.
- POLICY
  - eliminate potential lock-in problem – if its better for your business to switch, don't want tax to stop you.
- Like-Kind
  - MUST use BOTH for T or B or for investment.
    - So swapping business property for personal residence doesn't apply.
  - Reg1031(a)-1(b) – definition of like-kind
    - reference to the nature or character of the property, not its grade or quality
  - ex. Truck for a new truck or car for a new car.
- Courts are nitpicky in applying this rule.
  - Say A owns 1 and B owns 2. A wants to own Z. B doesn't want 1, however, but would rather have cash. C wants to buy 2. How do you do this without tax?
    - C buys 2 from B, then C and A pull of a 1031 exchange.
  - PROBLEM: Carlton court said that, when C buys 2, if C doesn't ever get legal title, then this doesn't work!

Formula: New Basis = Old Basis – Dollars Received + Gain Recognized – Loss Recognized

Examples of 1031 exchanges with cash

- C owns RA: FMV = 100 and B = 40. D owns WA: FMV = 125 and B = 75. C and D trade, and C further gives D $25.
  - C has received only WA, so he has exchanged solely for property of like kind.
    - AR = 125
    - B = 40 + 25 = 65
    - Gain realized = 60
    - Gain recognized = 0
  - D has received like-kind property and cash.
    - AR = 100 + 25 = 125
    - B = 75
    - Gain realized = 50
    - Gain recognized = 25
- Suppose D's basis is now 110.
  - AR = 125; B = 110; Gain realized = 15; Gain recognized = 15 => **if your gain realized is less than your boot, you only recognize your gain, not your boot**
- Calculate C's new basis
  - Old basis = 65
  - Dollars received = 0
  - Gain recognized = 0
  - loss recognized = 0
  - So new basis = 65!
  - <u>go back and make sure this makes sense – never stop here</u>
    - if he sold the new property, he'd have AR = 125 and new basis of 65, which would give him a gain of 60. This matches what he was at before: He started with a property with FMV of 100 and B = 40!
- Calculate D where basis is 75
  - Old basis = 75
  - Dollars received = 25
  - Gain recognized = 25
  - loss recognized = 0
  - New basis = 75 - 25 + 25 – 0 = 75
  - <u>Does this make sense?</u>
    - If he sold right now, he'd have AR = 125 and new basis of 75, giving gain of 50. Before, he had FMV of 125 and B of 75, which would have been a gain of 50.
- Calculate D where basis is 110
  - Old basis = 110
  - Dollars received = 25
  - Gain recognized = 15
  - Loss recognized = 0
  - So New Basis = 110 – 25 + 15 – 0 = 100
  - Does this make sense?
    - If he sold right now, he'd have AR = 125 and new basis of 100, which would give him a gain of 25. Before, he had FMV of 125 and basis of 115, which would have been a gain of 10. He pays an extra 15 now because he got boot in excess of the gain that is not being recognized in the amount of 15 – 1031 only applies to the gain of 10 that was not recognized between his old basis (115) and old FMV (125).

Example of 1031 exchange with boot

- C owns RA: FMV = 100 and B = 40. D owns WA: FMV = 125 and B = 75. C and D trade, and C further gives D a boat worth $25 and a basis of 20
  - C
    - Old basis = 40 (land) + 20 (non-cash boot) = 60
    - AR = 125
    - Gain realized = 65 still
    - Gain recognized = $5 (the gain on the boot)
    - New basis = 60 – 0 + 5 – 0 = 65

- Does this make sense?
  - Before, he had land with FMV of 100 and Basis of 40, so his gain before was 60. We want to preserve this.
  - His new basis is 65 for property valued at 125, so his gain is still now 60.
  - We just shifted the basis of the boat over, and added the $5 he "spent" in buying the new land.
- D receives two pieces of property.
  - AR = 100 + 25 = 125
  - Old basis = 75
  - Gain realized = 50
  - Gain recognized = 25
  - New basis = 75 – 0 + 25 – 0 = 100
  - BUT we have to spread this basis out over the 2 properties.
    - FIRST fill up the basis of the boot
    - so his basis on the boat is its FMV, which is 25.
    - This leaves the new basis for the land as 75.
  - Does this make sense?
    - He used to have a gain of 50. Now, he has a gain of 50.
- So when we subtract "dollars received," we're pretty much just giving the cash a "basis" in the value of the cash.
  - We're implicitly applying the cash to the basis of the property in which we recognized gain
- Why do we subtract loss recognized?
  - If you traded property which depreciated, then we don't recognize the loss if you trade it for like-kind.
  - BUT 1031(c) does provide for recognition of losses on the boot – so if the boat had decreased in value for some reason – it would have a loss
  - So you subtract loss recognized from the boot.

IRC1033 – Involuntary Conversions

- If property is involuntarily (because of theft, requisition, condemnation, etc.,) converted into
  - similar property, then no gain recognized
  - dissimilar property, gain is recognized, except
    - if for the purpose of replacing TP purchases other property similar, at the election of TP gain is recognized to the extent AR upon such conversion exceeds the cost of the other property
- so you can either keep the cash and pay tax on it, or reinvest in property similar or related in service or use, and we postpone the gain.
- 1033 "like-kind" is narrower than 1031 (except when condemned)
  - decide whether the TP has achieved a sufficient continuity of investment to justify non-recognition of the gain, or whether the differences in the relationship of the TP to the two investments are such as to compel the conclusion that he has taken advantage of the condemnation to alter the nature of his investment for his own purposes.
- New basis rules are the same as in 1031 – if its solely 1033 non-recognition, then you have carry-over basis.

B. Leverage and Deferral

Issue: What is the effect of borrowing on basis and realization?

Note: Non-recourse (lender can't go after borrower) and recourse (lender CAN go after borrower) loans are treated the same for tax purposes.

	Recourse	**Non-Recourse**
Benefit of Gain	Borrower	Borrower
Risk of Loss	Borrower	Lender

Crane

- B got apartment building from husband worth 260k, subject to a non-recourse mortgage on which she has paid back no principal. She took depreciation deductions of 28k for 6 years. She then sold the building (and mortgage) for 2.5k
- Real world: she got 2.5k. Court just wants tax world to match the real world.

- Suppose she bought the property in 1932 for 260k, taken a 28k deduction, then sold it for 260k plus 2.5k
  - AR = 262.5k
  - Basis = 260k
  - Adjusted Basis = 260k-28k = 232k
  - Gain = 262.5k – 232k = 30.5k
  - Overall tax, then, is 30.5k – 28k she wasn't taxed on from her deduction = 2.5k
- Her position: She had 2.5k AR and 0 basis – she inherited encumbered property with FMV = 0 to her!
  - Problem: she took a deduction already, so she would then have a loss: 0 – 28.5k + 2.5k = (25.5k)
- Court: ignore the loan and say basis is the FMV
  - AR = 262.5k
    - think about it as if buyer paid 262.5k and you paid off the 260k loan.
  - Basis = 260k – 28k = 232k
  - So gain = 262.5k – 232k = 30.5k
  - She has to pay the tax on the 28k she deducted, so she ends up being taxed on the 2.5k

	CASH hypo	**Crane's Position**	**Supreme Court**
1938			
AR	262500	$2,500	262,500
Basis	232,000	0	232000
Gain on sale	30,500	2,500	30,500
Overall			
1938 Gain	30,500	2,500	30,500
Previous Deductions	(28,000)	(28,000)	(28,000)
Overall Tax Gain	2,500	(25,500) loss	2,500

- PROBLEM for the IRS with <u>Crane</u>
  - Now, it looks like TPs can just borrow money from the bank (balloon payment loan, where you just pay interest, no principal, until the end of the loan), buy property, and take depreciation deductions to offset income, and defer the tax until later!
  - It seems like you can borrow money (not income) and use it to buy something and take depreciation deductions
    - tax paid will always be the same, its just a matter of scheduling, as usual.
  - Because court said that the mortgage is taken into account when figuring out the amount realized, if mortgage indebtedness is included in AR when property is sold, then it must also be reflected in the seller's adjusted basis when acquired!
- Court left open issue of what happens if the amount of debt had exceeded the value of the property.

<u>Tufts</u>
- Problem with <u>Crane</u> – in cases where it makes sense for you to just walk away (amount of debt is larger than value of property), what happens?
- Facts: T takes out 1.85M loan and adds 50k of his own investment to build a building worth 1.9M. T took depreciation deductions of 450k per year (Under <u>Crane</u>, there is no doubt that this 1.9M is fully depreciable). Adjusted basis, therefore, is 1.9M – 450k = 1.45M. Later, the property value dropped to 1.4M.
  - So at this point, non-recourse debt is 1.85M and the FMV of the thing is 1.4M (note: none of the principal was paid back)
- Real world: Bank is out 1.85M – 1.4M = 450k and TP is out 50k.
  - Make tax match real world!
- If <u>Crane</u> applied, then AR = 1.85M because the non-recourse debt is included in amount realized
- Distinguish <u>Crane</u> from here
  - in <u>Crane</u>, she could have just turned in the keys, but she wouldn't have gotten the 2.5k.
    - Crane received an economic benefit by treating it as a loan to be repaid – if she hadn't, she wouldn't have gotten the 2.5k
  - Here, there is no chance of turning a profit – so he might as well turn in the keys
    - if the mortgage is more than the value of the property, the mortgagor can't recognize a benefit equal to the value of the mortgage
- Court just wants to make the tax consequence match the real world
- under the <u>economic benefit theory</u>, the max benefit from abandoning this property is the value of the property when the

loan is transferred. Problem:
- So AR = 1.4M,
- adjusted basis is 1.9M – 450k = 1.45M
- Loss is (50k) – they put in 50k and lost this
- Problem is that you need to account for the 450k depreciation... and this wouldn't work out with the real world.

- Solution: treat non-recourse debt as true loans
  - S Ct said not to respect the distinction in FN37 in Crane
  - So AR = 1.85M; B = 1.45M; Gain = 400k.
  - So because of the depreciation deduction of 450k, their total tax outcome is (50k) – this matches the real world
- O'Connor
  - Separate mortgage transaction from asset transaction

	TP Position	Majority Position	O'Connor	
			Asset	Loan
1972				
AR	$1.4M	$1.85M	$1.4M	$1.85M
Basis	$1.45M	$1.45M	$1.45M	(Repaid by turning in keys) 1.4M
Gain or Loss	(50K)	$400K	(50K)	$450K
			$400K	
OVERALL				
Gain/Loss in 1972	(50K)	$400K	400k	
Depreciation Deductions	(450K)	(450K)	(450k)	
Overall Gain/Loss	(500K) (Doesn't match)	(50K)	(50k)	

- Difference between Majority and O'Connor
  - O'Connor's method is better for TP: TP can exclude CoD income if insolvent.
- What was Bayles's basis (he assumed 1.85M non-recourse debt for property with FMV of 1.4M)?
  - Options
    - If Franklin means that property must be worth at least the face-value of the debt, else its a sham
      - then depreciable basis is zero
      - Problem: what if he sells for 2M, still subject to the non-recourse debt? Point: if you don't take non-recourse debt into account for basis, then you don't take it into account for AR
    - Crane/Tufts
      - Basis is 1.85M, the debt you take on. Further, you keep 1.85M in the AR too.
      - Its ok to let him depreciate 1.85M even though we know its only worth 1.4M
    - Pleasant Summit
      - Basis = 1.4M, its FMV. Recognize value of debt as basis only up to the FMV
      - This is a compromise
  - Moral of the story: Manipulate numbers to get them to match the real world.
  - We're not really responsible for this issue.

Franklin
- R sold T to F for 1.2M, with a lease back: F only wrote a 75k check to R. F had to pay 1.2% interest on the 1.2M sale. Rs are supposed to pay rent to F. So the rent and the interest payments offset – no cash is flowing.
  - The only cash flow was the 75k check and the final balloon payment of 1.2M in 10 years.
  - This 1.2M is a non-recourse debt obligation
    - so if F doesn't pay, then the property just goes back to R.
- Issue: can F take deductions on this property?
- Crane/Tufts would say that F's basis is 1.2M, the value of the loan
  - therefore you could take depreciation deductions of the full 1.2M
- Court: no evidence of the purchase price being the FMV – concerned about a sham: the purchase price could have been a billion dollars, and nothing would have changed.
  - Similar to Knetsch
- Tax court treated it as an option: this isn't a purchase, so you can't take any depreciation deductions.
- Appeals court focused on the FMV instead, however.
  - They never showed what the FMV is
  - If the FMV was 500k, then its easy to just do this "sale" for 1.2M, take a bunch of deductions, and walk away.

Effectively, F could have just bought 1.2M in depreciation deductions for 75k!

- What if F borrowed from a bank and gave $ to R?
  - From R's point of view, things are different – R gets money.
  - From F's point of view, nothing is different!
    - He'd get the depreciations under this, however, because now you take away the element of "shamness"
  - **always be suspicious when you have no outside valuation**

Note: Non-recourse versus recourse

- If you have a recourse obligation, then you split it up into your asset and your loan
  - ex. TP buys property with 1M non-recourse loan. TP pays 100k in principal and interest. TP takes deduction of 400k. TP gives back to bank when its worth 700k.
    - AR = outstanding debt that is forgiven = 1M – 100k = 900k
    - Adjusted basis = 1M – 400k = 600k
    - Gain = 300k
  - ex. Same thing, but with recourse obligation
    - Split asset and loan
      - asset: AR = 700k; B = 600k => G = 100k
      - loan: AR (forgiven loan) = 900k; B (what he repaid – the asset) = 700k => Cancellation of Debt income = 200k
      - So we have a total gain of 300k – same result.

1031 Exchanges with Debt

- Ex. B has GA with FMV of 650 and Basis of 500. B trades with C for BA with FMV of 600 and cash of 50.
  - B's AR = 600 + 50 = 650
  - B's basis = 500
  - B's gain recognized = 50
  - B's new basis = 500 – 50 + 50 – 0 = 500
  - Does this make sense? Before, he would have had a gain of 150. If he sold now, he has 50 cash in the gain recognized and 100 in FMV – new basis, so thats 150 gain.
- Now suppose B's property is encumbered with a mortgage with 150 in principle. So C gives up his land and cash, and is also assuming this mortgage
  - Crane / Tufts says you include forgiven or assumed loan in AR, so B's AR is 600 + 50 + 150 = 800
  - Basis is still 500
  - So gain realized is 300
  - **1031(d) - if part of the consideration to the TPer is that another party assumed a liability, such assumption shall be considered as money received by the TPer on the exchange. So we treat it as "dollars received" in our formula.**
  - So recognize gain of 150 + 50 = 200, and non-recognize 100.
  - New basis = 500 – 200 + 200 – 0 = 500
  - Does this make sense? He used to have a gain of 150. Now, he has recognized gain of 50 and if he sold, he'd have a gain of 100
- What about C's point of view, if his original basis is 200?
  - AR = 650 + 150 = 800
    - the mortgage is still considered cash paid
  - Basis = 200 + 50 + 150 = 400
    - add in the 50 and 150 because this is cash he paid/is going to pay in the investment
  - Gain realized = 800 – 400 = 400
  - New Basis = 400 – 0 + 0 – 0 = 400
  - Does this make sense? Before if he sold, he'd have a gain of 600 – 200 = 400. Now, if he sold, he'd have a gain of 250 and he has paid 50 and 150 too
- What about a second mortgage?
  - If B takes out a second mortgage, you don't adjust the basis – don't adjust basis for loans that aren't part of the original acquisition cost

C. Annual Reporting and Accounting

Burnet v. Sanford
- They had 176k loss on government K. They later receive 176k plus interest. They want to use the deduction from loss before now.
- Court: You have to do everything by the taxable year, or else people will just wait forever before claiming gains, hoping there might be a loss.
- This is why we have the net operating loss rules to help with business fluctuations.

IRC172 – Net Operating Loss Deduction
- You can take a deduction for net operating losses going backward 2 years or going forward 20 years.
- Net operating loss = Excess of deductions over GI
- the NoL of a loss year is carried to the earliest possible taxable year.
- The portion of the loss carried to other taxable years is the excess of the amount of such loss over the sum of the TI for each of the prior taxable years to which such loss may be carried.
- No net operating loss deduction is allowed, meaning no net operating loss that has become a deduction can be used again in the future.
  - When you calculate the NoL for a particular year, you don't sum up all the ones from before (Say you had a loss of 10k in 2005 and 2006. Your NoL in 2006 is 10k, not 20k – don't make it cumulative)
- Personal exemptions not deducted before cannot be carried forward/backward.
- Deductions from capital gains losses can only be used for includible capital gains
- Nonbusiness deductions are allowable to the extent of non-business GI

Ex. Tax rate is 30%

	2006	2007	2008	2009
TI (before NoL)	10k	(10k)	(10k)	25k
TI (after NoL)	0 from 2007 loss	0 carried back	0 carried forward	15k from 200

IRC1341(a) – Computation of Tax where TP Restores Substantial Amount held under Claim or Right
- If
  - 1) item was included in GI in prior year because it seemed TP had an unrestricted right to it,
    - NOT an embezzler who stole something
  - 2) a deduction is allowable because TP later found out he did not have an unrestricted right; and
  - 3) amount of deduction exceeds 3k,
- THEN tax imposed is the lesser of:
  - tax for the taxable year computed with such deduction, or
  - amount equal to
    - tax for year computed without the deduction MINUS
    - the decrease in tax for the prior taxable year which would result from the exclusion of such item from GI in the prior year.

Ex. In 2007, employee gets 10k bonus, and is in the 35% bracket. He pays tax of 3.5k. In 2008, he has to repay the bonus, and is now in the 25% bracket.
- If he took the deduction, he'd only save 2.5k!
- So if the employee meets the requirements in 1341 (10k deduction is more than 3k), then his tax would be
  - 1341(a)(4) – tax computed with such deduction
    - Lets say he makes 55k. Lets say tax on this is 10k, and his MTR is 25%.
    - So under this section, his TI would be 45k, and the tax on that would be 2.5k less – 10k – 2.5k = 7.5k
  - 1341(a)(5) – tax computed without deduction minus decrease in tax in prior year that would have resulted without the item
    - So 10k (tax now) minus 3.5k (tax paid then) = 6.5k
- So he pays the lesser of 7.5k in tax and 6.5k
- Note: Do NOT re-open earlier return, like in NoL

IRC111(a) – Recovery of Tax Benefit Items
- This is the inclusionary principle of the tax benefit rule
- GI != income from recovery of amount deducted in a prior year to the extent such amount did not reduce the tax

imposed
  - So if you had a deduction that you couldn't use (so you didn't take it), then if you recover the deduction later, you don't pay tax on it – you effectively already paid tax on it, I guess, in not using the deduction...
- If you have no TI (lots of deductions) then you cant recover deductions you never used!
  - So if company takes a deduction in the year they make a payment, and then they receive it back in a later year, they include it in income.
  - BUT if the deduction didn't reduce tax (completely or to some extent), like a start-up company, then we don't include the amount when they recover in a later year.
- Note: We do NOT adjust for rates here, like we do in 1341
  - so if the deduction was useless to you, we'll give you relief.
  - If it was useful, then we don't adjust anything – you pay the higher/lower tax rate if there is such a thing
- Suppose a TP properly deducts in one year, but gets it back in another year – the subsequent recovery is included in TP's income in the later year, provided that the earlier deduction produced a tax saving in the prior period.

<u>IRC461 – General Rule for Taxable Year of Deduction</u>
- Amount of deduction or credit shall be taken in its taxable year under the method of accounting used in computing taxable income.
- All events test is not met any earlier than when <u>economic performance</u> with respect to the item occurs
  - time when <u>economic performance</u> occurs is
    - time services are rendered
    - time property is provided
    - time TP uses the property
  - If TP has to pay because of tort liability, then economic performance occurs when payment is made, so if payment in installments, then the performance only occurs when paid, not when first issued
- All events test is met if all events have occurred which determine the fact and amount of liability

<u>Tax Accounting</u>
- Tax accounting isn't the same thing as financial accounting
- Two methods
  - Cash
    - you account for it when you receive/spend the cash
    - note: if you get a loan, you don't account for it – you aren't taxed on a loan!
    - <u>Doctrine of constructive receipt</u> – if employer says that paycheck is ready at office, then thats constructive receipt. You can't defer receiving it to defer tax.
      - TP may not postpone income that is available to her merely by failing to exercise her power to collect it.
    - This is what most non-corporate TPs use
    - Note: there is an issue with deferred compensation – they can't just defer compensation and pay tax later, if the funds are available in any way now.
  - Accrual
    - You take income/expenses into account when they are earned/incurred, regardless of when the money is actually transferred.
    - <u>All events test</u> - "if all events have occurred which determine the fact of income and the amount of the income can be determined with reasonable accuracy"
    - For expenses, we do all events test, but also we also have the <u>economic performance</u> rule which puts accrual method TP's on cash method for certain thigns.

D. Deferred & Equity Compensation

<u>409A(a) – Inclusion in GI of Deferred Compensation under Non-qualified Deferred Compensation Plans</u>
- If the nonqualified deferred compensation plan fails 2, 3, or 4, then all compensation of that year and previous years is includible in GI to the extent its not subject to substantial risk of forfeiture and not previously included in GI
- If you have to go back and pay, then you add interest and 20% of the compensation
- 2) Distribution requirement
  - compensation can't be deferred earlier than
    - separation of service

        - date becomes disabled
        - death
        - specified time
        - change in ownership of company, or
        - unforeseeable emergency
- 3) acceleration of benefits: the plan cannot be accelerated

Deferred Compensation
- Qualified plans are subject to stringent rules by IRC and ERISA
    - forbidden to discriminate in favor of highly compensated employees
    - employees are allowed to deduct deferred compensation currently, and employees are not taxed currently, but are taxed when compensation is paid during retirement
    - Investment income on the deferred compensation is not taxed to the trust that invests the money
        - similar to an IRA – investment income is not taxed
- Deferred compensation and Constructive receipt
    - its not constructive receipt merely because payor would have been willing to agree to an earlier payment
- IRAs
    - Under current law, the max that can be contributed to an IRA and deducted is 5k.
        - If you withdraw early, you're generally subject to a 10% penalty
    - Roth IRA p. 746

IRC83 – Property Transferred in Connection with Performance of Services
- Applies to stock options other than the "incentive options" covered by 421
- For performance of services, if property is transferred to any person other than the person for whom such services are performed, excess of
        - FMV of such property at the first time the rights are transferable or are not subject to forfeiture, over
        - amount paid for property
    - IS INCLUDED IN GI
- You can elect to include it in the GI of the year the property is transferred. Amount is the excess of
    - FMV of property at time of transfer without regard to restrictions, over
    - amount paid
    - election is allowed even if there is a substantial risk of forfeiture
    - You might want to elect, say, if you won't be able to buy more stock later (Small private company) and its a start-up (stock is worthless) so all your appreciation will be long-term capital gain
- Substantial risk of forfeiture: person's rights to full enjoyment are conditioned upon future performance
- Transferability of property – transferable only if the rights are not subject to a substantial risk of forfeiture
- 83 does not apply to
    - 421, 401, or 404 transactions
    - **transfer of an option without readily ascertainable FMV**
    - transfer of property pursuant to exercise of an option with readily ascertainable FMV at date of grant
    - group term life insurance
- **If an employee receives a nonforfeitable option which has an ascertainable FMV at grant date, that value is ordinary income – no income is recognized when the option is exercised – it'll just be a capital gain/loss. If no value is ascertainable at date of grant, then you tax at exercise.**
- Reg1.83-7
    - 83 applies to things not covered under 421 if the option has a readily ascertainable FMV at the time the option is granted.
    - If 83(a) doesn't apply because non-readily ascertainable FMV, then 83(a) and (b) apply at time the option is exercised
- Note: If the person receives property subject to a substantial risk of forfeiture at the time of transfer, the property is treated as still owned by the transferor and no income is realized. When the forfeiture risk is removed or the property becomes transferable, the FMV of the property at that time is includible in income.

FMV of private stock
- Companies just say their FMV is really low.

IRC421(a) – General Rules of Certain Stock Options

- If stock is transferred meeting reqs of 422(a) or 423(a), then
  - no income to individual at time of transfer upon his exercise
  - no deduction under 162 for employer, and
  - no amount other than price paid under option is considered as received by the company
- 421 creates a special class of so-called incentive stock options. The conditions to be an incentive stock option are in 422

IRC422 – Incentive Stock Options

- 421(a) applies to the exercise of an incentive stock option if
  - TP doesn't dispose of the stock within 2 years from the date of granting of the option nor within 1 year after the transfer of such share to him, AND
  - at all times beginning on date of grant and 3 months before the exercise, he was an employee of the company
- incentive stock option – option granted to individual for employment but only if
  - option is granted pursuant to a plan saying the number of shares and employees eligible and approved by shareholders within 12 months of the adoption of the plan
  - option is granted within 10 years from the date the plan is adopted
  - option doesn't last longer than 10 years
  - option price is not less than the FMV of the stock
  - option is non-transferable (other than by will)
  - option is not giving to someone who already owns more than 10% of the company's voting power
- it is not an incentive stock option if the aggregate FMV for options at 1st time exercisable if they are over 100k
- these incentives are free from the *Lo Bue* FMV ascertainable problem and enjoy preferential status if restrictions are met
  - some restrictions:
    - option price be at least equal to MV at time the options are granted
    - stock must be held for at least 2 years after date of grant and one year after date of exercise
  - If these are satisfied, then neither the grant nor the exercise of the option results in TI to the employee (and no deduction for the employer)
    - Gain is deferred until the stock is sold, and the tax is a capital gain tax, with no ordinary income whatsoever.

AMT Tax Problem

- Don't look at difference between value at exercise and exercise price for regular income tax – you just look at the sale price.
- For AMT, however, you add this spread back in!

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VII. Capital Gains and Losses

A. History and Mechanics

IRC1(h) - Tax Imposed: Capital Gains Rate

- Conceptualize the "stacking"
  - First, note that when calculating tax, note we have a progressive schedule, so
  - First 7825 is taxed at 10%
  - Then until 31,850 taxed at 15%
  - etc.
- Conceptualize capital gain: TI = 35k, where 5k is LTCG
  - OI
    - First 7825 is still taxed at 10%
    - Then up to 30k, you pay 15% tax on the OI.
  - Now you are in CG land
    - So between 30k and 31850 (1.85k) the capital gain is taxed at 5%.

    - After 31850, the capital gain is taxed at 15% - 5k – 1.85k = 3150, which is taxed at 15%
  - In this case, you saved 10% on the whole 5k (before 31850, you had 5%, not 15% and after 31850, you had 15%, not 25%)
- Now do how the code does it
- If TP has net capital gain, tax shall not exceed sum of A, B, and C
  - A
    - tax as if no (h) on the greater of
      - TI – NCG
        - NCG = NLTCG – NSTCL
        - LTCG = gain from capital asset held for over 1 year
      - So in our hypo, 35k – 5k = 30k
    - lesser of (figuring out if you're breached the 25% bracket or not)
      - amount of TI taxed below 25%, or
        - for us, thats 31.85k
      - TI reduced by adjusted NCG
        - Adjusted NCG = NCG – unrecaptured 1250 gain – 28% rate gain (collectible) + dividends
      - 35k – 5k = 30k
    - A = the greater of 30k and 30k = 30k
  - B
    - 5% of the adjusted NCG as does not exceed the 25% cutoff
      - So basically 5% of the adjusted NCG between i) and ii) in (A)
    - 31850 – 30k = 1.85k
    - so if there is any room between non NCG TI and the 25% cutoff, tax it at 5%
  - C
    - tax the rest of it at 15%
- Net capital gain = net capital gain plus dividend gain

<u>IRC64 – Ordinary Income Defined</u>
- OI = gain from sale which is neither a capital asset nor 1231 property.

<u>IRC65 – Ordinary Loss Defined</u>
- ordinary loss = loss from sale of property not a capital asset.

<u>IRC1211 – Limitation on Capital Losses</u>
- Corporations – capital loss can only displace capital gains
- individuals – Capital loss can only displace capital gains plus 3k of OI

<u>IRC1212(b) – Capital Loss Carrybacks and Carryovers: Other Taxpayers</u>
- If not a corporation
  - NSTCL – NLTCG = STCL
  - NLTCL – NSTCG = LTCL

<u>IRC1222 – Other Terms Relating to Capital Gains and Losses</u>
- STCG = gain for asset held less than a year
- STCL = loss for asset held less than a year
- LTCG = gain for asset held more than a year
- LTCL = loss for asset held more than a year
- NSTCG = STCG – STCL
- NSTCL = STCL – STCG
- NLTCG = LTCG – LTCL
- NLTCL = LTCL – LTCG
- capital gain net income = gains from capital assets – losses from capital assets
- net capital loss = losses from sale of capital assets – sum allowed under 1211
- **<u>net capital gain = NLTCG – NSTCL</u>**

Net short term sales separately from long term sales. Then you compare them to each other using the following table:

<table>
<tr><td></td><td colspan="3">Net Long Term</td></tr>
<tr><td rowspan="3">Net Short Term</td><td></td><td>Gain</td><td>Loss</td></tr>
<tr><td>Gain</td><td>NLTG = NCG taxed @5 or 15%

NSTG = OI ==> (1(h) is only for NCG)</td><td>NSTG – NLTL > 0 = Ordinary Income

NLTL – NSTG > 0 =
Basically, if you still have losses, the excess losses can be used to offset $3K of OI, and the balance carries forward as a LTCL</td></tr>
<tr><td>Loss</td><td>NLTG – NSTL > 0 = NCG taxed @ 5/15%

NSTL – NLTG >0 =
Basically, if you still have losses, the excess losses can be used to offset $3K of OI. If you have any left, then it carries forward as STCL</td><td>Combined to offset $3K of OI, the balance carried forward.</td></tr>
</table>

- (Note: character (ST or LT) carries forward)
- (Note: the 3k of OI is treated as a STCG!)
- NOTE: capital losses carry forward <u>indefinitely</u>

Examples
- LTG = 20k; LTL = (15k); STG = 6k; STL = (4k)
  - NLTG = 5k; NSTG = 2k
  - NCG = 5k taxed at 5 or 15; 2k taxed as OI
- LTG = 20k; LTL = (15k); STG = 6k; STL = (8k)
  - NLTG = 5k; NSTL = (2k)
  - NCG = 3k is taxed at 5 or 15
- LTG = 5k; LTL = (15k); STG = 6k; STL = (4k)
  - NLTL = (10k); NSTG = 2k
  - No net capital gain; you have long-term loss leftover of 5k. So you can offset 3k of OI with that, and 8k-3k = 5k LTL carries forward.

What is better STG or LTG?
- You want to reduce STGs because they are OI
- So you prefer short term losses because they get rid of short term gains, and you want to hold on to long term gains.

Tax Planning Problem
- TP has a LTG of 10k on X. He has 2 stocks: gain of10k of A he has had for less than a year and sell quickly and long term loss of 10k of B. A is STG of 10k.
  - If you sell B
    - 10k LTCG on X and (10k) LTCL on B
    - So no net capital gain
    - STG on A is taxed as OI
  - If you hold on to B and A
    - 2008: LTCG on X is taxed at 15%
    - 2009: LTCL on B and STCG on A cancel.
- **Moral of the story: isolate long term gains and use your losses to offset your short term gains**

B. Rationale

Rationales
- Informal inflation adjustment
- encourage investment
- alleviate bunching
- mitigate lock-in

Problems
- Regressivity – this generally benefits high income TPs

C. Statutory Requirements

i. Sale or Exchange

Note: Difference between "sale or disposition" in AR and "sale or exchange" in capital gain analysis

What if your factory burns down and insurance gives you 100k and you don't spend it on like-kind – then what?
- This is a disposition, but not quite a sale...

ii. Holding Period

IRC1223 – Holding Period of Property
- if basis carried over, then you include the time of holding of the first one – tack the holding period of the exchanged asset with the holding period of the acquired asset in the exchange
- So if you get an inter vivos gift, it has carry-over basis and you'll tack on the holding period.
- HOWEVER, 1223(9) says that if you get the property from a decedent, if the basis is determined under 1014 and the property is sold or disposed of within a year after the death, then the person is considered to have held the property for more than a year regardless of how long the decedent had it!
- This holding period is for determining whether its a LTCG

iii. Capital Asset

Note: **difference between capital asset and capital expenditure**
- Capital expenditure is immediately deducted as an expense or must be capitalized and recovered through depreciation or on sale
- capital asset is a term of art for when you are figuring out capital gains

a. Property Held for Sale to Customers

IRC1221(a)(7) – Capital Asset Defined
- Capital asset does not include
  - stock in trade which would be included in inventory
    - so real estate developer who buys huge lots of real estate – these are not capital assets
    - if you buy artwork for your house, its a capital asset, but if you're an art dealer, then probably not
  - any hedging transaction which is clearly identified as such before the close of the day on which it was acquired
    - Congress is saying you can treat the hedging as ordinary OR capital – you just have to choose up front.
- so it depends on the TP's purpose

Corn Products
- Note: Companies don't have capital gains preference. They can only offset capital losses with capital gains.
- CP is buying futures in corn to protect against shortages
  - a future is buying now – you bought it
  - an option is a right to buy, but isn't an obligation to buy.
  - Ex. Say the buy futures at $10 a bushel now. Later, the price is $12 per bushel. So they're ahead by $2.
    - so they had a choice – they didn't have to take delivery – they could sell it and even buy the corn at spot prices if they wanted.
- In 1940, they had a profit of 680k, and in 1941 they had a loss of 109k. They argue that these are capital assets so they can carry-back the loss.
- Argument that its a capital asset

- this is not manufacturing, which is their business
  - it is property, it is held by TP, and it is not inventory – they don't sell inventory
- they are saying they are speculators, they are buying and selling and making a profit – this is separate from their corn business
- This is an imperfect hedge – hedging protects against rises and falls
  - if they buy at $10 and it goes up to $12, then they can buy the corn or sell the K
  - it is imperfect because if they buy at $10 and it goes down to $8, they haven't protected themselves.
- Under our 4 rationales, it doesn't seem like this should be a capital asset
  - no concern with bunching
  - no lock-in effect
  - no inflation concerns
  - do we want to encourage investment in corn?
- Court: this is an integrated part of their business, so it should be taxed normally – lot of emphasis on business purpose.
- This is a "win the battle, lose the war" case for the IRS
- Potential whipsaw
  - if they price is bought at 10 and price drops to 8, they wouldn't sell the contract – they'd take the corn and put it in inventory! So they aren't just "investing in futures!"

Arkansas Best
- Before AB, CP could be read as a business exception to capital assets – if its for business, its not a capital asset
  - business exploited this: IRS wouldn't say anything if you bought stock and said it was a capital asset and the gain is a capital gain. BUT they do notice when you buy stock and call it ordinary income – but if you say its for your business, you can get losses!
- 1968 AB buys 65% stock in bank. They buy more stock in 72-74. In 75 they sell stock for ordinary loss – they can offset ordinary gains this way!
  - They 72-74 stock was to keep the company afloat, not to invest in it – they said this was ordinary loss.
  - Under Corn Products, this should be ordinary and not a capital asset
- PROBLEM with CP: potential whipsaw
  - the capital asset test becomes a subjective test – the IRS can't handle it!
  - We have seen subjective tests with bad debts, but this treatment is too big and important for these subjective tests.
- So S Ct said futures in CP were the inventory exception to capital assets is broad enough to include futures, not that capital asset is narrowly read!
  - The futures contracts in CP weren't inventory themselves, but were in the inventory process, so they fall into the inventory exception to capital assets.
- So there is no business exception

b. Real and Depreciable Property Used in Trade or Business

Note: Inventory exception makes the property income ordinary income. In 1221(a)(2), the exception is for gain on proprty subject to depreciation used in T or B – this is 1231 property!
- So this isn't falling out of capital asset into ordinary income, but it "falls" into the best tax treatment you can get
  - 1231 is the best tax treatment you can get

IRC1221(a)(7) – Capital Asset Defined
- Capital asset does not include
  - property used in T or B subject to the allowance for depreciation in 167 or real property used in T or B

IRC1231 – Property Used in the T or B and Involuntary Conversions
- (b) overlaps perfectly with 1221(a)(2) – property used in T or B subject to depreciation and real property for T or B
- stuff that falls into 1231
  - if things go well, and you have gains, then its a LTCG
  - if things go badly, and you get a loss, then treat it as ordinary loss
- ex. Building for business. AR = 100. Basis = 50. If it goes up in value, its LTCG. If it declines, the ordinary loss.
- Policy
  - Congress wants people to invest in their companies

- Suppose you have two 1231 assets – you net the gain and ordinary loss on all your 1231 assets and then see what you have – a LTG or an ordinary loss

<u>IRC1245 – Gain from Dispositions of Certain Depreciable Property</u>

- This provision fixes the problem where you take a deduction on 167 depreciable property against ordinary income, but then, if you have a gain, you get taxed at the capital gain rate! You save money!
- You treat as OCI the <u>recomputed basis</u> – <u>adjusted basis</u> to see what your previous depreciation deductions are
  - Recomputed basis is usually the original basis
- So **if you sell depreciable property at a gain**
  - split up the gain into the depreciation you've already taken and the rest of the gain
  - Tax the depreciation you've taken as ordinary income and then tax the rest at the capital gains rate.
- This is for PERSONAL PROPERTY that is 167 depreciable property
- ex. Machine with B = 100; AR = 250; Depreciation deduction = (50); so Gain = 200
  - split gain into 50 and 150
    - tax 50 at OI rate
    - tax 150 at CG rate
- we are **recapturing** the basis
  - we're not worried about present value of money issues
- If your gain is less than the old depreciation deduction, then its all ordinary – you recapture the depreciation deduction basis FIRST, then treat gain as capital gain
- Policy
  - Depreciation is an estimate of the loss in value of the asset. If you can sell it for a gain, then you depreciated too much, and need to give back the deduction you took.
  - If you sell for a loss, you didn't take enough depreciation, so you get to deduct whatever your further loss was.
- Real property
  - pretty complicated – you recapture the difference between straight-line depreciation and accelerated depreciation, but this is very little recapture

<u>1231</u> and <u>1245</u>

- if property is subject to both, then the first thin you do is, if you have gain on the sale, do 1245 and recapture the profit up to the amount of depreciation you've taken.
  - In some cases this is the end of the line because the profit does not exceed the depreciation you took
  - if you are above it, then you do exceed and you have LTCG
- 1231 – if you end up having a loss, then its an ordinary loss, not a capital loss, despite the fact that it would have been a LTCG.

D. Substitute for Ordinary Income

Key issue: when does something stop being property and start being income? When are we disposing of property, and when are we disposing of income?

<u>Hort</u>

- Hort is leasing property to bank. He takes $140k in consideration for ending the lease. He reported a loss of the difference between the present value of what he would have gotten from the lease and what he got.
- Claim: Lease is a property right. He is saying that they gave him 140k, but it was worth 160k, so he is claiming a loss of 20k
  - PROBLEM: he never had a basis of 160k to claim that loss! How does he have basis in this lease? Its like buying stock for 10, watching it go up to 30, then sell it at 20, and claim a loss of 10. Although there is an economic loss, he never turned this into income.
- So what about the 140k?
  - Court said this is a lump sum <u>substitute for ordinary income</u>
  - He basically carved out an interest, like in <u>Horst</u> – he hasn't sold the property subject to the lease!
  - But whats the difference between this and stocks
    - stocks are just the right to receive dividends...
- what if he sells the lease to me, but I wind up collecting less, is this a capital asset?

    - The lease is property – looks like a capital asset
- What about if Hort just accelerated the stream of payments that would have been ordinary – then it seems the lump sum payment is ordinary
- What if he sold the property subject to the lease? This lease would increase the value of the property.
    - The property would be the capital asset, and the increase due to the lease seems to be the capital gain.
- <u>If you sell a property subject to a lease, you get capital. If you cancel the lease and get collection, then its ordinary</u>
    - we have a <u>Blair</u> and <u>Horst</u> type situation – fruit and tree: property is the tree, and anything derived from it is the fruit.
    - So it'd be different if someone else's "tree" is just a lease.
    - You have to sell the "tree" for it to be a capital asset.
    - Hort carved out the lease.
- Note: <u>Prebola</u> – if you push this substitute for ordinary income idea to the extreme, nothing is a capital asset!

<u>McAllister</u>
- H sets up trust. Wife got a life estate in the trust when he died. R is the remainderman after W dies. Estate needs cash, so R buys out W's life interest in the trust for 55k.
- W claims a loss – present value of the life interest is much greater than 55k!
    - Note: Economic loss is NOT tax loss – if you wouldn't be taxed on the income, then you don't get a loss.
    - She has no basis in this life estate – how can she have a loss?
- Is the 55k ordinary income or capital asset?
    - Court sees life interest as property, not income.
- Compare to <u>Hort</u>
    - Hort carved out an interest – he kept the land. Here, she released all of her interest – her "tree." She retained nothing. <u>No carve-out</u>
    - If she just sold a 5 year interest in her life estate, then this would clearly be a carve-out, like <u>Blair</u>, and this would be income.
- Court has pretty much overruled this case in <u>Prebola</u>
    - Wife has this interest for life, then it goes to R. This thing is just one big carve-out - we are taking this one piece of income from the whole estate and packing it up: there is still more to the estate
        - so if W and R could have gotten together and sold everything in the trust, then it'd be property, not income...
    - Normally, the beneficiary of a life interest in a trust, under <u>Gavit</u>, only gets income – none of the basis goes to the life tenant. The basis goes on to the remainderman. As such, McAllister should not have been able to say this is a capital asset!
- Court's aim was to deny a) capital treatment and b) an offsetting basis, to one who disposes of a right to future income which has been carved out of a larger estate
    - <u>carved out interest rule</u> – is a shorthand for the substitute of ordinary income – carved out interests don't absorb any of the TP's property basis

Blair/Horst issue was with a transfer of property and determining who pays tax on the interest
Here, Hort/McAllister is also about property, but whether its capital gain or ordinary income

<u>P.G. Lake</u>
- Company owes president 600k. Instead of giving cash, it assigns him an interest – he gets a fraction of the oil producing property until the oil payments pay the debt off
- These oil payments might be an interest in land, but they are still ordinary income
- This case can stand for the proposition that you can't just bundle up 3 years of dividends from your stock and argue that they're capital assets.
- This case extended the rule of <u>Hort</u>
- Chirelstein says that this is just another carving-out thing – they carved out, they didn't sever.

<u>Prebola</u>
- Woman wins the lottery. She gets a few payments, then sells her K-right to the rest of the payments for a lumped sum.
- She argues that the K-right is a property right and that its a capital asset.
- Although this isn't a carve-out, court said this is a <u>substitute for ordinary income</u>: all she has done is accelerate the receipt of ordinary income.
- Court kind of overruled <u>McAllister</u>

- not the best overruling – McAllister was a life interest (carve-out) whereas this is everything

So basically we have a smell test: does this look/smell like a capital asset?

E. Deferred and Contingent Payments

<u>Ferrer</u>

- TP had 3 property interests in a dramatic performance K
  - 1) lease of the play – k right to take the novel and put it on stage
  - 2) some power over movie, tv, and radio production
  - 3) right to receive 40% of movie proceeds if it becomes a movie.
- TP's movie K
  - He gave up rights in the first contract, for
    - Acting services (and he got ordinary income for these services)
    - % of movie profits
- When movie producer gets % of movie profits, its clearly OI. Ferrer is arguing that when he gets the %, its capital because they are in return for
- Look to see if capital asset
  - Lease of play
    - This is capital asset treatment
    - He is more like a tenant than Hort in <u>Hort</u>
    - Ferrer had an equitable interest so its capital gain
  - Block movie rights
    - capital gain
    - this is something that is protected in equity – assign that as capital gain
  - % proceeds from movie
    - ordinary income
    - there is no equitable interest here

On exam, argue under carve-out analysis, smells like analysis, and equitable interest analysis (control?)