

# TAX OUTLINE

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12:00 PM

## • POLICIES

1. Taxes levied commensurate with one's ability to pay.
2. Fairness/Equity:
  - i. Horizontal Equity: persons who are similarly situated should be taxed in a similar fashion.
  - ii. Vertical Equity: persons whose situations are different should be taxed differently.
3. Efficiency: one should seek a balance between maximizing tax revenues and minimizing social costs of taxation.
  - i. *note*: this would violate horizontal equity.
4. Simplicity/Administrative Ease: it should not be so hard as to make it impossible to pay taxes or understand how to pay them.
5. Neutrality: the tax system should avoid unnecessarily shaping economic behavior.

## • GROSS INCOME (§ 61)

- **§ 61**: "all income from whatever source derived"
- **Haig-Simons**: gains or increases in wealth over a particular period regardless of whether spent on consumption or saved.
- **Glenshaw Glass (1)** undeniable instance of accession of wealth, **(2)** clearly realized, **(3)** over which the taxpayer has complete dominion.
- **Statutory Exclusions (IRC §§ 101-140)**:
  - Gifts (§ 102)
    - Excludes gifts from employers
  - Discharge of Indebtedness (§ 108)
  - Employee Benefits (§ 132, § 74(c), § 274(j))
  - Employee Achievement Awards. **§ 74(c)**
  - Rebates
- **Treasure Trove**: To the extent of its value in US currency, treasure trove constitutes gross income for the taxable year in which it is reduced to undisputed possession. (*Cesarini*)
- **Tax Payments by Employer (or any third party)**
  - The payment by the employer of the income taxes, assessable against the employee, constitutes additional taxable income to such employee. (*Old Colony Trust*)
- **Certain Situations**
  - **Extreme Home Makeover**: use 280A(g)
  - **Recovered Home Run Ball**
  - **Last Month's Rent**: Income
  - **Security Deposit**: Depends on the lease. If it's to offset costs and returns to the tenant, no. But if it can be credited towards rent, that's income. The critical distinction is whether the tenant still has a right to the funds. So long as she does, the landlord need not include it in gross income.

## • PROPERTY (§ 1001)

- **61(a)(3)**: gross income includes gains derived from *dealings in property*.
- **Realization**: such gains must be realized.
  - **1001(a)-(b)**: gains or losses from the sale or other disposition of property is calculated thusly:

□ Gains realized =	(Amount Realized - Adjusted Basis)
□ Loss realized =	(Adjusted Basis - Amount Realized)

- ◆ **Amount Realized** = Sum of Money Received + Fair Market Value of any Property (other than money) received in the transaction.
  - ◇ **FMV**: The proper basis for determining fair market value under the Code is the value of the property. (*Crane*)
  - ◇ *Note*: the amount included in gross income is not the amount realized, but the gain realized. This prevents being taxed for the amount of money already spent on the property sold.
- ◆ **Adjusted Basis** = Basis (**1012**), adjusted as provided in **1016**.
  - ◇ **Cost basis (1012)**: the amount the taxpayer has paid for, or invested in, the property
    - ▶ The cost basis of the property received in a taxable exchange is the fair market value of the property **received** in the exchange. (*Phila. Park*).
  - ◇ **Tax Cost basis (1.61-2(d)(2)(i))**: the fair market value of property acquired from other dealings used to purchase the property instead of cash.
  - ◇ **Gift Tax basis & Stepped-Up basis (§§ 1014, 1015)**: If taxpayer uses property received as a gift, the basis is the giver's adjusted basis at the time of gift (1015). If the taxpayer uses property received as a devise, the basis is the fair market value at the time of the giver's death (1014).
  - ◇ **Adjustments to Basis (§ 1016)**: The initial basis of property is adjusted *upward* for the cost of any improvements to the property and *downward* for cost recovery deductions (depreciation) allowed with respect to the property.

- **"sale or other disposition"**: depends on whether the taxpayer has experienced a **"realization event"**

Realization events	Not Realization events
<ul style="list-style-type: none"> <li>• Property sold for money or other property</li> <li>• Transfer of property to a creditor in satisfaction of a debt</li> <li>• Exchange of property for different property</li> <li>• Compensation by insurance or otherwise when property is destroyed, stolen or expropriated.</li> </ul>	<ul style="list-style-type: none"> <li>• Property gifted to relative or donated to charity, with nothing received in return.</li> <li>• Refinancing</li> </ul>

- **NOTE:** just because you lose on a property transaction, does not mean you can claim that loss. There must be a statute applying to that specific loss, like **165**.
- When you improve a home, the money you put into the home goes into the Basis, even if you borrow it.

- **Recognition**

- **1001(c):** All gains realized are recognized unless there is an exception in the Code.
  - These are called **non-recognition provisions** -- they do not permanently exclude gain from gross income, but merely postpone reporting the gain to a later year when the property received in the transaction is sold or disposed of in a taxable transaction.
  - **Non-recognition provisions**
    - ◆ **1041(a):** transfers incident to divorce
    - ◆ **1031:** like-kind exchanges

- **Impact of Liabilities in Property Transactions**

- A **loan** is the equivalent of a cash investment and therefore included in the basis of the asset if finances, regardless of whether it is a recourse or non-recourse loan.
- When the taxpayer sells the encumbered property, the **relief from debt** is realized for purposes of determining gain or loss realized.
- **The entire amount of nonrecourse debt must be included in amount realized, even if value of the property is less than the amount of the mortgage (Tufts).**

- **GIFTS & INHERITENCES (§ 102)**

- **General Rule (§ 102):** Gross income **does not include** the value of property acquired by gift, bequest, devise or inheritance.
- **Does not apply to income** from such property received (**102(b)**), or to property given by an employer (**102(c)**).
  - **Inter Vivos Gifts**
    - **Duberstein:** What was the primary purpose of the transfer? Gifts are given out of **detached and disinterested generosity**.
  - **Bequests, Devices and Inheritances**
    - **Gross income does not include:**
      - ◆ Property received under a will or under statutes of descent and distribution
      - ◆ Settlements obtained in will contest actions
    - **Gross income does include:**
      - ◆ Prizes, awards or scholarships (covered instead under **§§ 74, 117**).
        - ◇ **74(a) General rule:** Except as otherwise provided in this section or in section 117 (relating to qualified scholarships), gross income includes amounts received as prizes and awards.
        - ◇ **117(a) General rule:** Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization described in section 170 (b)(1)(A)(ii).
      - ◆ **Fees for executors and executrixes since it is compensation.**
        - ◇ The executor/trix can get around this by waving the compensation and taking the income as a bequest.
        - ◇ **But,** if the bequest is for services performed during the lifetime, such bequests are income. (*Wolder*).
      - ◆ **Exception: 274(j)** - employee achievement award exception, but must pass the test under this section. Must be **tangible personal property**, i.e., NOT CASH.
        - ◇ **274(j)(3)(A) Employee achievement award:** The term "employee achievement award" means an item of tangible personal property which is—
          - ▶ **(i)** transferred by an employer to an employee for length of service achievement or safety achievement,
          - ▶ **(ii)** awarded as part of a meaningful presentation, and
          - ▶ **(iii)** awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.
- **How to calculate basis:**
  - **Property acquired by gift:** generally the same basis the donor had in the property ("transferred basis") (**§§ 1015(a), 7701(a)(43)**), even if its worth more at the time of transfer. This means that any gain that accrued while the donor held the property shifts to the donee and then must be realized by the donee when she disposes of the property.
    - **Note: if the donee sells the property for a loss, the basis for calculating the loss is the lower FMV, not the basis.**
  - **Property acquired by inheritance:** The **fair market value** of the property on the date of decedent's death (§

**1014(a)(1)**). This wipes out any taxable gain the deceased had in the property if it appreciated. This incentivizes holding onto the property until death, rather than selling or making an inter vivos gift. Only the portion of the property that passes from decedent receives the "stepped-up" basis. In cases of community property, the surviving spouse will have a stepped-up basis in both halves of the property, even though only one half passed to him.

- **Tax Planning Considerations:** If one owns properties with varying bases and is interested in making inter vivos gifts, he should consider:
  - *giving away* properties with higher tax bases, and
  - *passing at death* properties with lower tax bases.
  - Exception (**1014(e)**): prevents one from "stepping up" tax basis by transferring property to one who dies and devises the property back within one year.
- **Property acquired as part gift/part sale:** the donee's basis is the higher of the donor's basis, or the amount the donee paid for it.

#### • DISCHARGE OF INDEBTEDNESS (§ 108)

- **General Rule (§ 61(a)(12)):** gross income *includes* discharge of indebtedness ("COD income", or cancellation of debt), or repayment of debt at less than its face amount.

- **Exceptions (§ 108)**

- **Contested Liability:** if a borrower disagrees with a lender over the amount owed and subsequently settles that dispute for a lower amount, the difference is not considered discharge-of-indebtedness income.
  - **Two Theories:**
    - ◆ **Zarim:** If a taxpayer disputes the *original amount* of a debt in good faith, a subsequent settlement of that dispute is treated as the amount of debt cognizable for tax purposes.
    - ◆ **Preslar:** contested liability applies only to those cases where the *amount* is contested, not its enforceability. Therefore, in cases where the amount owed is clear, but parties settle for a lesser amount because of questionable enforcement mechanisms, taxpayer cannot escape discharge of indebtedness income.
- **Student loan forgiveness - Rev. Rul. 2008-34 for law student loans.**
  - **108(f):** excludes discharged student loans if, among other things, the student whose loan is discharged works for a certain period of time "in certain professions." There is nothing in the Code explaining the meaning of this phrase. In *Porton v. Commissioner*, T.C. Memo 1993-73, the court said that "[t]he term 'certain professions' to which sec. 108(f)(1) applies are medicine, nursing, and teaching." That phrase was picked up in a more recent T.C. Summary opinion dealing with a law student. See *Moloney v Commissioner*, T.C. Summ. Op. 2006-53 n.5 (Apr. 17, 2006). Does this mean that section 108(f)(1) does not apply to Anna who is performing work in the legal profession, a profession other than the ones mentioned? The Service has issued Revenue Ruling 2008-34, which clarifies that law school loan forgiveness programs qualify for the section 108(f)(1) exception. See Rev. Rul 2008- 34, 2008-28 I.R.B. 76.
  - **Maloney:** law school "dual-payee" systems that write checks to both the graduate and the lender do not fall under "refinancing" programs and are thus not excluded from COD income requirements.
    - ◆ **Cain: this includes if a public organization helps you pay it off.**
- **Bankruptcy:** gross incomes does not include discharge of indebtedness income if the discharge occurs in a title 11 bankruptcy case (**§ 108(a)(1)(A)**)
- **Insolvency:** gross income does not include discharge-of-indebtedness income if the discharge occurs when the taxpayer is insolvent, to the extent he is insolvent (**§ 108(a)(1)(B)**).

#### **Conditions for applying Bankruptcy and Insolvency exceptions:**

- There are two options:
  - a) Taxpayer reduces certain tax benefits (AKA "tax attributes") by the amount excluded. The reductions must be done in the following order:
    - i) net operating losses
    - ii) certain tax credit carryovers
    - iii) capital loss carryovers
    - iv) adjusted basis of property
    - v) passive activity loss and credit carryovers, and
    - vi) foreign tax credit carryovers (**§ 108(b)(5)**).
  - b) Taxpayer does the same thing, except, instead of following this order, he reduces the adjusted basis of property by the amount excluded.
- **Effect:** there's more gain, or less loss to be calculated *later* by sale of the property but more benefits now by preserving tax attributes.
- **Debt Discharges Cloaked as Other Kinds of Income**
  - **General Rule:** Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules. (Rev. Rule 84-176, 1984-2 C.B. 34)
  - **Debt discharge by employer in lieu of compensation:** represents compensation under **§ 61(a)(1)**. Therefore the bankruptcy and insolvency exclusions under **§ 108** are unavailable.
  - **Debt discharge given as gift:** excluded from income under **§ 102**, but again **§ 108** would not apply and therefore there would be no reduction in tax attributes.
    - **Rules for gifts apply,** meaning must discern intent before ruling something is a gift.
- **Tax Treatment for Lenders who Discharge Debts**
  - Lender may be entitled to a **bad debt deduction** under **§ 166**.
    - A **business bad debt**, whether partially or entirely worthless, is deductible as an "ordinary" loss to the extent

- charged off by the lender.
      - A **non-business bad debt**, if entirely worthless, is deductible as a "short term capital loss."
    - Two requirements must be met for a deduction:
      - (1) there must be a bona fide debt (*See 1.166-1(c)*), and
      - (2) the debt must be worthless within the tax year.
- **FRINGE BENEFITS (§ 132)**
  - **Generally**, they are included in gross income, subject to the **exclusions** below.
  - **§ 132 Exclusions**
    - **No-Additional-Cost Services (§ 132(b))**: service provided to an employee which the employer ordinarily provides to customers and which it is able to provide to the employee at no substantial additional cost, including foregone revenue.
      - **Limitations**:
        - ◆ Service must be in the line of business in which the employee works. (132(c)(4))
        - ◆ Not available to highly compensated employees unless it is widely available to other employees as well (132(j)(1)).
      - **Special Allowances**:
        - ◆ Spouses and dependent children, retired and disable employees, and the surviving spouses of deceased employees, are entitled to the exclusions
      - **Note**:
        - ◆ **rebate checks** work the same way. Treas. Reg. § 1.132-2(a)(3)-(4).
        - ◆ **free air travel**: if employees get a free seat on a plane that was full, they can still deduct 20% of the cost under a **qualified employee discount**.
    - **Qualified Employee Discount**: a reduction in the retail price given to an employee on qualified services or property not in excess of either the employer's gross profit percentage or, in the case of services, not in excess of 20% of the retail price (132(c)(1)).
      - **Note**: The gross profit percentage is determined by subtracting the aggregate costs from the aggregate sales to derive a gross profit of and dividing it by the aggregate sales. IRC § 132(c)(2)(B).
      - **Limitations**:
        - ◆ Service must be in the line of business in which the employee works. (132(c)(4))
        - ◆ Not available to highly compensated employees unless it is widely available to other employees as well (132(j)(1)).
      - **Special Allowances**:
        - ◆ Spouses and dependent children, retired and disable employees, and the surviving spouses of deceased employees, are entitled to the exclusions
        - ◆ Airline employees and parents of airline employees can exclude the value of free or reduced air travel.
    - **Working Condition (a)(3), (d)**: a benefit given to an employee which, if the employee paid for the benefit, it would entitle the employee to a deduction as a business expense (§ 162) or depreciation expense.
      - **Examples**:
        - ◆ Business travel
        - ◆ Depreciation of an employee-owned auto used for the business
      - **Special Allowances**: not subject to non-discrimination rules of § 132(j)
    - **De minimis**: the benefit is so small that's it's not worth accounting for (132(e)(1)).
      - **Special Allowances**: not subject to non-discrimination rules of § 132(j)
    - **Frequent Flyer Miles**: service will not seek to tax those miles so long as they are not converted to cash.
  - **Other § 132 Exclusions**:
    - Qualified transportation fringe - (a)(5)
    - Qualified moving expense reimbursement - (a)(6)
    - Qualified retirement planning services - (a)(7)
    - On premises athletic facilities - (j)(4)
  - **Other Exclusions provided elsewhere in the Code**:
    - Housing for ministers of religion (§ 107)
    - Education subsidies (§§ 117, 127)
    - Combat pay (§ 112)
    - Health plans (§§ 105, 106)
    - Term life insurance (§ 79)
    - Dependent care assistance (§ 129)
    - Adoption assistance (§ 137)
    - Disaster relief payments (§ 139)
    - Health savings accounts (§ 223)
  - **Meals or Lodging for the Employer's Convenience**
    - **§ 119** excludes from an employee's gross income the value of **employer provided** meals and lodging when those benefits are provided **as condition of employment for the convenience of the employer**.
      - **119(a)(1-2)** - the **meals** must be served on the business premises and the **lodging** must be on the business premises.
    - **Additional Allowances**:
      - Applies to spouse and dependents of the employee as well
    - **Requirements: <---- must satisfy all of these**

- Must be furnished on the business premises of the employer.
    - Acceptance of the lodging must be a condition of employment, and
    - the lodging must be on the employer's business premises (with some exceptions).
  - **Employment Related Payments from Third Parties**
    - **Free Samples:** no income need be reported as long as the recipient does not seek a charitable gift deduction for a subsequent transfer of the property.
    - **Free travel to induce traveler to do business with the company:** there is authority for the traveler to exclude the income - *if it was for the convenience of the payor. (Gotcher)*
- **BUSINESS EXPENSE DEDUCTIONS (§ 162)**
  - **§ 162 Trade or Business Expenses**
    - Authorizes the deduction of "**ordinary and necessary expenses**" arising from the "**carrying on**" of any **trade or business**."
    - "**ordinary and necessary**"
      - **Includes:** supplies, employee uniforms, utility bills, business lunches (subject to the 50% limitation), consultants' fees, contractors' fees (such as janitors), professional dues, journal subscriptions, travel between different offices, etc. **Note:** also includes **customary** expenses, such as a magazines in a doctor's office.
      - **Business Attire:** must be **(a)** specifically required for employment and **(b)** is not suitable for general usage as ordinary clothing.
    - "**expenses**" vs. "**expenditures**"
      - An **expense** is an expenditure that benefits the current year only.
      - A **capital expenditure** (§ 263) is an expenditure that benefits more than the current year.
      - **IOW:** Even an expenditure that is clearly for the purpose of making money may not be currently deductible if the expenditure will help produce income over a longer period of time than the current year.
    - "**carrying on**"
      - **§ 162** permits deductions only for those costs paid or incurred in connection with any **active, ongoing business** and denies current deductibility for start-up or pre-opening costs incurred prior to the beginning of actual business operations.
        - ◆ **Welch:** It's not necessary that the taxpayer's trade or business be of the same type as that engaged in by the person on whose behalf the payments are made.
      - **§ 195** permits taxpayers to deduct up to \$5,000 of start-up expenditures with the remainder deductible over 15 years. A **start-up expenditure** is an amount paid in connection with investigating the create or acquisition of a business and other expenses incurred preliminarily to actively engaging in the business. The expenditure involved must be one that would be otherwise deductible under § 162.
    - "**trade or business**"
      - To be engaged in a trade or business, **(1)** the taxpayer must be involved in the activity with continuity and regularity, and **(2)** the taxpayer's primary purpose for engaging in the activity must be for income or profit.
        - ◆ These are questions to be determined by the trier of fact.
        - ◆ Activities like hobbies will not qualify as a trade or business but might be covered under **§ 183**.
        - ◆ **§ 262:** Must not be personal, family or living expenses.
  - **Education expenses**
    - Deductible under **§ 162** if they are incurred:
      - in order to **maintain or improve skills** in a trade or business in which the taxpayer is already engaged, or
      - to meet the requirements of one's employer or of one's profession as a condition to retention of employment.
      - **IOW:** the employee must be educating in order to **retain** employment, not **advance** or **change** it.
    - Not deductible if they are incurred to:
      - enter a line of business, or
      - meet the minimum requirements to qualify to enter a trade or business.
  - **Travel Expenses**
    - **§ 162(a)(2)** authorizes the deduction of "traveling expenses ... while away from home in the pursuit of a trade or business."
    - **Where is "home"?**
      - **Service:** The taxpayer's home is where the taxpayer's **principle place of employment** is located. See Rev. Rul. 54-147, 1954-1 C.B. 51 (providing home is where the greatest amount of the taxpayer's earnings arise).
      - **1st Circuit:** Employ a functional test that focuses on whether duplicate living expenses arise from business necessity. If such duplicate expenses do occur, the court may then look to a variety of factors such as length of residence and amount earned in the location to determine which location should be deemed the taxpayer's home.
    - **The Sleep or Rest Rule**
      - The only **meal expenses** covered by **§ 162(a)(2)** are those involving a lengthy period of rest or an overnight stay away from home.
      - **Does not apply** to transportation expenses associated with business such as plane fares or automobile mileage.
      - **Expenses for meals at which business is conducted** are typically separately deductible under the main rule of § 162(a) as an ordinary and necessary business expense, but they must involve clients or customers and not merely one's work colleagues.
    - **Temporary Reassignments**
      - By and large, the employee's expenses are deductible under § 162(a)(2) while living in a temporary location,

however the service set one year as the limit for such a temporary assignment.

- **Limitations**

- **Meals**

- ◆ **274(n)(1)** places a **50%** limit on the deductibility of business meals contained in the section.
      - ◇ **Exceptions to the 50% limit:** employees may deduct 100% of reimbursements for meal costs.
  - **§ 280A** limits the deductibility of expenses related to home offices and vacation homes used as rental properties.

- **INVESTMENT EXPENSES (§ 212)**

- **§ 212** allows deduction of **ordinary and necessary expenses** incurred or paid for **(1)** the production or collection of income, **(2)** the management of income producing property, or **(3)** in connection with the determination, collection, or refund of taxes.
  - **Typical items covered include:** office rent, custodial services, investment counsel fees, and tax preparation fees.
  - **Capital expenditures** may not be deducted under § 212 just as they may not be deducted under § 162.
    - Typical example: broker's fees, since when it's paid upon the acquisition of stock, it's added to the cost basis of the stock, which pays off over several years.
  - **Broker's fees**
    - **Spreckles:** broker's fees at acquisition are not deductible. Instead they are added to basis as a cost of acquisition and thus capitalized.
    - **Treas. Reg. § 1.263(a)-2(e):** The fees at time of sale are not deductible since they reduce the amount realized.

- **CAPITAL EXPENDITURES (§ 263)**

- **Defined:** those expenditures to create or acquire long lived assets and those expenditures that either "add to the value, or substantially prolong the useful life" of property, or "adapt property to a new or different use."
- **General Rule:** May not be immediately deducted.
- **Tests to Determine whether expense must be capitalized:**
  - **"Separate-and-Distinct" Asset Test (*Lincoln Savings*):** any expenditure that serves to create or enhance a separate and distinct asset must be capitalized.
  - **"INDOPCO" test:** If an expenditure gives rise to **future benefits (beyond the year in which the expense is incurred)**, even if it does not give rise to a separate and distinct asset, capitalization is required.
    - **This does not include:**
      - ◆ Advertising costs (deductible under § 162)
        - ◇ **Revenue Ruling 92-80:** although advertising costs are deductible, they must be capitalized if the costs produce a **tangible asset** such as a billboard or sign.
      - ◆ Incidental repair costs as business expenses (deductible under § 162)
      - ◆ Severance payments due to business downsizing
      - ◆ Employee training costs
        - ◇ **Exception:** Costs of employee training must be capitalized in unusual circumstances where the training provides benefits significantly beyond those traditionally associated with normal training.  
**See Rev. Rul. 96-62.**

- 1. **Costs of Acquiring, Constructing, and Disposing of Property**

- i. **Acquisition Costs**

- Costs incurred in the acquisition of an asset having a useful life extending beyond the taxable year are nondeductible capital expenditures. This includes:
      - ◆ Purchase price
      - ◆ Appraisal fees
      - ◆ Commissions
      - ◆ Accounting
      - ◆ Legal fees

- ii. **Construction Costs**

- The costs of constructing property which has a useful life beyond the taxable year must be capitalized. This includes costs that would otherwise be immediately deductible, including:
      - ◆ Wages paid to construction workers
      - ◆ Rent paid for construction tools
      - ◆ Interest paid on construction loans
      - ◆ Equipment depreciation allocable to the taxpayer's construction of capital facilities

- iii. **Disposition Costs**

- The costs of selling or otherwise disposing of property are not deductible when paid or incurred; rather they must be capitalized. This includes:
      - ◆ Sales commissions
      - ◆ Fix-up costs
    - The disposition costs are either added to the basis of the disposed property or subtracted from the amount realized.
    - **Exceptions:**
      - ◆ **Removal costs** (retiring, removing or discarding property) are generally deductible in the year the asset is retired and the costs are incurred.
      - ◆ **Package designs** are deductible.

## 2. Costs in Defending and Perfecting Title to Property

- The costs incurred in **defending or perfecting title** to property are considered to be a part of the cost of the property and they must be capitalized.
- The tax treatment of **litigation costs** varies depending on the nature of the litigation. To be immediately deductible, litigation costs must not have their origin in the acquisition or disposition of an asset.

## 3. Costs of Repairing and Improving Property

- **Capitalized:** Expenditures for replacements or improvements (that "add to the value, or substantially prolong the useful life, of property" or that "adapt property to a new or different use").
- **Deducted:** Expenditures for repair and maintenance ("incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition").

## 4. Costs of Advertising

- **Deducted:** ordinary business advertising
- **Capitalized:** when advertising is directed toward obtaining future benefits significantly beyond the current year.

## 5. Costs of Acquiring or Creating INTANGIBLE Assets

### i. Acquisition Costs

- A taxpayer is required to capitalize amounts paid to *acquire* an intangible asset. Examples include:
  - ◆ Ownership interests in corporations, partnerships and other entities
  - ◆ Debt instruments
  - ◆ Options to provide or acquire property
  - ◆ Leases
  - ◆ Intellectual property
  - ◆ Franchises

### ii. Creation Costs

- A taxpayer is required to capitalize amounts paid to *create* an intangible asset. These include:
  - ◆ Financial interests (ownership interests in corporations, partnerships and other entities)
  - ◆ Debt instruments
  - ◆ Options to provide or acquire property
  - ◆ Prepaid expenses
  - ◆ Certain memberships and privileges
  - ◆ Certain rights obtained from a government agency. **Treas. Reg. § 1.263(a)-4(d)(5).**
  - ◆ 1.263(a)(4): not salaries if it's only part of the individual's job.
- A taxpayer is required to capitalize amounts paid to create or enhance a ***separate and distinct intangible asset***. These include:
  - a) A property interest of ascertainable and measurable value in money's worth
  - b) That is subject to protection under applicable state, federal, or foreign law, and
  - c) The possession and control of which is intrinsically capable of being sold, transferred, or pledged (ignoring any restrictions imposed on assignability)
- **EXCEPTIONS:**
  - ◆ Under the **12-month rule**, a taxpayer is not required to capitalize amounts if the amounts do not create any right or benefit for the taxpayer that extends beyond the earlier of:
    - i) 12 months after the first date on which the taxpayer realizes the right or benefit, or
    - ii) the end of the taxable year following the taxable year in which the payment is made
      - ▶ **Treas. Reg. § 1.263(a)-4(f)(1).**
  - ◆ An amount paid to create a **package design** is not treated as an amount that creates a separate and distinct intangible asset. **Treas. Reg. § 1.263(a)-4(b)(3)(v).**

### iii. Transaction Costs

- **Capitalization is required** for amounts paid to **facilitate** the acquisition or creation of an intangible asset if the amount is paid in the process of investigating or otherwise pursuing the asset.
  - ◆ **Facilitation** is demonstrated by asking *whether the amount would or would not have been paid but for the transaction.*
- **Capitalization is not required** for:
  - ◆ **employee compensation and overhead costs related to the acquisition or creation of an intangible**
  - ◆ *de minimis* transaction costs (not exceeding \$5K)

### ○ **Section 263A**

- **This covers above and beyond 263(a), things like indirect costs, where it wasn't clear under 263(a) what must be deducted and capitalized.**
- Capitalization is required of all **direct and indirect costs** allocable to construction or production of real property or tangible personal property.
  - **Direct costs include:** costs of materials that become an integral part of the asset produced and those materials that are consumed in the production process, as well as compensation paid for full-time, part-time, and contract labor.
  - **Indirect costs include:** purchasing costs, storage costs, depreciation, rent, taxes, insurance, utilities maintenance, and interest on debt.
- **Costs not included under 263A:**
  - Selling and distribution costs such as marketing, selling, and advertising costs.
  - Costs incurred in the rendition of services, even if they result in the production of tangible personal property because production of property is incidental to the services rendered.

- **Qualified Creative Expenses:**

- **263A(h)** provides that qualified creative expenses are not required to be capitalized.
  - ◆ **A qualified creative expense includes:** any expense paid or incurred by an individual in the trade or business of being a writer, photographer, or artist, which, except for the uniform capitalization rules of § 263A, would otherwise be deductible for the taxable year.
  - ◆ **A qualified creative expense does not include:** any expense related to printing, photographic plates, motion picture films, video tapes, or similar items.

- **DEPRECIATION (§ 167)**

- **Defined:**

- **In an economic sense,** depreciation is the decline in value of an asset **due to wear and tear and obsolescence.**
  - **Simon:** The test is whether property will suffer exhaustion, wear and tear, or obsolescence in its use by a business.
- **In a tax sense,** depreciation is a deduction from gross income to permit the taxpayer to recover the cost of that asset.

- A. Depreciation of Tangible Property**

- **§ 167** authorizes the depreciation of tangible property:
  - used in a trade or business, or
  - held for production of income.
    - ◆ **This does not include:**
      - ◇ inventory
      - ◇ personal use (personal residence)
  - **Limitations:**
    - ◆ **Only property that is subject to wear and tear or obsolescence.**
    - ◆ Bare land is not depreciable.
- **General Rules:**
  - The amount depreciated is limited to the basis in the asset, which is usually cost
  - For personal use property converted to business use, the base is the value of the property at the date of conversion
  - Taxpayer is entitled to recover full value, even if it still has value at the end of the recovery.
  - Basis in depreciable property **must be reduced** by the greater of the amount allowed (claimed) or allowable (could have been claimed). Therefore, if taxpayer does not take deduction, basis is reduced nevertheless.

- B. § 168 Calculating a Depreciation Schedule:**

- **Takes over from § 167 and turns "depreciation" into "cost recovery"**
- **Step 1: Ascertain the applicable convention (§ 168(d))**

- **Applicable Convention**

- ◆ **Note:** depends on when you put the property into service or use.

<b>Tangible Personal Property (d)(1)</b>	<b>Real Property (d)(2)</b>
Half-year	Mid-month

- **Step 2: Ascertain the applicable recovery period (§§ 168(c), (e), Rev. Proc. 87-56)**

- **Applicable Recovery Period**

- ◆ Artificial recovery periods for all tangible property.

<b>Residential Real Estate</b>	<b>Non-residential real-estate</b>	<b>Cars &amp; Trucks</b>
◆ <b>Defined:</b> 80% of the income it produces comes from <i>dwelling units</i> (living accommodations largely used for long-term occupancy). (§ 168(e)(2)(A)(ii))	<b>Defined:</b> office buildings, factories, stores, hotels and motels (§§ 168(e)(2)(B), 1250(c))	
27.5 years (§ 168(c))	39 years (§ 168(c))	7 years

- **Step 3: Ascertain the applicable depreciation method (§ 168(b))**

- **Applicable Depreciation Method**

<b>Straight-Line</b>	<b>Double (200%) Declining Balance</b>	<b>150% Declining Balance</b>
<ul style="list-style-type: none"> <li>• Ratable cost of recovery over the applicable recovery period</li> <li>• Straight-line % = 100/Applicable Recovery Period</li> <li>◆ Applies to depreciable real property</li> </ul>	<ul style="list-style-type: none"> <li>1. Take the straight-line %, double it</li> <li>3. apply it to the basis reduced by all prior years' deductions for depreciation.</li> <li>• Accelerates the largest part of deductions to the earliest years of recovery period</li> <li>• Must switch to straight-line method if it yields a greater deduction</li> <li>• Applies to any tangible property with a recovery period under 15</li> </ul>	<ul style="list-style-type: none"> <li>• Applies to tangible personal property with recovery period between 15 and 20 years.</li> </ul>

- **BONUS DEPRECIATION (§ 179)**

- **§ 179 property**

- **Defined (§ 179(d)):** tangible property *or* off-the-shelf computer software which is **§ 1245 property** (depreciable personal property) and which is purchased for the **active conduct of a trade or business**.
    - **Purpose:** To encourage economic investment, it grants additional depreciation deductions in the year of acquisition.
    - **Limitations:**
      - **Maximum Allowable:** \$125,000.
        - ◆ This amount is reduced dollar-for-dollar by the amount by which the cost of qualifying property placed in service during the tax year exceeds \$500,000.
      - The amount eligible to be expensed cannot exceed the taxable income derived by the taxpayer from the active conduct of any trade or business.

- **AMORTIZATION OF INTANGIBLE PROPERTY (§ 197)**

- **§ 197:** 15-year recovery period for many types of **PURCHASED** intangible property

- **Includes:** Good will, Going concern value, Customer lists, Patents, Copyrights, Licenses, Covenants not to compete, Franchises, Trademarks, Trade names, Etc.
    - **Those not listed** are governed by pre-§ 197 law (i.e., § 167).

- **DEDUCTIBLE PERSONAL EXPENSES: CASUALTY AND THEFT LOSSES (§ 165)**

- **§ 165(c)(1-2): Generally,**

- **One may deduct** losses arising from business and investment activities.
    - **One may not deduct:**
      - losses or expenses that arise from personal concerns.
      - Personal residences
      - Non-property losses, such as future earnings due to physical injury
        - ◆ *But these may be excluded from gross income* (§ 104(a)(2)).
      - **Exception:**
        - ◆ **Personal property converted into an investment property by renting it out:** any loss recognition is limited to losses that arose *after* the residence was converted. (**§ 1.165-9(b)(2)**)
    - **Blackman**
      - **Bars to Casualty Loss Deductions:**
        - gross negligence
        - willful damage
        - knowingly damaging
      - **Not Bars to Casualty Loss Deductions:**
        - Negligence

- **The Personal Casualty Loss Deduction**

- **165(c)(3):** authorizes the deduction of personal losses "if such losses arise from fire, storm, shipwreck, or other *casualty*, or from theft."
      - **Casualty Losses** arise when there is damage or destruction of property by **sudden**, unexpected, or unusual events (*Ruecker*). **These include:** natural disasters (floods, earthquakes, hurricanes, tornados, volcanic eruptions), mine cave-ins, sonic booms, vandalism and car accidents.
    - **Deductions allowed:**
      - Taxpayer demonstrates *permanent* degradation of neighborhood quality (*Finkbohner v. Commissioner*, 11th Circuit)
    - **Deductions not allowed:**
      - Temporary declines in market value
      - Indirect damages
      - Damages developing slowly from insect infestations, dry rot, and disease (Rev. Rul. 59-102, 1959-1 C.B. 200).

- **Measuring the Loss ...**



- **... when property is totally lost:**

- The amount of loss is calculated in reference to either the:
        - ◆ **property's adjusted basis**, or
        - ◆ **property's decline in market value**
        - ◆ **whichever is LESS.**

- **... when property is damaged but not rendered worthless:**

- the difference between its fair market value before the disaster and its fair market value after the disaster, unless that exceeds the taxpayers adjusted basis in the property.
      - **Note:** improvements to real property are regarded as integral components and have no separate basis for computing loss (§ 1.165-7(b)(2)(ii)).
      - **Effects of Reimbursements:** The amount of the taxpayer's loss is reduced by any
        - **§ 1.165-1(c)(4):** reimbursements received on account of the loss.

- **§ 1.165-1(d)(2)(i):** claim for reimbursement for which there is a reasonable prospect of recovery.
  - Other forms of reimbursement, including: condemnation awards, disaster relief grants, cancellation of disaster relief loans.
    - ◆ **Exception:** insurance payments and disaster relief grants for out-of-pocket expenses (*Spak v. Commissioner*).
- **Restrictions on the Deduction**
  - **The \$100 Threshold**
    - **§ 165(h)(1):** Casualty losses for personal use properties are subject to a \$100 threshold before consideration for deduction, meaning one cannot deduct the first \$100 of any casualty loss.
    - **§ 1.165-7(b)(4)(ii):** \$100 applies separately to each loss event
  - **The 10% of AGI Threshold**
    - **§ 165(h)(2)(A):** If the losses exceed the gains, the taxpayer has a "net casualty loss" which is then only deductible to the extent it exceeds 10% of her AGI, after applying the \$100 haircut
- **Adjustments to Basis for Casualty Loss Deduction and Reimbursements**
  - **§ 1016(a):** A reimbursement for damages to a piece of property reduces one's basis in the asset to the extent of the reimbursement. **Note:** only the amount of the "deductible loss" reduces basis, so the part of the loss that is disallowed by the \$100 threshold and the 10% AGI threshold will not reduce basis.
  - **§ 1.162-4:** Similarly, if the taxpayer spends that reimbursement restoring the home, she may be entitled to basis increase.
- **OTHER DEDUCTIBLE PERSONAL EXPENSES**
  - Most of these deductions are *itemized*.
  - **Investment interest**
    - may only be deducted to the extent of "**net investment income.**" (§ 163(d)(1))
    - The excess carries over to later years. (d)(2).
    - **Note:** the interest is always a part of the investment in the asset you are trying to acquire.
  - **Qualified Residence Interest**
    - **§ 163(a)** authorizes the deduction of all interest paid or accrued within the taxable year on indebtedness.
      - **Limitations**
        - ◆ **163(h)(1):** "personal interest" is not deductible.
          - ◇ **Exceptions**
            - ▶ **interest on a "qualified residence" (163(h)(2)(D))**
              - ▶ **Explanation:** This allows for a deduction of home mortgage interest.
              - ▶ **Two kinds of qualified residence interest: § 163(f)(3)(A)**
                - **(1) acquisition indebtedness:** debt which is incurred to acquire or improve a *qualified residence*, which is secured by the residence. This includes refinancing, so long as the refinanced funds go back into the home (163-h-3-B). It is limited to \$1,000,000. (\$500,000 for married couples filing separately).
                - **(2) home equity indebtedness:** any indebtedness, other than acquisition indebtedness, secured by a qualified residence to the extent it does not exceed the fair market value of the residence minus any acquisition indebtedness. There is a \$100,000 limit. (\$50,000 for married couples filing separately).
                  - ◆ **Note:** under this prong, you can take a loan against the home to pay for something else and still deduct the interest.
                  - ◆ **Note:** any amount over the *acquisition indebtedness* limit may qualify for the *home equity indebtedness*.
              - ▶ **qualified residence:**
                - the taxpayer's personal residence, and
                - one other residence
                  - ◆ **280A(d)(1):** the 2nd residence must be used 14 days a year or 10% of the number of days it is rented out (whichever is greater).
                  - ◆ **§ 163-10T(p)(3)(ii):** it may include trailers and boats.
              - ▶ **points paid on home acquisition indebtedness (461(g)(2))** if the points are **pre-paid**. If you add them to the loan, you cannot deduct them. So, if you can, it's always best to pre-pay from your own savings so you can deduct right away.
                - ▶ **Limitations:**
                  - must be on **personal residence**
                  - points must have been paid from personal funds, rather than merely withholding them from the loan
                  - does not include points paid to refinance
      - **State & Local Taxes**
        - **§ 154(a)** authorizes the deduction of state, foreign, and local property and income taxes on a taxpayer's federal income tax return. Taxpayers have the option of deducting state and local sales tax instead (164(b)(5)), which benefits those living in states without income taxes.
      - **Charitable Contributions**
        - **§ 170(a)(1)** authorizes a deduction for *charitable contributions* to certain charities.

- **Moving Expenses**
  - **§ 217** allows a deduction for expenses involved in moving in order to change or find a job.
    - **Limitations:**
      - ◆ must arise from need to find or change jobs
      - ◆ the new job must be more than 50 miles farther from the taxpayer's former residence than the distance between the former residence and the former place of work. IRC § 217(c)(1).
      - ◆ taxpayer must be employed in the new location for 39 weeks in the 12 months immediately following the move. If self-employed, the taxpayer must be so employed 78 months of the next 24 months (217(c)(2)).
      - ◆ if a deducted moving expense is reimbursed by the taxpayer's employer, the reimbursement must be reported as income. **Exception:** the taxpayer can exclude the reimbursement from income if she also forgoes the deduction (132(a)(6), (g)).
    - Expenses deductible include:
      - ◆ cost of moving household goods, and
      - ◆ cost of moving oneself and one's family.
    - Does not include:
      - ◆ meals (217(b))
- **Medical Expenses**
  - **§ 213(a)** permits the deduction of medical care expenses of the taxpayer, the taxpayer's spouse, and dependents.
    - **General Rule:** For an expense to be deductible, it must both be:
      - ◆ **(1)** an essential element of treatment, and
      - ◆ **(2)** not otherwise been incurred for nonmedical reasons.
      - ◆ Otherwise, it is a nondeductible personal expense under § 262.
      - ◆ *Jacobs v. Commissioner*
    - **Limitations:**
      - ◆ limited to that part of the otherwise deductible medical expenses that exceeds 7.5% of one's AGI.
    - **Includes:** (213(b), (d)(1))
      - ◆ Prescription medications
      - ◆ Doctor's costs
      - ◆ Insurance
      - ◆ Laboratory tests
      - ◆ Hospitalization
      - ◆ Some medical related travel (213(d)(2))
      - ◆ Eyeglasses (§ 1.213(e)(1)(iii))
      - ◆ Seeing eye dogs (§ 1.213(e)(1)(iii))
      - ◆ Prosthetic limbs (§ 1.213(e)(1)(iii))
      - ◆ Wheelchairs (§ 1.213(e)(1)(iii))
      - ◆ Medically necessary improvements to property, such as air conditioning, but only to the extent it does not enhance the value of the property (*Gerard v. Commissioner*).
        - ◇ **Rev. Rul. 87-106:** Expenditures for the following purposes generally do not increase the fair market value of a personal residence and thus generally are eligible in full for the medical expense deduction when made for the primary purpose of accommodating a personal resident to the handicapped condition of the taxpayer, the taxpayer's spouse, or dependents who reside there:
          1. Constructing entrance or exit ramps to the residence
          2. Widening doorways at entrances or exist to the residence
          3. Widening or otherwise modifying hallways and interior doorways
          4. Installing railing, support bars, or other modifications to bathrooms
          5. Lowering or making other modifications to kitchen cabinets and equipment
          6. Altering the location of or otherwise modifying the electrical outlets and fixtures
          7. Installing porch lifts and other forms of lifts (generally this does not include elevators as they enhance the value of property and any deduction would have to be decreased as such)
          8. Modifying fire alarms, smoke detectors, and other warning systems
          9. Modifying stairs
          10. Adding handrails or grab bars whether or not in bathrooms
          11. Modifying hardware on doors
          12. Modifying areas in front of entrance and exit doorways, and
          13. Grading of ground to provide access to the residence.
            - Only **reasonable costs** incurred to accommodate a personal residence to the handicapped condition are considered to be incurred for the purpose of medical care or are directly related to medical care for purposes of § 213.
    - **Not included:**
      - ◆ Most elective cosmetic surgery (213(d)(9))
        - ◇ **Rev. Rul. 2003-57:** Medical care does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or a disfiguring disease.
          - **Breast Surgery:** Breast reconstruction surgery is elected to **ameliorate a deformity directly related to a disease** (breast cancer).

- **Laser Eye Surgery:** Cost is allowed for deduction because the surgery is a procedure that *meaningfully promotes the proper function of the body*. Eye surgery to correct defective vision, including laser eye surgery, corrects a dysfunction of the body, and is therefore deductible as an expense.
- **Teeth Whitening:** The teeth-whitening procedure does not treat a physical or mental disease or promote the proper function of the body, but is directed at improving one's appearance, and therefore not deductible as an expense.
- **Sex Changes: 134 T.C. No 4:** deductible if needed to cure gender identity disorder.

- **DEDUCTION HIERARCHY**

- **Gross Income --> AGI (includes ATL deductions) --> Itemized or Standard --> Exemptions --> Taxable Inc.**

- **ABOVE THE LINE DEDUCTIONS (§ 62):**

- Trade or business expenses (§ 162, Chap. 7)
- Investment expenses (§ 212, Chap. 7)
- Business and investment losses
- Depreciation expenses (§ 168, Chap. 9)
- Alimony (§ 71, Chap. 31)
- Moving expenses (§ 217, Chap. 11)
- Certain expenses associated with attending college
- A few more...

- **Also includes (a):**

- (2) Certain trade and business deductions of employees
  - (A) Reimbursed expenses of employees
  - (B) Certain expenses of performing artists
  - (C) Certain expenses of officials
  - (D) Certain expenses of elementary and secondary school teachers
  - (E) Certain expenses of members of reserve components of the Armed Forces of the United States
- (3) Losses from sale or exchange of property
- (4) Deductions attributable to rents and royalties
- (5) Certain deductions of life tenants and income beneficiaries of property
- (6) Pension, profit-sharing, and annuity plans of self-employed individuals
- (7) Retirement savings
- (9) Penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits
- (10) Alimony
- (11) Reforestation expenses
- (12) Certain required repayments of supplemental unemployment compensation benefits
- (13) Jury duty pay remitted to employer
- (14) Deduction for clean-fuel vehicles and certain refueling property
- (16) Archer MSAs
- (17) Interest on education loans
- (18) Higher education expenses
- (19) Health savings accounts
- (20) Costs involving discrimination suits, etc.
- (21) Attorneys fees relating to awards to whistleblowers

- **BELOW THE LINE DEDUCTIONS (§ 63(a), § 67)**

- **ITEMIZED DEDUCTIONS (§ 63)**

- Interest (§ 163)
- Property and state income taxes (§ 164)
- Casualty losses (§ 165)
- Charitable deductions (§ 170)
- Medical expenses (§ 213)

- **MISCELLANEOUS DEDUCTIONS (§ 67)**

- **Limitations:** deductible only to the extent they exceed **2%** of the taxpayer's AGI.
- **Most common:**
  - ◆ **§ 162** un-reimbursed **employee business expenses**.
  - ◆ Tax preparation fees
  - ◆ Other expenses:
    - ◇ To produce or collect income that must be included in your gross income,
    - ◇ To manage, conserve, or maintain property held for producing such income, or
    - ◇ To determine, contest, pay, or claim a refund of any tax.
    - ◇ Appraisal fees for a casualty loss or charitable contribution.
    - ◇ Casualty and theft losses from property used in performing services as an employee.
    - ◇ Clerical help and office rent in caring for investments.

- ◇ Depreciation on home computers used for investments.
  - ◇ Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust.
  - ◇ Fees to collect interest and dividends.
  - ◇ Hobby expenses, but generally not more than hobby income.
  - ◇ Indirect miscellaneous deductions of pass-through entities.
  - ◇ Investment fees and expenses.
  - ◇ Legal fees related to producing or collecting taxable income or getting tax advice.
  - ◇ Loss on deposits in an insolvent or bankrupt financial institution.
  - ◇ Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed to you.
  - ◇ Repayments of income.
  - ◇ Repayments of social security benefits.
  - ◇ Safe deposit box rental.
  - ◇ Service charges on dividend reinvestment plans.
  - ◇ Tax advice fees.
  - ◇ Trustee's fees for your IRA, if separately billed and paid.
- **STANDARD DEDUCTIONS (63(c)(2)(B)):**
    - **Married couple filing jointly:** \$6,000
    - **Surviving spouse:** \$6,000
    - **Head of Household:** \$4,400
    - **Single/Married filing separately:** \$3,000
    - **Blind and old persons:** additional \$1,100. (§ 63(f)(1))
- **PERSONAL AND DEPENDENCY EXEMPTIONS (§ 151, 152)**
    - **Personal Exemption:** an automatic deduction to which most taxpayers are entitled.
      - **2010:** the exemption was \$3,650.
      - **Code: \$2,000 for self and each dependent**
      - **As a married couple, filing jointly, you would get 2 exemptions + dependents.**
      - **Blind** taxpayers and those **over age 65** are entitled to an additional \$600 exemption. 63(f)(1).
    - **Dependents (§ 152(a)):**
      - **qualifying child (§ 152(c)):**
        - ◆ **Requirements:**
          - ◇ Must have **proper relationship** to taxpayer:
            - ▶ Biological children
            - ▶ Adopted children
            - ▶ Stepchildren
            - ▶ Descendants of these persons
            - ▶ Siblings and the descendants of siblings
            - ▶ Missing children. § 152(f)(6).
          - ◇ Must have **same residence** as taxpayer more than half the year.
          - ◇ Meet **age** requirements
          - ◇ Must not have provided more than one-half of **his or her own support for the year.**
            - ▶ Waived for children's scholarships and handicapped persons.
          - ◇ **No older** than 18 (23 if in college).
            - ▶ Waived for disabled persons. § 152(c)(3)(B).
            - ▶ **See 1.152-1(b)**
              - ▶ Applies to any individual who lives with the taxpayer and is a member of the taxpayer's household during the **entire taxable year** of the taxpayer.
              - ▶ "The taxpayer and dependent will be considered as occupying the household for such entire taxable year notwithstanding **temporary absences** from the household due to special circumstances."
        - ◆ **Tie Breakers:**
          - ◇ **(1) parentage**
            - ▶ The **parent.**
            - ▶ If **neither person is the parent**, the one with the higher AGI gets the exemption.
            - ▶ If **both claimants are parents**, the one with whom the child resided for long period of time during the year gets the exemption.
            - ▶ If the period of residence with each parent was **equal**, the parent with the **higher AGI** gets the exemption.
          - ◇ **(2) children of divorced parents **Special Rules for Divorced Parents (152(e))****
            - ▶ The custodial parent may transfer the exemption to the other parent by way of a written release. § 152(e)(2).
            - ▶ The custodial parent is the parent who has custody of the child for the greater portion of the year.
        - **qualifying relative (§ 152(d)):**

- ◆ **Requirements:**
  - ◇ Must have **proper relationship** to taxpayer **(d)(2)**:
    - ▶ Child or descendent of child
    - ▶ Sibling (including step siblings)
    - ▶ Parent or ancestor of parent
      - **Note:** need not live in same household
    - ▶ Step parent
    - ▶ Niece or nephew
    - ▶ Aunt or uncle
    - ▶ Most in-laws
    - ▶ A person who has shared the taxpayer's home for the year and is a member of the taxpayer's household. **((2)(H))**
  - ◇ Must have **less gross income** than the exemption amount **(\$2,000)**
  - ◇ Must **receive more than half of their support** from the taxpayer.
    - ▶ § 152(f)(4) disregards this requirement for handicapped persons.
  - ◇ **Dependents** of one taxpayer cannot be a qualifying relative of another **taxpayer** (not just another individual).
  - ◇ Your relationship must not violate **local law**.
    - ▶ **Note:** being an illegal alien *does not* have anything to do with the relationship between the two individuals.

## • RECORDING METHODS

- **Businesses** are obliged to use the accrual method.
  - **Exceptions:**
    - Taxpayers with \$1,000,000 or less in annual gross receipts **(Rev. Proc. 2000-22)**.
    - Certain taxpayers with \$10,000,000 or less in annual gross receipts **(Rev. Proc. 2002-28)**.
- **THE CASH METHOD**
  - **Income under the cash method:** Income is reported when it is **actually** or **constructively** received. This applies to receipts in the form of property or services.
    - **"Cash Equivalence" doctrine:** The receipt of an instrument such as a **check** that is readily negotiable at or near its face value is treated the same as the receipt of cash. **Treas. Reg. § 1.451-1(a); Kahler**
      - ◆ **IOUs:** Not current income if:
        - ◇ There is a substantial risk of non-payment, and
        - ◇ No third-party is likely to be willing to buy the IOU for anything approaching its face value.
    - **"Constructive Receipt" doctrine:** an item is **constructively received** when it is credited to the taxpayer's account or set aside for him and there is no substantial restrictions on his control **(1.451-2(a))**.
      - ◆ **Relevant Facts:**
        - ◇ Payment is located hundreds of miles away
        - ◇ No advanced notice of payment coming
        - ◇ Cannot acquire possession in that year
      - ◆ **Lotteries: 451(h): An exception to constructive receipt,** if the payout is over a period of 10 years or more the option to take a lump sum payout is to be disregarded, meaning not all the income must be deducted in the current year when the taxpayer is receiving the payments over so many years.
  - **Deductions under the Cash Method:** the deduction is taken when the expense is paid. The mailing of a check is sufficient.
    - **Prepayment of Expenses (§ 263)**
      - ◆ **General Rule:** taxpayer must capitalize prepaid expenses and amounts paid for certain contract rights.
      - ◆ **Main Limitation:** principle of **capitalization**. An expenditure that benefits more than one accounting period must be capitalized and recovered over the life of the asset acquired through the expenditure.
        - ◇ **Example:** Prepayment of rent.
      - ◆ **Exception: 12-month rule** - taxpayer is not required to capitalize amounts if the amounts do not create any right or benefit for the taxpayer that extends beyond the **earlier of:**
        - ◇ 12 months after the first date on which the taxpayer realizes the right or benefit, or
        - ◇ The end of the taxable year following the taxable year in which the payment is made.
      - ◆ **Interest Expenses:** prepayment of interest on debt will not increase the deduction. Instead, the deduction must be taken as the interest accrues **(461(g)(1))**.
        - ◇ **Exception:** payment of points on mortgage for one's home (Chapter 11).
- **THE ACCRUAL METHOD**
  - **Income under the accrual method:** income is generally included in the taxable year in which all events have occurred fixing the right to the income and in which the amount of the income can be determined with reasonable accuracy. This is known as **"the all events test."** IOW, income is reportable when it is earned.
    - **Prepayments:** taxpayer has income when cash is received, even if services have yet to be rendered, which would seem to not follow the all events test. **Schlude.**
      - ◆ **Exceptions (Artnell, p. 185):** season ticket sales - taxpayer was ultimately permitted to accrue the income as the games were played since this approach clearly reflected its income **(Rev. Proc. 71-21,**

**1971-2 C.B. 549).** But it must be in that next tax year. That's as long as you can defer.

- **Deductions under the accrual method:** taken in the year in which all events have occurred establishing the fact of liability and the amount of liability and in which economic performance has occurred with respect to the liability (**1.461-1(a)(2)(i)**). Economic performance occurs when the person to whom the liability is owed performs his end of the bargain. **§ 461(h)(1) & (2)**.

- **Inventory Accounting**

- ◆ **Multiple shipments into inventory:**

- ◇ **FIFO (first in-first out):** assumes that the first widgets purchases are the first ones sold
- ◇ **LIFO (last in-first out):** assumes that the most recently purchased widgets are the first ones sold.
- ◇ Profit from both will even out over time.

- **Principles Applicable to BOTH methods:**

- **The claim of right doctrine:** earnings held under an unrestricted claim of right must be currently reported as income when received even if another person is asserting a claim to those same funds. **North American Consolidated.**
- **The tax benefit rule:** If a taxpayer properly takes a deduction in one year and in a later year recovers the amount deducted, then usually the taxpayer must take the amount of the recovery into income.
- **Cain - 280E:** No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business consists of trafficking in controlled substances.

- **TAX RATES**

- **The Rate Structure of Ordinary Income**

- **Two rate structures**

- **ordinary income**
- **capital gains**

- **ORDINARY INCOME**

- **The Basic Rates**

- ◆ **§ 1(a-d):** basic tax rates (see **TABLE, p. 203**)

- ◇ **(a):** Married Individuals Filing Jointly & Surviving Spouses

- ▶ **Notes:**

- ▶ When spouses file a joint return they are jointly and severally liable for the resulting tax liability. **§ 6013(d)(3)**.

- ◇ **(b):** Heads of Households

- ◇ **(c):** Unmarried Individuals (other than surviving spouses or heads of households)

- ◇ **(d):** Married Individuals Filing Separate Returns

- ◇ **(e):** Estates & Trusts

- ◆ **Marginal tax rate:** the highest rate applicable to a person's income

- ◆ **Effective tax rate:** the percentage of one's total income that one pays in taxes.

- **Determining Marital Status (determined under 7703)**

- ◆ **§ 7703:** determined at year's end

- ◆ **§ 2(b)(2)(A):** a person who is legally separated from her spouse under a decree of divorce or separate maintenance is not considered married for federal tax purposes.

- ◆ **§ 2(b)(2)(B):** a person whose spouse is a non-resident alien is also not considered married for tax purposes.

- ◆ **7703(b):** sometimes if a married couple lives apart for an extended period, they are treated as unmarried for tax purposes.

- ◆ **§ 2(b)(2)(C):** a person whose spouse died during the tax year is treated as married for tax purposes for that tax year.

- ◆ **Domestic partners:** Those legally married cannot file joint returns as that right is reserved to husbands and wives (**§ 6013(a)**).

- ◇ **Poe v. Seaborn:**

- ▶ In community property states each spouse should be taxed on half of their aggregate earned income if they file separately.

- ▶ those living in community property states who are same sex registered domestic partners, may file as single and split their income 50/50 since the state grants SSDPs community property status.

- ◆ **Surviving Spouse**

- ◇ **In General:** the surviving spouse may get the benefit of the rate structure applicable to married couples filing jointly for a limited time.

- ◇ **Limitations:**

- ▶ **§ 2(a)(1)(A):** Taxpayer's spouse must have died in one of the two immediately preceding years.

- ▶ **§ 2(a)(1):** the taxpayer must maintain a household and provide over half the cost of such maintenance.

- ▶ The taxpayer's household must constitute the principal place of abode for one or more children of the taxpayer

- ▶ **§ 2(a)(1)(B)(i-ii):** The children must be qualified dependents of the taxpayer under **§ 152(a)(1)** for whom the taxpayer can claim deductions under **§ 151(c)(1)**.
- ▶ **§ 2(a)(2)(A):** The taxpayer cannot have remarried before or during the taxable year in question.

□ **Head of Household**

- ◆ **In General:** A head of household is an:
  - ◇ unmarried person who is
  - ◇ not a surviving spouse and
  - ◇ who has a child or other dependent at home
  - ◇ and pays more than 50% of the household **§ 2(b)**.
- ◆ **SSDP:** since with community property everything's 50/50, there is no one paying more than 50% of the household, so you need to transmute the income into a non-community property account.
  - ◇ This requires transferring the money to a separate account and agreeing that it becomes separate property.

- **Kiddie Tax (1(g)):** subjects unearned income of children under the age of 18 to the child's parent's marginal tax rate no matter what the source of the income.

• **TAX CREDITS**

- A **credit** reduces tax liability dollar for dollar, not by any percentages or rates.
- **Refundable vs. Non-Refundable Tax Credits**
  - **Non-Refundable:** reduces one's tax liability no lower than zero
  - **Refundable:** triggers a payment from the government to the taxpayer if the credit exceeds her tax liability.
- **Non-Refundable Credits (taken before refundable credits)**
  - **Note:** look for phase out rules on these.
  - **The Dependent Care Credit (§ 21):** provides a credit equal to the *applicable percentage* of a taxpayer's employment related dependent care expenses.
    - **Qualifying Individuals:**
      - ◆ (1) dependents of taxpayer **under age 13**.
      - ◆ (2) spouse or a defendant of the taxpayer who is **mentally or physically disabled**.
  - **The Child Tax Credit (§ 24):** establishes a tax credit for each *qualifying child* of the taxpayer.
    - Currently **\$1,000**.
    - **Qualifying child:**
      - ◆ (1) § 152 dependent
      - ◆ (2) under the age of 17
      - ◆ (3) who is *closely related* to the taxpayer.
  - **The Hope Scholarship Credit and the Lifetime Learning Credit**
    - **§ 25(f)(1):**
      - ◆ qualified tuition and related fees.
      - ◆ at an eligible institution of higher learning
      - ◆ for a taxpayer who is the student, the student's spouse, or if the student is the taxpayer's dependent
      - ◆ **Exception:** cost of housing and books not included
      - ◆ **§ 25A(g)(2):** eligibility reduced by amounts received as scholarships, but not student loans. If the student is paying with a loan, she may also be entitled to a § 221 interest payment deduction.
      - ◆ Cannot qualify for both simultaneously. The HSC overrules the LLC.
    - **Hope Scholarship Credit**
      - ◆ Only available for first two years of college
      - ◆ Limited to 100% of the first \$1,000 of qualified tuition and related expenses and 50% of the next \$1,000. **Max: \$1,500**
      - ◆ **Note:** phase out rules of **25A(d)**
      - ◆ **Restriction:** not allowed to those convicted of drug felonies in the current year. 25A(b)(2)(D).
      - ◆ **Application:** per student (can apply to more than one student per taxpayer)
    - **Lifetime Learning Credit**
      - ◆ Not limited to first two years
      - ◆ Limited to 20% of the first \$10,000. **Max: \$2,000**
      - ◆ **Note:** no limitation for drug felony convictions, as there is with the HSC.
      - ◆ **Application:** per taxpayer, not per student, so even if one taxpayer is supporting multiple students, she may only apply the credit to one.
- **Refundable Credits**
  - **The Credit for Withholding on Wages**
    - **§ 31** is the classic refundable credit, entitling taxpayer to a credit for taxes withheld from his paycheck.
    - **§ 6401(b)** provides that any tax paid in excess of the amount actually owed is an "overpayment."
    - **§ 6402(a)** says that overpayments, with a few exceptions, shall be refunded.
  - **The Earned Income Credit**
    - **§ 32** is intended to encourage people earning at or near the poverty level to continue to work rather than go

on welfare by providing a credit to those people. It plateaus the more they make.

- **Calculating it:**
  - the initial credit is determined by multiplying the credit percentage in section 32(b)(1)(A)
  - times the earned income amount in section 32(b)(2)(A)
  - this figure is then reduced by the phaseout percentage in section 32(b)(1)(A) multiplied times the excess of the taxpayer's earned income over the phase out amount in section 32(b)(2)(A).

- **CAPITAL GAINS**

- Step 1: Determine whether a loss is deducted or a gain is included in gross income
- Step 2: Characterize the gain or loss as either *capital* or *ordinary*.

- **LONG TERM CAPITAL GAINS: § 1222(3)**

- Gains **(1)** from the sale or exchange **(2)** of a capital asset **(3)** held for more than one year.

- **(1) The sale or exchange requirement**

- Has broad meaning.

- **(2) The capital asset requirement**

- **§ 1221(a):** all property held by the taxpayer (whether or not connected to a trade or business),

- ◇ **EXCEPT:**

- ▶ **(1) Inventory and Inventory-like Property**

- ▶ Stock-in trade

- ▶ Inventory

- ▶ Property held by the taxpayer **primarily for sale to customers** in the ordinary course of a trade or business.

- ▶ **(2) Property, Used in a Trade or Business, of a Character Which is Subject to the Allowance for Depreciation Provided in § 167, or Real Property Used in the Trade or Business (1221-a-2)**

- ▶ **Therefore, if it's not subject to § 167 depreciation or § 197 amortization, it can be capitalized.**

- ▶ Includes land, buildings, and depreciable equipment used in a taxpayer's business.

- ▶ Includes patents and copyrights

- ▶ **(3) Self-created Copyrights and Similar Property (1221-a-3)**

- ▶ Copyrights, literary, musical, or artistic compositions, and similar property ***held by the creator***, or a taxpayer with a basis carried over from the creator.

- ▶ **Purpose:** consistent with taxing wages and salaries as ordinary income.

- ▶ **Does not include self-created patents**, which may be ***capitalized***.

- ▶ **(4) Accounts Receivable for Service or Inventory (1221-a-4)**

- ▶ This includes mostly money owed to the taxpayer for services rendered or inventory-like property sold.

- ▶ **(5) Federal Publications (1221-a-5)**

- ▶ Effectively precludes a charitable tax deduction if such items are donated to libraries or other charitable organizations.

- ▶ **(6) Hedging Transactions (1221-a-7)**

- ▶ Excludes certain hedging transactions (i.e., those clearly identified as such before the close of the day on which they were acquired or entered into.)

- ▶ When the property becomes connected to the company in such a way that it is integral to the every day trade or business, it cannot be a capital asset, even though it otherwise would be.

- ▶ **(7) Supplies Used in a Trade or Business (1221-a-8)**

- ▶ Supplies regularly used or consumed by the tax payer in the taxpayer's trade or business are not capital assets.

- **(3) The Holding Period Requirement**

- ◆ A **long-term capital gain** requires a holding period of more than one year (1222-3).

- ◆ In computing the holding period, the taxpayer must disregard the day of acquisition, but may include the day of sale.

- ◆ In certain circumstances, the taxpayer can tack on to his or her actual holding period:

- ◇ (1) the period during which another taxpayer held the same property (as in a gift), or

- ◇ (2) the period during which he or she held other similar property.

- **Special Characterization Provisions**

- **Some provisions** supply one or more of the three requirements to a long term capital gain.

- **Some provisions** require the taxpayer to recognize ordinary income even if all the elements for capital gains treatment are otherwise satisfied.

- **Determining the Appropriate Capital Gains Rate on "Net Capital Gain"**

- **(a) 28 Percent Rate Gain**

- ◆ **§ 1(h)(5):** Includes gain from the sale of "collectibles", which includes artworks, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages and other collectibles as defined by § 408(m).

- ◆ **§ 1(h)(7):** Includes gains from the sale of small business stock described in **§ 1202** that was not excluded under that section.
  - ◆ **Note:** If a taxpayer is in a bracket lower than 28%, any 28-percent rate gain would be taxed at that lower rate just as would the taxpayer's ordinary income.
  - **(b) Unrecaptured § 1250 Gain (taxed at 25% max) (§ 1(h)(1)(D))**
    - ◆ **§ 1(h)(6):** Includes long-term capital gain attributable to depreciation allowed with respect to depreciable real estate held for more than one year.
    - ◆ **Note:** If taxpayer is in a lower bracket than 25%, any unrecaptured § 1250 gain would be taxed at a lower rate just as would the taxpayer's ordinary income.
  - **(c) Adjusted Net Capital Gain**
    - ◆ **§ 1(h)(3):** includes any capital gain that does not fall under one of the two categories above.
    - ◆ Broadest category, including long-term capital gains from the sale of most assets (real estate, stocks, bonds, etc.).
    - ◆ **Rates:**
      - ◇ **15%** if the taxpayer's ordinary marginal tax rate is 25%, 28%, 33%, or 35%.
      - ◇ **0%** if the taxpayer's ordinary marginal tax rate is 10% or 15%.
  - **When Purchasing Multiple Assets for One Large Sum ...**
    - **Allocate the price to assets according to § 1060.**
      - ◆ **(a) General rule:** In the case of any applicable asset acquisition, for purposes of determining both—
        - ◇ **(1)** the transferee's basis in such assets, and
        - ◇ **(2)** the gain or loss of the transferor with respect to such acquisition,
      - ◆ the consideration received for such assets shall be allocated among such assets acquired in such acquisition in the same manner as amounts are allocated to assets under section 338 (b)(5). ***If in connection with an applicable asset acquisition, the transferee and transferor agree in writing as to the allocation of any consideration, or as to the fair market value of any of the assets, such agreement shall be binding on both the transferee and transferor unless the Secretary determines that such allocation (or fair market value) is not appropriate.***
- **CAPITAL LOSSES**
- **§ 165(f):** the deduction of capital losses is restricted by §§ 1211 and 1212.
    - **§ 1211(b):** capital losses, whether long term or short term, may be deducted to the extent of capital gains (whether long term or short term).
    - To the extent capital losses exceed capital gains in a given tax year, up to **\$3,000** of the excess can be used to offset ordinary income in that year.
    - **§ 1212(b)(1):** Capital losses not allowed because of the § 1211(b) limitation may be carried over into subsequent tax years.
      - Treated as if they arose in that year and deemed short term or long term, just like they would have been treated in the original year.
    - **§ 1212(b)(2):** net short term losses must be used first to offset the \$3,000 of ordinary income permitted by § 1211.
  - **Which capital losses offset which long-term capital gains? § 1(h)(4):**
    - **Short-term** capital losses are applied to reduce **short-term capital gains**. Any excess (i.e., a net short-term loss) is
      - first applied to reduce gain taxed at 28% (28% rate gain).
      - next applied to reduce gain taxed at 25% (unrecaptured § 1250 gain)
      - finally applied to reduce gain taxed at 15% (adjusted net capital gain)
    - **Long-term** capital losses are generally allocated to their related category of long-term capital gain.
      - Long-term capital losses from the sale of collectibles are applied to reduce any gain from the sale of collectibles.
      - Long-term capital losses not resulting from the sale of collectibles will be applied generally to gains taxed at 15%.
- **QUASI CAPITAL ASSETS (§ 1231)**
- **§ 1231 Exception** applies to **two types** of transactions:
    - **§ 1231(a)(3)(A)(i):** the sale or exchange of "**property used in the trade or business.**"
      - **Includes:**
        - ◆ **(1) depreciable** business property **held for more than one year** or **(2) real property** used in business that has been held more than one year. **§ 1231(b)(1)**
        - ◆ Intangibles amortized under § 197 because such assets are treated as property subject to the allowance for depreciation under § 167.
      - **Excludes:**
        1. Inventory
        2. Property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, and
        3. Copyrights, literary, musical, or artistic compositions, or similar property if held by the creator or a taxpayer with a basis carried over from the creator. **§ 1231(b)(1)(A-C)**
    - **§ 1231(a)(3)(A)(ii):** the **involuntary or compulsory conversion** of (1) **property used in the trade or business** held for **more than one year** or (2) capital assets held for more than one year in connection with a trade

or business.

- **Includes:**
  - ◆ loss or destruction of property from casualties and thefts
  - ◆ condemnations and eminent domain (compulsory conversions)

○ **The Mechanics of § 1231**

1. Place in an **imaginary basket** or **principle hotchpot** all § 1231 gains and losses that occur during the year.
2. Net those gains and losses to determine their overall character.

|                           |   |
|---------------------------|---|
| 1231 gains > 1231 losses  | all gains and losses treated as <b>long-term capital gains and losses. § 1231(a)(1)</b> |
| 1231 gains <= 1231 losses | all gains and losses are <b>ordinary</b> .  |

3. Special rule for involuntary conversions
  - **Involuntary conversions** are not subject to § 1231 if the total involuntary losses exceed the involuntary gains.
  - **Step 1:** place all § 1231 gains and losses from involuntary conversions in a **preliminary basket**.

|   |   |
|---|---|
| Involuntary losses > involuntary gains  | Losses and gains are treated as <b>ordinary</b> .   |
| Involuntary losses <= involuntary gains | Losses and gains drop into the <b>principle hotchpot</b> for netting with all other § 1231 gains and section 1231 losses. |

○ **Recapture of "Net Ordinary Loss"**

- **§ 1231(c):** if a taxpayer's § 1231 gains exceed his § 1231 losses for a year, the excess ("net § 1231 gain") must be **recaptured** and treated as ordinary income to the extent of any net § 1231 losses from the preceding five years which have not previously been recaptured.

• **RECAPTURE OF DEPRECIATION**

○ **Tangible Personal Property (§ 1245)**

- **What it boils down to:** Figure out what the gain is on the disposition. How much was due to depreciation? That portion is ordinary income.

- **§ 1245 recapture** comes into play whenever **section 1245 property** is **disposed of. § 1245(a)(1)**

□ **Meaning of "§ 1245 Property"**

- ◆ **§ 1245 Property:** depreciable personal property, generally.
- ◆ **Includes:**

- ◇ Tangible personal property
- ◇ Intangible personal property subject to the allowance for the depreciation under § 167 (separately acquired patents and copyrights)
- ◇ Intangible personal property that is subject to 15-year amortization under § 197 (acquired trademarks and trade names)

□ **Meaning of "Disposed Of"**

- ◆ **§ 1245 does not apply to:**

◇ **Gifts. 1245(b)**

- ▶ **But,** if the individual later sells the gift, she will be required to recapture as ordinary income any gain attributable to the depreciation deductions claimed by the taxpayer. **1245(a)(2)(A)**

◇ **Conversions** from business to personal use

- ▶ **But,** if the taxpayer later sells the item, gain from the sale will be categorized as ordinary income (under § 1245) to the extent of previous depreciation deductions taken.

- ▶ **Note:** conversions, while not triggering 1245 recapture, may trigger **§ 179(d)(10)** recapture if a § 179 deduction was taken with respect to the property. In that case, the amount included in ordinary income is the benefit derived from electing § 179 treatment. This amount is then added to the basis of the property at the time of conversion.

▶ **Spouses**

- ▶ **§ 1041:** There is no gain on transfers of property between spouses. It is not a taxable transaction. It's treated as a gift.

□ **Mechanics**

- ◆ The amount treated as ordinary income under § 1245 is generally **the lower of:**

- ◇ **(1) recomputed basis** minus **adjusted basis**, or
- ◇ **(2) amount realized** minus **adjusted basis**.

- ◆ **Recomputed Basis:** the property's adjusted basis recomputed by adding back all the depreciation or amortization adjustments reflected in the adjusted basis. **§ 1245(a)(1)(A)**

- ◇ **Note:** this is typically the property's original basis.

- ◇ The taxpayer must give back not only depreciation deductions under **§ 167** and amortization deductions under **§ 197**, but also amounts expensed under **§ 179**.

○ **Real Property (§ 1250)**

- **Statutory Mechanics:**

- **Ordinary Income = applicable percentage of the lower of:**
  - ◆ (1) additional depreciation, or
  - ◆ (2) the excess of amount realized on the sale over adjusted basis.
  - ◆ **Additional depreciation**, in the case of property held for more than one year, is defined as depreciation adjustments in excess of what would be allowed under the straight line method.
- **§ 1250(b)(1)**
- **In other words, depreciations on these properties are treated as long term capital gains, rather than ordinary income.** This is because the property appreciates *while* it's depreciating.
- **Note: This does not go in the 1231 hotchpot because it's special.**
- **Applicable Percentages**
  - **"Unrecaptured 1250 Gain":** long-term capital gain from the sale of depreciable real property attributable to depreciation deductions taken that are not recaptured as ordinary income. **§ 1(h)(6)**
    - ◆ **These are taxed at 25%.**
- **Characterization Under § 1239**
  - Under **§ 1239**, any gain recognized on the direct or indirect sale or exchange of property between related parties will be treated as ordinary income if such property is, in the hands of the transferee, subject to the allowance for depreciation provided in **§ 167**.
  - **No part of the gain** may be recognized as capital gain.
  - **Purpose:** prevents taxpayers from selling low-basis, high-value depreciable property to a related party in order to step up the property's basis in the hands of the related transferee (for depreciation purposes) at the low cost of a capital gains tax to the transferor.
  - **"Related persons"** include an individual and a corporation if the individual owns 50% or more of the outstanding stock of the corporation. **§ 1239(b)**.
    - ◆ **To determine whether a transferor and transferee are related parties**, the constructive stock ownership rules of **§ 267(c)** should be applied. For example, under the rules, a taxpayer constructively owns stock that is owned by his or her children.
  - **Note: § 1239** comes into play only when the property sold is, in the hands of the transferee, subject to the allowance for depreciation provided in **§ 167**. This would include **patent applications (1239(e))**, and **§ 197 intangibles**.
- **CHARITABLE CONTRIBUTIONS (§ 170)**
  - **Charitable contributions** are gifts **to** or **for the use of** an organization described in § 170(c).
    - Such **organizations** include "corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes." **501(c)(3)**.
    - **Limitations:**
      - There can be no required consideration passing from the charity to the donor for the deductible part of a contribution. **§ 1.170A-1(c)(5)**
      - There is no charitable deduction for the contribution of services to charity. **§ 1.170A-1(g)**
    - **Allowances:**
      - Out of pocket expenses related to contributions of charitable services are deductible.
  - **The Structure of the Code: Sluices and Gates**
    1. **Defining Terms**
      - **Public Charity (PC):** any charity described in § 170(b)(1)(A).
      - **Disfavored Private Foundations (DPF):** certain private foundations, they tend to rely on a very limited number of donors for their funding and tend to simply pass money on to more active charities.
      - **Contribution Base (CB):** generally the same as the taxpayer's adjusted gross income. § 170(b)(1)(G)
      - **Long-term capital gain (LTCG):** in addition to normal LTCG, also includes § 1231 gains. § 170(e)(1)
    2. **Apply § 170 in the sequence below:**
      - 1) **Section 170(e)**
        - ◆ Determine the amount of cash and the fair market value of the property contributed.
        - ◆ Exclude any gain that is characterized as ordinary by operation of §§ 64, 1221, or 1245.
        - ◆ **Public Charities**
          - ◇ If the contribution is a gift to a public charity of tangible personal property unrelated to its charitable purpose, the LTCG is excluded. **§ 170(e)(1)(B)(i)(I)**.
          - ◇ If tangible personal property *is* related to the public charity's purpose, the LTCG is excluded if the property is sold by the charity in the year in which the contribution is made. § 170(e)(1)(B)(i)(II)
            - ▶ If such property is sold by the charity within 3 years, the donor must include in income (in the year of disposition) an amount equal to the excess of the donor's deduction over the donor's basis in the property at the time of contribution. § 170(e)(7)
        - ◆ **DPFs**
          - ◇ Long term capital gain is removed under § 170(e)(1)(B)(ii).
          - ◇ **Exception:** gifts of publicly traded stock. § 170(e)(5).
        - ◆ **Intellectual property to PCs and DPFs:**
          - ◇ Exclude all LTCG. § 170(e)(1)(B)(iii).

## 2) Section 170(b)(1)(A) & (B)

### ◆ PC

- ◇ A taxpayer's charitable deduction for gifts to public charities in any single year may not exceed 50% of the taxpayer's CB. § 170(b)(1)(A).
  - ▶ Any excess contribution carries over for up to 5 years. § 170(d)(1)(A).

### ◆ DPFs

- ◇ A taxpayer's charitable deduction for gifts to DPFs is limited to the *lesser* of 30% of the taxpayer's contribution base or the excess of 50% of total contribution base minus the amount given to PCs. § 170(b)(1)(B). In other words, when a taxpayer has made gifts to both PCs and DPFs, the gifts to PCs are deducted first.
  - ▶ Any excess contribution carries over for up to 5 years. § 170(b)(1)(B).

### ◆ Gifts "for the use of"

- ◇ Subject to the 30% limitation to either PCs or DPFs. § 170(b).

## 3) Section 170(b)(1)(C)

### ◆ PCs

- ◇ Charitable deductions limited to 30% of the taxpayer's contribution base if the **gift is capital gain property** to which **170(e)(1)(B)** did not apply (i.e., the LTCC was not wrung out already). 170(b)(1)(C)(i).
  - ▶ The excess carries over for 5 years. § 170(b)(1)(C)(ii)
  - ▶ Deduct any cash gifts first.
- ◇ **Exception:** The taxpayer may avoid the 30% cap by electing to have the LTCC wrung out as though § 170(e)(1)(B) had applied. **§ 170(b)(1)(C)(iii). In other words**, he can deduct 50% but then limits the deductions for all time to the basis in the property.
  - ▶ **Note:** this exception does not apply when the gift is of property unrelated to that organization's charitable purpose.

## 4) Section 170(b)(1)(D)

### ◆ DPFs

- ◇ Deductions for **gifts of capital gain property** are limited to the *lesser* of 20% of the taxpayer's contribution base or the excess of 30% of the contribution base over the section **170(b)(1)(C)** amount.
- ◇ **Capital gain property includes** property which has had the gain wrung out under § 170(e)(1)(B)(ii).
- ◇ This rule is applied after all other charitable contributions. § 170(b)(1)(D)(i).

## ▪ Summary of Charitable Deductions

- **First**, determine a gift has been made.
- **Second**, determine to what type of organization it was made.
  1. Start with the **fair market value** of donated property.
  2. Exclude **non-LTCC**. This includes both short-term capital gains and ordinary income.
  3. If the gift is of **tangible personal property** to a **PC** and the property donated is unrelated to its charitable function, exclude **LTCC**.
  4. If the gift is to a **DPF**, exclude **LTCC** (but note exception for publicly traded stock).
  5. If the gift consists of IP other than self-created copyrights, exclude **LTCC**, and **§ 170(m)** may apply.
  6. If the gift is to a **PC**, limit the deduction to 50% of the donor's **CB**. Carry over the remainder.
  7. If the gift is to a **DPF**, limit the deduction to 30% of the **CB**. Carry over the remainder. (coordinate w/ Step 6 if there is both PC and DPF contributions).
  8. If the gift is **capital gain property** given to a **PC** (to which step 3 or 5 did not apply), limit the deduction to 30% of the contribution base. Do not change step 7. If an election under § 170(b)(1)(C)(iii) is made, exclude **LTCC** but do not apply the 30% limit to the remainder. Carry over any excess.
    - If no § 170(b)(1)(C)(iii) election is made, follow these steps in this order. A step 8 limitation does not affect the step 7 computation. But if a § 170(b)(1)(C) election is made, the step 6 and step 7 computations must be reworked.
  9. If the gift is **capital gain property** given to a **DPF**, limit the deduction to the lesser of 20% of the contribution base or 30% of the contribution base reduced by the § 170(b)(1)(C) amount. Carry over the remainder.

## 3. Gifts of Intellectual Property: Section 170(m)

- **§ 170(e)(1)(A)** wrings out gains from self-created copyrights since they are not capital assets.
- **§ 170(e)(1)(B)(iii)** more broadly denies a deduction for the **LTCC** inherent in other forms of self-generated or purchased IP (which *can* be a capital asset).
- **§ 170(m)** allows a donor to deduct for up to 10 years gifts of royalty producing IP to **PCs**. This does not apply to gifts to **DPFs**.
  - The amount of the charitable deduction is a percentage of the royalty income earned by the donee, which declines over time. § 170(m)(1) & (7).
  - Subject to the percentage limits in § 170(b)(1)(A).
  - Reduced by the amount of the deduction allowed in the year of the gift.

## 4. Bargain Sales to Charities

- A sale of property to a charity at less than its fair market value.
- The basis is allocated to the sale in the same ratio as amount realized bears to fair market value. 1101(b):

|                          |          |   |
|--------------------------|----------|---|
| <b>Amount Realized</b>   | <b>X</b> | <b>Adjusted Basis = Basis Allocated to Sale</b> |
| <b>Fair Market Value</b> |          |   |

- The rest of the taxpayer's basis in the property is allocated to the charitable gift.
- The sale will be treated under § 1001 and the characterization rules and the gift will be treated under the rules of § 170.

- If property is transferred subject to a mortgage, the debt relief is an amount realized to the transferor.

• **RESIDENTIAL REAL ESTATE (§ 280A, § 121)**

- **Limitation:** applies to gains only, not losses.
- **General Rule:** expenses associated with maintaining a household are non-deductible personal expenses under § 262.
- **Exceptions:**

▪ **Home Office Deductions (§ 280A)**

- **Property taxes and mortgage interest expenses:** deductible regardless of whether the home is for personal or business use. § 280A(b).

- **Business activities conducted in the space.** § 280A(c)(1)(A-B). In order to use, the taxpayer must use part of the home *exclusively* and *regularly* as:

1. The taxpayer's **principle place of business** for conducting any trade or business, or

- ◇ **Principle Place of Business Test:** A factual analysis considering:

- ▶ The relative importance of the activities performed at each business location, and
- ▶ The time spent in each location.

- ◇ **Statutory Rule § 280a(c)(1):** includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.

2. A place where the taxpayer meets or deals with patients, clients, or customers in the normal course of the taxpayer's trade or business.

- ◆ **Note:** if the taxpayer is an *employee*, the home office expenses must also be incurred for the convenience of the employer.

- **Determining the Deductions Allowed (Perform in this Order):**

- ◆ **Fully Deductible:**

- ◇ **Category 1:** business expenses, regardless of whether conducted in home or not.

- ◆ **Fully and Partially Deductible:**

- ◇ **Category 2:** real estate taxes and home mortgage interest, whether or not home is used as business.

- ▶ **Note:** this is partially deductible if being deducted from business expenses.

- ◆ **Partially Deductible:**

- ◇ **Category 3:** expenses for keeping up and running the home, including property insurance, utilities, general repairs and maintenance.

- ◇ **Category 4:** depreciation.

- **Limitations:**

- ◆ based on the percentage of the home used for business.

- ◆ total amount of deductions may not exceed the gross income of the business, reduced by both the business portion of expenses deductible without regard to business use of a home (e.g., real estate taxes and home mortgage interest allocable to the office), and the business expenses that relate to the business activity of the home (e.g., supplies, separate telephone lines for the business and other expenses not allocable to use of the office).

- ◆ **Note:** any deductions disallowed may be carried over to the succeeding tax year. § 280A(c)(5).

▪ **Vacation Home Deductions**

- **Use as a Residence**

- ◆ **§ 280A General Rule:** disallow deductions for a *dwelling unit* used by the taxpayer as a residence.

- ◇ **What constitutes use as a residence?** If one uses such unit for personal purposes for a number of days which exceeds the greater of:

- ▶ 14 days, or

- ▶ 10 percent of the number of days during such year for which such unit is rented at a fair rental.

- ◇ **Note:**

- ▶ use of a personal residence by family and friends without paying fair rental value is deemed personal use of the residence by the owner for purposes of § 280A. § 280(d)(2).

- ▶ reciprocal exchanges of vacation homes are deemed the equivalent or personal use by the owner for § 280A purposes. § 280A(d)(2)(B).

- **Deductible Expenses and Their Limits**

- ◆ **Fully Deductible:**

- ◇ property taxes and mortgage interest to the extent that they would be deductible without regard to

- ◇ personal or business use,
  - ◇ otherwise deductible expenses that are attributable to the use as a rental property.
- ◆ **Three Categories of Rental Activity Deductions.** These are subject to a cap equal to the **gross rental income** from the rental activity. (*Gross rental income: the gross receipts from the rental minus expenditures to obtain tenants such as advertising and management fees.*)
  - ◇ **Category 1:** The expenses that would be deductible in any event (property taxes and mortgage interest) that are properly allocable to the days when the unit is rented.
  - ◇ **Category 2:** The expenses attributable to the rental activity that do not affect the taxpayer's basis in the property.
  - ◇ **Category 3:** The expenses attributable to the rental activity that do affect the taxpayer's basis in the property, i.e., depreciation.
  - ◇ **Order:**
    - ▶ **Category 1:**
      - ▶ **Proposed Regulation:** use the same ratio as category 2 and 3.
      - ▶ **Case Law:** use the ratio that days of rental bears to the total number of days in the year, which is much more beneficial to the taxpayer, since that leaves more room under the cap to sweep in Category 2 and 3 expenses.
    - ▶ **Category 2 and 3:**
      - ▶ To determine the amount of the expenses that are potentially deductible, one allocates expenses based on the ratio of days that the property was rented compared to the total number of days the property was used during the year. § 280a(e)(1).
    - ▶ Deductions disallowed carry over to the next year.
- **Exclusion of Gain on Sale of Residence**
  - **General Rule:** Under § 121, a taxpayer may excluded from gross income up to \$250,000 (\$500,000 with respect to certain married couples filing jointly) of gain realized on the sale or exchange of a principal residence.
  - **To be eligible for the exclusion, the taxpayer must:**
    - a) have **owned** the residence and **used** it as a **principle residence** for at least two of the five years before the **sale or exchange**, and
    - b) the taxpayer must not have claimed the exclusion for another sale within the immediately preceding two year period.
  - **Ownership and Use Requirement Exceptions:**
    - ◆ **Two-year** requirement need not be continuous.
    - ◆ Special rules applying to **deceased** and **divorced** spouses:
      - ◇ Taxpayer who receives property from a deceased spouse is treated as owning and using the property for the period the deceased spouse owned and used the property before death. **§ 121(d)(2).**
      - ◇ Taxpayer who obtains property from spouse or former spouse in a transaction described in **§ 1041(a)** is treated as owning the property for the period the transferor spouse owned the property. § 121(d)(3)(A). **<--- a step-up in basis**
      - ◇ Taxpayer whose spouse or former spouse is granted use of property under a divorce or separation instrument is treated as using the property as the taxpayer's principal residence, provided the taxpayer has an ownership interest in the property and the spouse or former spouse uses the property as his or her principal residence. **§ 121(d)(3)(B).** **<--- no step-up, and he's got to use it during his own 2-year period.**
    - ◆ **One Sale Every Two Years Limitation:**
      - ◇ **§ 121 Exclusion** is not allowed more than once every two years. § 121(b)(3).
      - ◇ A taxpayer may elect not to have § 121 exclusion apply (121f) if it would be beneficial to elect out of the exclusion for one sale and preserve the benefits for a future one.
    - ◆ **Amount of Exclusion**
      - ◇ **\$250,000** of gain excluded from gross income.
      - ◇ **\$500,000** of gain excluded if:
        - ▶ The spouses file a joint return for the year of sale;
        - ▶ **Either** spouse meets the 2-year **ownership requirement** with respect to the property
        - ▶ **Both** spouses meet the **use requirement with** respect to the property, and
        - ▶ Neither spouse used the exclusion within the last two years.
        - ▶ **Note:** special rules for surviving spouses. § 121(b)(4). \$500,000 maximum exclusion amount in the case of a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, provided certain requirements are met. Remember, spouse might not even have gain because under § 1014 he gets a step up in basis.
        - ▶ **Note:** marrying a taxpayer not entitled to the exclusion does not bar the taxpayer from entitlement.
      - ◇ **Exceptions:**
        - ▶ **§ 121(c)** provides a **reduced maximum exclusion** for taxpayers who sell a principal residence, but who fail to satisfy the ownership and use requirements, or the one-sale-every-2-years-rule.

► **Conditions:**

- The sale must be because of a change in place of employment (*must have new job over 50 miles away, or satisfy the factors in* Treas. Reg. § 1.121-3(b)(1)-(6)), health, or unforeseen circumstances.
- The amount of the reduced maximum exclusion is a portion of the general \$250,000 or \$500,000 exclusion amount that would otherwise apply if the taxpayer satisfied the requirements and rule. The portion is determined by this formula:

|   |   |                                       |   |  |
|---|---|---------------------------------------|---|--|
| <p>► <b>Reduced Maximum Exclusion</b></p> | = | <p><b>Normal Exclusion Amount</b></p> | X | <p><b>Shorter of (1) period owned and used as a principal residence, or (2) period between prior sale for which gain was excluded and current sale.....</b><br/> <b>24 months or 730 days.</b></p> |
|---|---|---------------------------------------|---|--|

□ **Principal Residence Requirement**

- ◆ If a taxpayer owned more than one residence, only one can qualify as the taxpayer's principal residence for § 121.

◆ **Defining Principal Residence:**

1. Property the taxpayer uses a majority of the time during the year.
2. Other relevant factors:
  - The taxpayer's place of employment
  - The principal place of abode for the taxpayer's family
  - The address listed on the taxpayer's returns, driver's license, auto registration, and voter registration card
  - The taxpayer's mailing address for bills and correspondence
  - The location of the taxpayer's banks
  - The location of the taxpayer's churches and recreational clubs.

◆ **Restriction: 121(b)(5)**

- ◇ **Purpose:** prevent taxpayers from moving into their vacation homes two years before they sell it to qualify for the 121 exclusion.
- ◇ **121(b)(5)** provides that gain on the sale of a residence is not excluded from gross income to the extent the gain is allocated to periods of "nonqualified use" of the residence (i.e., when it's not the principal residence).
- ◇ **Consequences:** If there is nonqualified use by the taxpayer, his spouse or former spouse, the amount of the gain not excluded is determined by multiplying the total gain by a fraction, the numerator of which is the aggregate periods of nonqualified use and the denominator of which is the total time the taxpayer owned the property.
- ◇ **Exceptions:** see § 121(b)(5)(C)(ii).

□ **Sale or Exchange**

- ◆ **Note:** the destruction, theft, seizure, requisition or condemnation of property is treated as the sale of property for purposes of § 121. § 121(d)(5).

• **HOBBY LOSSES (§ 183)**

○ **In General**

- **§ 183(a)** generally prohibits any deductions attributable to a hobby -- an *activity not engaged in for a profit*.
- **§ 183(b)** permits deductions attributable to a hobby, but only to the extent of income attributable to the hobby, i.e., not from other sources.

○ **Distinguishing Hobbies from Business or Profit-Seeking Activities**

- **9 relevant factors that should be taken into account in determining whether or not an activity is engaged in for profit (Treas. Reg. § 1.183-2(b)):**
  1. *Manner in which the taxpayer carries on the activity.*
  2. *The expertise of the taxpayer or his advisors.*
  3. *The time and effort expended by the taxpayer in carrying on the activity.*
  4. *Expectation that assets used in activity may appreciate in value....*
  5. *The success of the taxpayer in carrying on other similar or dissimilar activities....*
  6. *The taxpayer's history of income or losses with respect to the activity....*
  7. *The amount of occasional profits, if any, which are earned....*
  8. *The financial status of the taxpayer....*
  9. *Elements of personal pleasure or recreation.*
- **Notes:**
  - No one fact, nor even a majority of them, is controlling and other factors may be relevant
  - The code creates a rebuttable presumption that an activity is engaged in for profit if the activity was profitable (gross income exceeded deductions) for three or more years in the five-year period ending with the year in question. § 183(d).
- **Exception:**
  - Taxpayer may combine two or more undertakings into a single activity if doing so shows a profit, but all the facts and circumstances will be considered, including the degree of organizational and economic interrelationship, the business purpose served by the undertakings, and the similarity of the undertakings.

Treas. Reg. § 1.183-1(d).

- **Allowable Deductions - § 183(b)**
  - **3 Tiers of Permitted Deductions:**
    - **Tier 1:** Deductions that would be allowable whether or not an activity is engaged in for profit (e.g., state and local property taxes under § 164). Treas. Reg. § 1.183-1(b)(1).
      - **Deduction Allowed:** in full, subject to any limitation to which they would otherwise be subject (e.g., \$100 floor for casualty losses)
    - **Tier 2:** Deductions that would be allowable if the activity in question had been conducted for profit but that do not result in adjustments to basis of property (e.g., business expenses under § 162). Treas. Reg. § 1.183-1(b)(2).
      - **Deduction Allowed:** only to the extent that gross income from the activity exceeds the total Tier 1 deductions.
    - **Tier 3:** Deductions that would be allowable if the activity had been conducted for profit but, unlike Tier 2 deductions, result in basis adjustments (e.g., depreciation). Treas. Reg. § 1.183-1(b)(3).
      - **Deduction Allowed:** only to the extent that gross income from the activity exceeds the sum of Tier 1 and Tier 2 deductions.
    - **Limitation:** deductions allowed only to the extent of gains derived from the hobby.
- **Vacation Homes**
  - Application of § 280A and § 183 are mutually exclusive. Must apply one or the other.
- **Vacation Homes Not Used as Residences**
  - If the vacation home is not a taxpayer's residence for purposes of § 280A, § 183 will apply.
  - If the vacation home rental is considered an activity engaged in for profit, allocable expenses are deductible in full.
  - If the rental is considered an activity not engaged in for profit, then allocable expenses are deductible only to the extent of rental income from the vacation home.
  - **Note:** Whether or not § 280A or § 183 applies, expenses still must be allocated between personal and rental use. § 280A(e)(1).
- **§ 183 Checklist**
  1. **Define the "activity" of the taxpayer.** Note that two or more undertakings may be treated as one activity for purposes of § 183. Treas. Reg. § 1.183-1(d).
  2. **Is the activity engaged in for profit?** Consider § 183(d) presumption. Consider the 9 factors in Treas. Reg. § 1.183-2(b).
  3. **If the activity is not engaged in for profit, deductions are allowed to the extent of hobby income.** Apply § 183(b); Treas. Reg. § 1.183-1(b).
  4. **If the activity is engaged in for profit, determine whether the activity is a "trade or business" activity or an "investment" activity.** Apply *Groetzinger v. Commissioner*, discussed in Chap. 7.
  5. **If the activity is a trade or business, see § 162** (expenses), **§ 165(c)(1)** (losses), **§ 167(a)(1)** (depreciation).
  6. **If the activity is an investment, see § 212** (expenses), **§ 165(c)(2)** (losses), **§ 167(a)(2)** (depreciation).
- **LIKE KIND EXCHANGES (§ 1031)**
  - **Generally,** a sale or exchange of property will trigger the recognition of gain or loss on the transaction by operation of § 1001(c).
  - **Exception:** *Non-recognition provisions* like **§ 1031 - Like Kind Exchanges.**
  - **§ 1031**
    - **Defined:** grants complete non-recognition when a taxpayer swaps real property for other real property of equal value.
    - **Purpose:** the taxpayer has not changed her overall economic position
    - **Catch:** basis is not stepped up, so any unrecognized gain still lurking in the property passes on to the transferee.
    - **Does Not Apply to:**
      - **(A)** stock in trade or other property held primarily for sale,
        - ◆ **note:** this could include land
      - **(B)** stocks, bonds, or notes,
      - **(C)** other securities or evidences of indebtedness or interest,
      - **(D)** interests in a partnership,
      - **(E)** certificates of trust or beneficial interests, or
      - **(F)** choses in action.
  - **Determining Like Kindness**
    - **1031:** grant non-recognition of gain or loss on the exchange of business or investment property for like kind business or investment property.
    - **Like Kindness:** the properties exchanged must be similar in nature or character.
      - **Real Property Examples:**
        - ◆ Any sort of fee interest in real estate is similar in nature or character to any other form of fee interest in real estate.
        - ◆ Real property held for investment exchanged for real property to be used in a trade or business.

- ◆ An exchange of a gold mine for a coal mine subject to coal supply contracts qualifies and the supply contracts are not even treated as boot.
  - **Applied to Tangible Personal Property (TPP)**
    - **General Rule:** the code is less generous
      - ◆ Livestock of different sexes are not like kind
      - ◆ Gold for silver is not like kind
  - **Applied to Depreciable Tangible Personal Property (DTPP)**
    - **General Rule:** meets the like kind requirement if exchanged for property that is either like kind or "of a like class". The are like class is they are within the same general asset class.
  - **Applied to Intangible Personal Property (IPP)**
    - Law is less well developed. Two levels of analysis are required:
      - ◆ The nature of the intangible property.
      - ◆ And they both must relate to underlying property of the same general asset class.
    - **Examples:**
      - ◆ Going concern value of one business is not like kind with the going concern of another.
      - ◆ The exchange of a copyright of a novel for the copyright of another is a like kind exchange.
      - ◆ The exchange of a copyright of a novel for the copyright of a song is not.
    - **§ 1091**
      - ◆ Denies losses on the sales of stock when substantially identical stock is acquired by the taxpayer within 30 days before or after the sale. However, the cost basis in the new shares is increased by the disallowed loss.
- **Planning the Exchange**
  - **Three Cornered Exchanges**
    - **General Rule:** typically involves the buyer first purchasing the desired exchange property from a third party and then engaging in the exchange with the seller who is seeking non-recognition. **RR 77-297.**
    - **Enforcing the Exchange:** typically accomplished through the use of a contract that includes an escrow arrangement.
      - ◆ **Very Important:**
        - ◇ Cash held in escrow is not constructively received by the seller as long as the seller's right to control receipt is subject to substantial restrictions. **If the seller has the right to take the cash** at any time prior to replacement property being found, **the doctrine of constructive receipt** will apply and may cause the whole transaction to be treated as a sale outside of § 1031 even if like kind property is ultimately received.
  - **Deferred Exchanges**
    - **General Rule: § 1031(a)(3)** allows the parties to "park" one of the properties with an intermediary who can hold title to the property until the parties are ready for the exchange to proceed. § 1.1031(k)-1(g).
      - ◆ These are called **QEAs:**
        - ◇ governed by **Rev. Proc. 2000-37**
        - ◇ But if revenue ruling doesn't apply, might find room in case law.
      - ◆ **Starker Exchanges:**
        - ◇ The precursor to deferred exchange
  - **Reverse Deferred Exchanges (or, Deferred Relinquishments)**
    - **General Rule:** If the transactions are structured properly, the person seeking to engage in a like kind exchange can acquire the replacement property through an intermediary before finding a buyer for the property he intends to relinquish. **Rev. Proc. 2000-37, 2000-2 C.B. 308.**
- **Timing**
  - Taxpayer must *identify* the replacement property within 45 days after the transfer of the property given up. § 1031(a)(3)(A).
    - One may indentify multiple properties in some cases. § 1.1031(k)-1(c)(4).
  - The replacement property must be *received* within 180 days after the taxpayer transfers the property given up. § 1031(a)(3)(B).
- **Boots and Recognition of Gains and Losses**
  - **How it applies:** one party may have to pay some cash or transfer some non-like kind property to equalize the deal. This is called the boot.
  - **Rules:**
    - The **recipient:**
      - ◆ must recognize gain to the extent of the *lesser* of gain realized or the value of the boot received. § 1031(b). **In other words, the most you have to recognize is gain realized.**
      - ◆ is not allowed to recognize a loss on the like kind property given up. 1031(c).
    - The **provider:**
      - ◆ may still recognize losses resulting from *giving* boot.
      - ◆ Go to **§ 165(c) for rules on losses.**
        - ◇ **(1) ... incurred in the trade or business.**
  - **Basis in New Property and in Boot Received**
    - **§ 1031(d):** the taxpayer's basis in the property *received* is her basis in the property *given up* minus any money

- received, plus any gain recognized, and minus any loss recognized.
  - **§ 1.1031(d)-1(a)**: the beginning basis number is the aggregate of the bases in all property given up and includes the amount of any cash given as well.
  - **Aggregate Basis Under § 1031(d)**
    - ◆ Aggregate Basis of Property Given (Including Cash)
      - Money Received
      - + Gain Recognized
      - Loss Recognized
      - Aggregate Basis in Property Received
  - **Basis of Like Kind Property Received**
    - ◆ Aggregate Basis in Property Received
    - FMV Basis for Boot Received
    - Basis of Like Kind Property Received
  - ◆ **Note**: if more than one like kind property is received, the basis is allocated among the like kind properties in proportion to their FMVs.
- **Holding Period**
    - If the property given up is either a capital asset or trade or business property described in § 1231, the taxpayer will tack her holding period for the property given up to the holding period of the property received. § 1223(1).
- **Assumptions of Liability**
    - **§ 1031** treats assumptions of liability as the equivalent of cash payments for most purposes, but only the **transferor** of the property subject to the **greater liability** is deemed to have boot for gain recognition purposes.
  - **Depreciation Recapture**
    - **In General**:
      - **§ 1245, 1250 override all other code sections.** But both have cutback rules that applicable to like kind exchanges.
    - **Exception**
      - **§ 1245(b)(4) & 1250(d)(4)** provide that §§ 1245 and 1250 will not override § 1031 as long as the property received in the exchange is also 1245 property or 1250 property respectively.
      - **Limitation**: if any boots are received by the taxpayer, the recognized gain will be ordinary income to the extent of the *lesser* of the amount of the boot or the amount of recapture gain inherent in the surrendered property.
- **INVOLUNTARY CONVERSIONS (§ 1033)**
    - **§ 1033(a)(1)**: if property is involuntarily converted directly into similar-use property, the gain realized, if any, will not be recognized.
    - **§ 1033(a)(2)**: if property is involuntarily converted into money (e.g., condemnation award or fire insurance proceeds), the gain realized, if any, will be recognized unless the taxpayer elects non-recognition treatment by purchasing similar-use property within a prescribed time period.
      - **Limits**:
        - gain is recognized to the extent that the conversion proceeds exceed the cost of the replacement property.
        - Applies only to **gains**, not losses, realized from **involuntary conversions**.
    - **Involuntary Conversions**
      - Property must be **compulsorily or involuntarily converted**.
      - **Rule**: conversion must result from one of four identified events:
        1. **Destruction in whole or in part**
          - ◆ Encompasses unusual and unexpected events constituting casualties within the meaning of § 165(c)(3), i.e.:
            - ◇ Destruction of house by tornado
            - ◇ Destruction of livestock by lightening
            - ◇ Destruction of wheat crop by hail
          - ◆ **Exceptions**:
            - ◇ Unlike § 165(c), the event need not be **sudden**. The gradual deterioration of property could qualify for § 1033 treatment.
            - ◇ **Partial destruction** may qualify for § 1033 treatment.
          - ◆ **Factual Determination**: Whether a post-casualty sale of property is treated as an involuntary conversion depends on whether the taxpayer had a choice to either keep or sell the partially damaged property. The choice turns, in part, on whether the taxpayer could restore or repair the property.
        2. **Theft**
        3. **Seizure**
          - ◆ Encompasses the confiscation of property by a government entity without compensation.
        4. **Requisition or condemnation** (or threat or imminence thereof)

- ◆ Typically encompasses the compensable taking of property by a governmental entity or quasi-governmental entity for public use
  - ◆ Also applied when there is a threat or imminence of condemnation. This is designed to encourage sales to condemning authorities in advance of formal takings of property.
- **Similar or Related in Service or Use**
- **General Rule:** non-recognition of gain is available only if a taxpayer acquires qualified replacement property; that is, *property similar or related in service or use* to the converted property.
    - It is not necessary for a taxpayer to acquire property that is the *exact* duplicate of the converted property; however, a taxpayer cannot change the character of his or her investment.
  - **Limit:** the similar or related in service or use standard of § 1033 is *more stringent* than the like-kind situation of § 1031.
    - **Case Law Tests**
      - ◆ **"Functional" or "End Use" Test:** <---- applies to owner-users of property
        - ◇ Takes into account only the actual physical end use to which the properties involved are put, whether that use be by the owner-taxpayer or by his tenant.
        - ◇ **Limit:** cannot apply this test to the holder of investment property who replaces such property with other investment property.
      - ◆ **"Relation to the Taxpayer" Test:** <---- applies to holders of investment property
        - ◇ The properties must be reasonably similar in their relation to the taxpayer. In applying this test to a lessor, a court must compare the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties.
        - ◇ **Application:** this is the test to apply to holders of investment property.
    - **Rev. Rul. 64-237**
      - ◆ **Investment Properties**
        - ◇ attention will be paid primarily to the similarity in the relationship of the services or uses which the original and replacement properties have to the taxpayer-owner. In applying this test, a determination will be made as to:
          - ▶ whether the properties are of a similar service to the taxpayer,
          - ▶ the nature of the business risks connected with the properties, and
          - ▶ what such properties demand of the taxpayer in the way of management, services and relations to the tenants.
    - **Exception: § 1033(g)**
      - ◆ Allows certain converted real property to be replaced by *like-kind* property.
      - ◆ **Limitations:**
        - ◇ Only applies to real property held for business use or investment
        - ◇ Only applies if the property is converted by reason of seizure, requisition or condemnation, or threat or imminence thereof
        - ◇ Does not apply to seizures or destructions.
- **When Replacement Must Occur**
- **General Rule:** the replacement period **begins** on the date of involuntary conversion and **ends** two years after the close of the taxable year in which the gain is first realized. § 1033(a)(2)(B).
  - **Exceptions:**
    - a **3-year** replacement period applies to *condemnations* of *business or investment real property* described in § 1033(g).
    - a **4-year** replacement period applies to involuntary conversions of *principle residences* as a result of *presidentially declared disasters*. § 1033(h).
- **Basis and Holding Period of Replacement Property**
- **General Rule: § 1033 defers** gain until disposition of the replacement property
  - **Situations:**
    - If the property is involuntarily converted into similar-use property and gain is not recognized pursuant to § 1033(a)(1), then the **basis** of the replacement property is the same as the taxpayer's basis in the converted property. § 1033(b)(1).
    - If the property is involuntarily converted into money and the taxpayer elects not to recognize gain pursuant to § 1033(a)(2), then the basis of the replacement property is the cost of the replacement minus the amount of unrecognized gain on the conversion. § 1033(b)(2).
  - **Holding Period**
    - The holding period of the replacement property includes the holding period of the converted property if the latter was a capital asset at the time of conversion. Rev. Rul. 72-451.
- **The Effect of Recapture**
- **§ 1245(b)(4)** contains an exception to the rule that one must recognize gains that would otherwise be deferred via § 1033. Specifically, § 1245 will not apply if the requirements of § 1033 are met and if the conversion proceeds attributable to § 1245 property are reinvested entirely in § 1245 property.

- **§ 1250(d)(4)** provides an exception for involuntary conversions of property otherwise subject to § 1250 recapture.

- **INSTALLMENT SALES (§ 453)**

- **Purpose:** allows taxpayers to defer gain on sales for which payments are made over time.
  - Under the **cash method**, the taxpayer would take the fair market value of the note into income at the time of its receipt (since the note is property under 1001).
  - Under the **accrual method**, the taxpayer would have income upon execution of the contract and transfer of title (since all events have occurred fixing the right to receive income).
  - The **installment method** is an exception to both of these. It applies automatically unless the taxpayer elects out under **§ 453(d)**.
  - **Justification:** taxpayer liquidity.
- **The Mechanics of § 453 and the Defined Terms**
  - **Defined:** an installment sale is where at least one payment comes after the end of the year in which the disposition occurs. § 453(b)(1).
    - **Excluded Sales:**
      - ◆ Dealer dispositions
      - ◆ Sales of inventory
    - **Calculating gain:** the tax gain recognized on each payment is that proportion of payment which the gross profit bears to the total price. 453(c).
      - **Gross Profit/Total Contract Price x Payment = Gain Recognized on Payment**
      - **Defining Terms:**
        - ◆ **Gross Profit** means "selling price" (SP) minus the seller's adjusted basis.
          - ◆ **Selling Price** means gross selling price but does not include interest.
        - ◆ **Total Contract Price** means selling price reduced by "qualified indebtedness" (QI) not in excess of seller's basis.
          - ◆ **Qualified indebtedness** is the buyer's acquisition indebtedness assumed from the seller.
        - ◆ **Payment** does not include the evidences of indebtedness that the seller receives from the buyer. Nor does it include any debt assumption by the buyer to the extent that the debt does not exceed the seller's adjusted basis. Nor does the gross profit ratio apply to payments of interest.
        - ◆ **Note:** Anytime you assume a mortgage in excess of your basis, your **gross profit ratio is 1**. That means taxpayer recognizes 100% of the payment.
  - **Dispositions of Installment Notes**
    - **General Rule:** the **transfer** of an installment obligation, even as a gift, triggers gain or loss recognition. 453B(a).
      - If the transfer is a **sale**, the gain or loss recognition is determined by reference to the difference between amount realized and **adjusted basis**.
      - If the transfer is by **gift**, the fair market value is deemed the amount realized.
      - The **adjusted basis** of the obligation is determined by deducting from its face value an amount equal to the gain that would have been realized had the installment obligation been paid in full. 453B(b).
      - **Exceptions to the transfer rules:**
        - ◆ **Transfers at death**
          - ◆ The transferee takes the transferor's basis. 453B(c). Thus the gain remains lurking in the note to be recognized by the transferee.
        - ◆ **Transfers between spouses or incident to divorce**
          - ◆ The transferee takes the transferor's basis. 453B(g). Thus the gain remains lurking in the note to be recognized by the transferee.
  - **Contingent Payment Sales**
    - **Defined:** installment sale structured with uncertainty as to the duration of the contract or as to the total sales price, or as to both.
    - **Conditions:**
      - **Stated Maximum Sales Price Rule**
        - ◆ If there is a **stated maximum sales price**, that amount is treated as the **selling price** for purposes of computing the **gross profit ratio**.
      - **Fixed Duration Rule**
        - ◆ If there is **no stated maximum sales price**, but the **period of payment** is of **fixed duration**, the seller recovers her basis ratably over the fixed period.
      - **15 year rule**
        - ◆ If there is neither a stated maximum sales price or a fixed duration, the seller recovers basis ratably over a **15 year period**.
  - **Installment Sales with Unstated or Understated Interest**
    - If the sale understates interest, the tax rules will derive an "imputed principal amount" by using the **applicable federal rate (AFR)** to discount the future payments to their present values, i.e., by wringing out the unstated interest.
    - The amounts paid in excess of the imputed principal amount are **original issue discounts (OIDs)**, and must be reported as interest.

- If one sells property to another for installment notes who then sells it to another for the full price and the first party forgives the second party's debt, that triggers gain to the first party.

- **INTELLECTUAL PROPERTY**

- **DEVELOPMENT**

- **Deductibility under § 162 - Ordinary and Necessary Business Expenses**

- § 162 establishes several requirements for the deduction of costs associated with a business. Such a cost must be **ordinary and necessary** and paid or incurred in **carrying on a trade or business**.
- § 263 & § 263A override § 162 - in other words, they prevent the current deductibility of many intellectual property development costs.

- **§ 263 Override**

- § 263 disallows the immediate deduction of costs that are considered **capital expenditures**. These include:
  - ◆ amounts paid to create an intangible described in **1.263(a)-4(d)**.
  - ◆ amounts paid to create a **separate and distinct intangible asset**, or "a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business."
    - ◇ **Exceptions:**
      - ▶ Does not include amount paid to create computer software.
      - ▶ Does not include amount paid to create a package design
        - ▶ However, taxpayer must capitalize costs of obtaining trademark and copyright protections on elements of the package design, since these are rights granted by a government agency.

- **§ 263A Override**

- § 263 requires the capitalization of direct and indirect costs attributable to **tangible personal property** produced by a taxpayer.
  - ◆ **Tangible personal property** includes films, sound recordings, video tapes, books, and **similar property** embodying words, ideas, concepts, images, or sounds by the creator thereof.
    - ◇ **Similar property** includes "intellectual or creative property for which, as costs are incurred in producing the property, it is intended (or is reasonably likely) that any tangible medium in which the property is embodied will be mass distributed by the creator or any one or more third parties in a form that is not substantially altered."
  - ◆ **Exceptions**
    - ◇ **§ 263(h):** qualified creative expenses
      - ▶ **Defined:** any expense paid or incurred by an individual in the trade or business of being a writer, photographer, or artist, which, except for the capitalization rules of § 263A, would otherwise be deductible for the tax year. § 263A(h)(2).
      - ▶ **Limitations:**
        - ▶ only certain individuals - writers, photographers, and artists, as those terms are described in the statute. § 263A(h)(3).
        - ▶ does not include any expense related to printing, photographic plates, motion picture films, video tapes, or similar items. § 263A(h)(2).
        - ▶ **§ 181** allows a taxpayer to immediately deduct the costs of any qualified film or television production in lieu of capitalization.

- **Deductibility under § 174 - Research and Experimental Expenditures**

- § 174(a) permits a taxpayer to deduct immediately research and experimental expenditures that would otherwise have to be capitalized under § 263. Applies only to costs qualifying as **research or experimental expenditures** and for costs paid or incurred **in connection with a trade or business**.
- § 174(b), alternatively, allows the taxpayer to elect to amortize the expenditures over 60 months.
  - ◆ **Research and Experimental Expenditures:** incurred in connection with the taxpayer's trade or business which represent research and development costs in the **experimental or laboratory sense**, and generally include all costs incident to the development or improvement of a **product**. 1.174-2(a)(1).
    - ◇ A **product**, for purposes of § 174, includes any pilot, model, process, formula, invention, technique, patent, or similar property that is either used by the taxpayer in its trade or business or held for sale, lease or license by the taxpayer. 1.174-2(a)(2).
    - ◇ Expenditures are incurred in the **experimental or laboratory sense** if they are incurred in activities intended to discover information that would eliminate **uncertainty** concerning the development or improvement of a product.
      - ▶ **Includes:**
        - ▶ Costs of obtaining a patent.
        - ▶ Attorney's fees in the prosecution of patent applications
      - ▶ **Excludes:**
        - ▶ Expenditures incurred for ordinary **quality control** testing or inspection
          - Note: this is really about after the product is already finished.
        - ▶ Business management expenses such as efficiency surveys, management surveys, and consumer surveys
        - ▶ Advertising and promotion costs
        - ▶ Costs of purchasing a patent, model, production, or process of another

- ▶ Expenditures for research in connection with literary, historical, or similar projects
  - ▶ Costs incurred after a commercially viable model exists (e.g., manufacturing and marketing costs)
- ◆ **In Connections With a Trade or Business**
  - ◇ **Taxpayer must demonstrate** a realistic prospect of entering into a trade or business that will exploit the technology under development. Taxpayer must demonstrate both an objective intent to enter into the trade or business and the capability to do so.
- **§ 41 Research Credit for Increasing Research Activities**
  - **General Credit:** equal to 20% of **qualified research** spending above a base amount.
  - **Alternative Simplified Credit:** an amount equal to 14% of the amount by which the **qualified research** expenses exceed 50% of the average qualified research expenses for the three preceding taxable years.
    - ◆ **qualified research:** research (1) with respect to which expenditures may be treated as expenses under § 174, (2) that is undertaken for the purpose of discovering information that is technological in nature, and the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and (3) substantially all of the activities of which constitute elements of a **process of experimentation** that relates to a new or improved function, performance, reliability, or quality. 41(d)(1)(A)-(C).
      - ◇ **process of experimentation:** requires a taxpayer to (1) identify the uncertainty regarding the development or improvement of a business component that is the object of the taxpayer's research activities, (2) identify one or more alternatives intended to eliminate that uncertainty, and (3) identify and conduct a process of evaluating the alternatives (e.g., modeling, simulation, or systematic trial and error).
- **ACQUISITIONS**
  - **Generally:** a taxpayer is required to capitalize amounts paid to another party to acquire an intangible from that party through a purchase or similar transaction.
  - **Amortization Under § 197**
    - **15 year amortization deduction** for the capitalized costs of any **§ 197 intangible** held **in connection with the conduct of a trade or business** or activity conducted for profit.
      - ◆ **Note:** does not apply to the purchase of § 197 intangibles not connected to a business. If that's the case, you amortize under § 167.
    - **Prohibition** of any other depreciation or amortization deduction with respect to that property.
      - ◆ **A § 197 intangible**
        - ◇ **Includes:** any patent, copyright, formula, process, design, pattern, know-how, format, package design, computer software, or interest in a film, sound recording, video tape, book, or other similar property. 1.197-2(b)(5). Also includes any trademark or trade name. (b)(10).
        - ◇ **Excludes:**
          - ▶ any interest in a patent, patent application, or copyright that is *not* acquired as part of a purchase of a trade or business.
          - ▶ any interest in computer software that is not acquired as part of a purchase of a trade or business.
          - ▶ trade secrets, know-how, trademarks, and trade names that are separately acquired assets.
      - ◆ **Exceptions:**
        - ◇ Does not apply to the cost of an interest in off-the-shelf software,
        - ◇ Does not apply to costs of an interest in computer software if such cost is included, without being separately stated, in the cost of hardware or some other tangible property and is consistently treated as part of the cost of hardware or some other tangible property. 1-197-2(g)(7). Software instead is included in hardware's basis and recovered according to the depreciation rules of § 168, which applies to tangible personal property, such as computers.
      - ◆ **Calculating Amount**
        - ◇ The amount of the § 197 amortization deduction is determined by amortizing the adjusted basis of the acquired intellectual property ratably over a 15-year period irrespective of the property's useful life.
        - ◇ Estimated salvage value is disregarded, so the entire adjusted basis may be recovered over the 15-year amortization period.
        - ◇ The 15-year period begins on the first day of the month in which the intellectual property is acquired and held in connection with either a trade or business (within meaning of § 162) or an activity for profit (within meaning of § 212).
        - ◇ **Fixed installment payments**
          - ▶ The entire amount of the payments are included in the basis at the time of purchase and amortization over 15 years.
        - ◇ **Contingent payments**
          - ▶ Basis is increased only as the contingent amounts are paid.
          - ▶ If payments come after the 15 year period and the purchase has already been completely amortized, the entire payment is written off in the current year. Treas. Reg. § 1.197-2(f)(2)(ii).

- **Amortization Under § 167**
  - **Applies when § 197 does not (usually because it was not acquired in connection with a trade or business - see above).**
  - **To be eligible for depreciation under § 167**, the acquired intellectual property must have a determinable useful life, and the taxpayer must be engaged in either a trade or business or an activity conducted for profit.
  - **Methods of amortizing capital costs of purchasing eligible IP:**
    - ◆ **Straight Line Method:** capitalized costs of acquiring eligible property (less salvage value) are deducted ratably over the period *the taxpayer expects* the property to be useful in his or her trade or business.
      - ◇ **Computer Software** is subject to an arbitrary 36-month recover period beginning on the first day of the month the computer software is placed in service. **167(f).**
      - ◇ **Bundled Software** is depreciated over the appropriate recovery period of the related hardware.
    - ◆ **Income Forecast Method:** costs of acquiring eligible intellectual property are recovered as income is earned from exploitation of the property. Computed by multiplying the depreciable basis of the property by a fraction, the numerator of which is current year income (income from the asset for the tax year) and the denominator of which is forecasted total income (estimated total income to be earned in connection with the asset during its useful life).
    - ◆ **Variable Contingent Payment Method:** a taxpayer who purchases IP (that is not subject to § 197) for contingent payments (e.g., payments computed by reference to income from the use of the IP), adds such payments to the basis of the IP in the taxable year paid but then amortizes the full amount paid in that year. In other words, the amortization deductions each year equals the amount of the royalty paid or incurred each year.
- **Licensing of Intellectual Property**
  - Payments made under a contract for the license of IP generally may be deducted under normal tax principles (§ 162) over the license term.

## • ASSIGNMENT OF INCOME

- **The Basic Rule and the Community Property Twist**
  - **Lucas v. Earl:** income is taxed to the person who earned it.
  - **Poe v. Seaborn:** income earned by an agent acting for a principal is taxed to the principal, at least when state law creates the agency relationship automatically.
- **More on Principals and Agents and a Note About Disclaimers**
  - **Employer/Employee:** A person who earns a fee while acting on behalf of his employer and who, by prior agreement, endorses that fee over to his employer, is not taxable on those earnings, so long as the transfer occurred before the act of earning occurred.
  - **Disclaimers:**
    - **Defined:** an **unconditional** refusal to accept earnings to which one is entitled.
      - ◆ To qualify as **unconditional**, the disclaimant cannot direct the earnings to another.
    - **Rule:** if the person making the disclaimer does so before the right to receive the income has been fixed, she will not be taxed on the earnings.
  - **The Teschner Twist:**
    - A father who won a prize he was ineligible to win and thus transferred the income to his daughter never had any right to the income and therefore did not have to report the income. The daughter did.
- **Assignments of Income from Property**
  - **Gratuitous Assignments**
    - **Generally**, if the assignment of the income from property is gratuitous, the owner of the property remains taxable on the income. **Helvering v. Horst**
    - **Trusts:** when taxpayer inherited income with no rights to the principal, transferred an undivided portion of the income interest to his children and took the position that the children, not he, were henceforth taxable on that income, the Supreme Court agreed, relying especially on the fact that **he gave up an undivided interest in everything he had.**
  - **Grantor Trusts, the Kiddie Tax and the Rate Structure for Entities**
    - **Grantor Trusts:** If a grantor sets up a trust but retains any of a number of different rights, including the right to revoke and certain rights of reversion, then the trust income remains **taxable to the grantor.**
      - ◆ See § 671 for instructions.
      - ◆ See § 676 power to revoke.
      - ◆ **To access reversionary interest, see IRS tables.**
    - **Kiddie Tax:** the unearned (i.e., investment) income of children under the age of 18 is taxed at the child's parents' top marginal tax rate.
    - **Entities:** the rate structure applicable to entities such as trusts and corporations is less graduated than the rate structure for individuals. This means the top tax rate for income taxed to trusts reaches higher rates faster, leaving little room for income tax savings.
  - **Allocations of Basis for Gratuitous Assignments in Trust**
    - **Bequeathed** property takes a **date of death** fair market value basis under § 1014(a).
    - **Gifted** property takes a **carryover basis** for gain purposes under § 1015(a).
    - **Transfer of fee to one individual, with life estate in another:**
      - ◆ **Initially**, basis is allocated between the entities in proportion to **FMV** of their interests.

- ◆ **Problem for life tenant:** he is not permitted to deduct any portion of his basis from the income distributions
    - ◆ **Solution:** transfer both interests to a third party in one transaction. **§ 1001(e)(3)**. This is the only way for the life tenant to use basis to reduce the amount of gain allocated to him.
  - **Anticipatory Assignments for Value**
    - **Situation:** when a taxpayer sells the right to future income while retaining the property that produces the income.
    - **General Rule:** a sale of future income will be respected for tax purposes.
    - **Procedure:** Buyer takes a **§ 1012** cost basis in the income. Once the full amount of the future income is paid, the buyer will have income determined by reference to the difference between basis and amount realized.
  - **Assignments Designed to Transmute Ordinary Income into Capital Gains**
    - **Commissioner v. P.G. Lake:** one who converts future ordinary income into present income will find that the present income is also ordinary income.
    - **Exception:** it is possible to get capital gains treatment, however. Typically, capital gains treatment will be appropriate when the taxpayer did not retain the income producing asset.
  - **The Special Case of Gift Loans**
    - **Situation:** family member provides a loan without interest when a similar loan to a non-family member would be expected to garner significant interest.
    - **General Rule:** **§ 7872** mandates that the loaner will incur interest income under **§ 61** and the loanee will have an interest deduction under **§ 163**.
- **ALIMONY & CHILD SUPPORT**
    - **3 Ways to Treat Payments from one spouse to another**
      - **Alimony:** ordinary income to the payee, deductible by the payor.
      - **Child Support:** neither income to the payee nor deductible by the payor.
      - **Property Settlement:** a non-recognition event for both parties, resulting in a transferred basis.
    - **ALIMONY**
      - **§ 71(a)** provides for the inclusion of alimony or separate maintenance in the gross income of the payee spouse or former spouse.
      - **§ 215(a)** provides for a deduction from gross income for the payor spouse or former spouse. The payor's deduction is measured by reference to the payee's inclusion. **§ 215(b)**.
      - **Alimony Requirements**
        - **§ 71(b):** A **cash payment** is alimony if:
          - ◆ It is received under a **divorce or separation instrument**:
            - ◇ *Note: includes a temporary support order. § 71(b)(2)(C). But spouses are not required to live apart.*
            - ◇ *Note: does not include informal agreements set forth in letters from one spouse's attorney to another.*
          - ◆ It is not designated as a non-alimony payment;
          - ◆ It is made at a time when the payor and payee are not members of same household (if the divorce is final or there is a legal separation); and
          - ◆ There is no liability to make further payments after the death of the payee.
      - **Disguised Property Settlements under § 71(f)**
        - **Purpose:** restrain the parties from **front-loading**, or characterizing as alimony payments what are really property settlements in order to take advantage of the deduction.
        - **How it works:**
          - ◆ Recaptures what otherwise qualifies for treatment as alimony so that the payor has gross income and the payee has a deduction in the later year. **§ 71(f)(1)**.
          - ◆ Recapture occurs in the third year of post-separation payments, but it arises by reference to an analysis of first and second year post-separation payments. The clock does not begin to run on this analysis until the first year when alimony is paid. **§ 71(f)(6)**.
        - **Calculation:**
          - ◆ The recapture amount is the sum of the **excess alimony payments** from the first post-separation year and the second post-separation year.
          - ◆ This is done in **reverse order**.
          - ◆ **2nd Year Excess Payments (E.P.) Formula: § 71(f)(4)**
            - ◇ **2nd Year E.P. = 2nd Yr. Pmts - (3rd Yr. Pmts + \$15K)**
          - ◆ **1st Year Excess Payments (E.P.) Formula: § 71(f)(3)**
            - ◇ **1st Year E.P. = 1st Yr. Pmts - [(2nd Yr. Pmts. - 2nd Yr. E.P. + 3rd Yr. Pmts)/2 + \$15K]**
          - ◆ **Exceptions:**
            - ◇ Death or remarriage of the payee or the death of the payor. **§ 71(f)(5)**.
          - ◆ **Note: read carefully § 71(f)(1)(B) - Is deduction above the line or itemized?**
      - **Indirect Payments**
        - **Rule:** Payments of cash to someone other than the former spouse can be alimony if the other requirements of **§ 71(b)** are met. **§ 71(b)(1)(A)**.
        - **Requirement:** the payment must satisfy an exclusive obligation of the payee spouse. **§ 1.71-1T(b) Q&A 6, 7.**

- **Expenses to Obtain Alimony and to Defend Against Those Claims**
  - **§ 212(1):** expenses incurred to *obtain* alimony are deductible.
  - **Fleishman:** expenses incurred to *defend against* an alimony claim are not deductible.
- **CHILD SUPPORT**
  - Payments denominated as child support are **not deductible** by the payor and are **not included** in the gross income of the payee. § 71(c)(1).
  - **§ 71(c)(2): see problem 1(f):** if any amount specified in the instrument will be reduced—
    - **(A)** on the happening of a contingency specified in the instrument **relating to a child** (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or
    - **(B)** at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A),
  - an amount equal to the amount of such reduction **will be treated as child support, not alimony.**
  - **Failure to Pay:**
    - Under **§ 71(c)(3)**, the payor gets no **alimony** deduction until first fully satisfying the payor's **child support** obligation.
  - **Expenses to Obtain Child Support**
    - Legal fees incurred to collect child support have been held non-deductible on grounds similar to those for denying deduction of expenses associated with defending an alimony claim. **McClendon**
  - **Dependency Exemption:**
    - **General Rule:** the divorced parent with custody for the greater part of the year is entitled to the exemption for a minor child.
    - **§ 152(e)** allows the custodial parent to waive it, therefore making it a negotiable item in a divorce settlement.
    - **Child Tax Credit:** Goes to the parent who is entitled to the dependency exemption. § 24(c)(1), 152(e)(1).
- **TRANSFER OF PROPERTY INCIDENT TO DIVORCE (§ 1041)**
  - **§ 1041:** Prevents the recognition of gain or loss by the transferor. Transferee has no income because **the transfer is treated as a gift.**
    - **Basis:** transferred in *all cases* for the transferee.
    - **Holding Period:** transferee tacks on to the transferor's holding period.
  - **Transfers Incident to Divorce**
    - **§ 1041** only applies to transfers **incident to divorce.** (a)(2).
      - **Incident to divorce** is defined as
        - ◆ within one year from the date on which the marriage ends, or
        - ◆ is "related to the **cessation of the marriage.**" § 1041(c).
          - ◇ Transfer is related to the **cessation of marriage** if:
            - ▶ it is pursuant to a divorce or separation instrument (as defined in 71(b)(2)), **and**
            - ▶ the transfer occurs within six years of the marriage's end. 1.1041-IT Q&A 7.
      - **Annulments:** treated as divorces for **§ 1041** purposes.
  - **Transfers to Third Parties**
    - **§ 1041** applies when *either* the divorce decree or a written agreement between the spouses authorizes a spouse or former spouse to make the payment on behalf of the other spouse or former spouse.
    - **Tax consequences:**
      - **Transferor:** non-recognition, as if the transfer was to the other spouse directly
      - **Transferee:** recognition of gains or losses, as if the transferee spouse had herself made the taxable transfer to a third party.
  - **Incorporated Family Businesses**
    - **Three Methods**
      - **Straight Purchase**
        - ◆ **Defined:** a sale of the stock to the remaining spouse in which the remaining spouse uses his or her own funds for the purchase.
        - ◆ Departing spouse receives non-recognition and the remaining spouse takes carryover basis.
      - **Distribution Followed by Purchase**
        - ◆ **Defined:** the funds for the purchase are distributed from the corporation to the remaining spouse who then transfers them to the departing spouse in exchange for the departing spouse's stock.
        - ◆ Tax treatment of distributions are governed by **§ 301.**
        - ◆ **Remaining Spouse**
          - ◇ treated as having dividend income.
          - ◇ taxed under § 1041 with no basis adjustment in the stock received from the departing spouse.
        - ◆ **Departing Spouse**
          - ◆ non-recognition under § 1041.
      - **Redemption**
        - ◆ **Defined:** a purchase of the shareholder's stock by the issuing corporation.
        - ◆ Tax treatment covered by **§ 302.**
        - ◆ **Departing Spouse:**
          - ◆ treated as having engaged in a sale or exchange with the corporation. 302(a), (b)(3). Thus, § 1041



- **Robinson v. Comm'r:** The allocation solely to compensatory damages may not be respected if:
      - ◆ (1) the victim asked for substantial punitive damages in the initial pleadings, and
      - ◆ (2) the allocation did not result from adversarial, arm's-length negotiation.
    - **Amos:** it is the nature and character of the claim settled, and not its validity, that determines whether the settlement payment is excludable from gross income under § 104(a)(2).
  - **Structured Settlements**
    - **§ 104(a)(2)** makes no distinction between those settlements allocated in one lump sum payment and those allocated periodically.
    - **Note:** if a recipient prefers payments spread out over time, she is better off agreeing to a structured settlement arrangement rather than receiving a lump sum and then purchasing an annuity with a lump sum payment. The portion of each annuity payment is includable in gross income. **§ 72(b)**.
    - **Alternative to Periodic Payments:**
      - Defendant may assign the liability to a third-party (insurance company). The funds received by the structured settlement company (which it then uses to purchase a "qualified funding asset" to collect interest) are excludable from its gross income. **§ 130**.
  - **Accident or Health Insurance Proceeds**
    - **104(a)(3)** excludes from gross income amounts received under **self-financed** accident and health insurance policies for personal injuries or sickness (even if such amounts exceed expenses actually incurred). However, amounts received from **employer-financed** plans are not excludable.
      - **Exception:** funds received from employer-financed plans may be excludable under **§ 105(b-c)** for **permanent bodily injuries and disfigurement** but it is **limited only to the extent of medical expenses actually paid**. See *Rev. Rul. 69-154, 1969-1 C.B. 46*.
      - **Rev. Rul. 69-154: When expenses paid by both policies, use the following calculation:**
        - ◆ **Amounts Attributable to Employee-Paid Benefits =**
          - ◇  $(\text{Indemnification (Employee-paid Policy)} / \text{Total Indemnification}) \times \text{Total Expenses}$
        - ◆ **Amounts Attributable to Employer-Paid Benefits =**
          - ◇  $(\text{Indemnification (Employer-paid Policy)} / \text{Total Indemnification}) \times \text{Total Expenses}$
        - ◆ **Excess benefits attributable to employer-paid policy and thus includable in employee's gross income.**
    - **§ 106** excludes from **employer's** gross income an employer's contributions to accident and health insurance plans or other payments to compensate or reimburse employees for injury or sickness.
- **ATTORNEY'S FEES**
  - **Primary Test for Attorney's Fees**
    - The **origin and character of the claim** with respect to which litigation costs are incurred is the controlling test. **Gilmore**.
    - **Relevant factors include:**
      - Intent in filing the suit
      - Issues involved
      - Nature and objective of the litigation
      - Defenses asserted
      - Purposes for which the amounts claimed to be deductible were expended
      - Background of the litigation
      - All facts pertaining to the controversy.
  - **Codes Under Which You May Recover**
    - **§ 162 Trade or Business**
    - **§ 212(1) Production of Income**
      - **Rule for Recovery Under 212(1):** For legal fees to be deductible under § 212(1), they must relate to the **production or collection of taxable income**, i.e. amounts included in gross income.
        - ◆ **Examples:**
          - ◇ Recovering damages for non-physical injuries
          - ◇ Attorney's fees to *secure* alimony (not defend)
        - ◆ **Examples of fees not deductible:**
          - ◇ Recovering damages for physical injuries
          - ◇ Receipt of child support
    - **§ 212(2) Management of Income Producing Property**
    - **§ 212(3) Tax Advice**
      - **Recoverable:**
        - ◆ Determination, collection, or refund of any tax
        - ◆ Fees for tax planning advice
        - ◆ Legal fees and expenses for real estate planning advice
    - If a fee is partially deductible and partially nondeductible, the taxpayer must allocate the fee between the deductible and nondeductible portions. Lawyer fee statements that make a reasonable and good faith allocation are typically respected.
  - **Above or Below the Line Determination**

- **Above the Line**
  - ◆ **§ 62(a)(1)**: fees related to a trade or business that are deductible under § 162 (other than the trade or business of being an employee).
    - ◇ **Examples:**
      - ▶ Tax preparation for that business
      - ▶ Contesting tax deficiencies arising from the business
  - ◆ **§ 62(a)(20)** provides an above-the-line deduction for attorney's fees and costs in connection with claims of **unlawful discrimination** and certain claims against the federal government.
    - ◇ **Limitation:** amount deducted may not exceed taxpayer's gross income for the taxable year.
    - ◇ **Unlawful discrimination includes:**
      - ▶ Specific federal statutes
      - ▶ Federal whistle-blower statutes
      - ▶ Any federal, state, or local law providing for
        - ▶ the enforcement of civil rights, or
        - ▶ regulating any aspect of the employment relationship, or
        - ▶ prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee
        - ▶ ...for asserting rights or taking other actions permitted by law.
    - ◇ **Unlawful discrimination does not include: <--- these are itemized below the line**
      - ▶ Claims for defamation
      - ▶ Invasion of privacy
      - ▶ False imprisonment
      - ▶ Intentional infliction of emotional distress
      - ▶ Tortious interference with contract that occur outside the employment context.
- **Contingent Fees**
  - **Banks:** as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee.

## • RETIREMENT RESOURCES AND DEFERRED COMPENSATION

### ○ Overview

#### ▪ Five Sources of Support During Retirement

1. Personal Savings
2. Deferred Compensation
3. Social Security Benefits
4. Family contributions
5. Further Employment

### A. Savings

#### ▪ Strategies

1. Pay off mortgage before retirement
2. Build a nest egg independent of housing or order to maintain a level of financial **solvency and liquidity**.

#### ▪ Solvency & Liquidity Mechanisms

##### 1. Annuities (§ 72)

- ◆ **Defined:** A contract calling for a stream of future payments to an annuitant, usually for life, received for an upfront payment or payments to the obligor. The payments are derived by an actuarial calculation that considers the life expectancy of the annuitant and the expected rate of return on the up front payment.
- ◆ **Taxation**
  - ◇ **§ 72** treats a portion of each payment as a non-taxable **return of basis/investment in the contract** and part as taxable income. § 72(c)(1).
  - ◇ The amount of basis recovery in each payment is determined by reference to the **exclusion ratio**, the numerator of which is investment in the contract and the denominator of which is the **"expected return on the contract."** § 72(b)(1).
    - ▶ The **expected return** is determined in reference to an actuarial table.
  - ◇ **Exclusion Ratio:**

$$\frac{\text{Investment in the Contract}}{\text{Expected Return on the Contract}}$$
  - ◇ **Return of Investment in Each Payment**

$$\text{Payment} \times \text{Exclusion Ratio} = \text{Return of Investment}$$
- ◆ **Outliving/Dying Before Basis is Recovered**
  - ◇ **Outliving:** If the annuitant out lives her life expectancy and thus fully recovers her investment/basis in the contract, the **full amount** of all future payments thereafter are taxable income. § 72(b)(2).
  - ◇ **Dying Prematurely:** If the annuitant dies before recovering her full investment, the unrecovered investment amount is deductible on the decedent's final return. § 72(b)(3-4).

- ◇ **Heirs:** Anything the successor in interest receives **in excess of the investment** is income (§ 691).

## 2. Reverse Mortgages

- ◆ **Defined:** a lender, usually a bank, agrees to make monthly payments to a homeowner in return for an ever growing share of the homeowner's equity.
- ◆ **Tax Consequences:** The payments do not trigger any gain recognition for the homeowner, even if the limits of § 121 are exceeded.
- ◆ **Interest on the Mortgage**
  - ◇ **Rev. Rul. 80-248:** Interest is includible in the lender's gross income when it is actually or constructively received by the lender and is deductible by the borrower when it is actually paid by the borrower. Actual or constructive receipt or payment does not occur when the interest is added to the outstanding loan balance. Therefore, the interest is neither includible in the lender's gross income nor deductible by the borrower at that time.

## B. Retirement Plans

### 1. Employer Funded Retirement Plans

#### a. Defined Benefit and Defined Contribution Qualified Plans

- **Defined Benefit:** a promise to pay from the employer to employee. Employer accepts the risk the funds do not grow as planned. Employee, however, can expect a defined benefit to be dispensed at a specific time.
- **Defined Contribution:** an investment account into which the employer and, sometimes the employee, place funds for which risk of loss is on the employee.

#### b. Payout

- Usually in the form of an **annuity for life**.
- **No tax basis** if the account was paid with pre-tax dollars. §§ 72(a), 402(a), 403(a).
- **Consequence:** entire amount of the payments are taxable income as received.
- **Distribution:** usually must reach age 59.5 without being penalized 10% of the distribution for early withdrawal.

### 2. Individually Funded Retirement Accounts (401Ks)

#### a. Pre-Tax Contribution Accounts

- Direct pre-tax dollars into investment accounts on a tax deferred basis.
- **Distribution:** usually must reach age 59.5 without being penalized 10% of the distribution for early withdrawal.
  - ▶ **Exceptions:**
    - ▶ Qualified education expenses
    - ▶ First time home purchasers. § 72(t)(2)(E-F).

#### b. Post-Tax Contribution accounts ("Roth" accounts)

- Neither the principal nor the earnings on these accounts are taxed upon distribution as long as the distributions occur more than five years after establishing the IRA and after the beneficiary has reached age 59.5.
- **Not taxable** to the beneficiary who inherits it, even if they distribute early.
  - ▶ **Exception:**
    - ▶ **Ge:** Once one chooses to roll the funds from her deceased spouse's IRA to her own IRA upon the former's death, she loses the ability to qualify for the exception from the 10% additional tax on early distributions from the combined account, even if the distribution is limited to the amount she rolled over.

## C. Social Security

### 1. Eligibility

- ◆ Requires 40 SS credits
- ◆ One can earn up to 4 credits per year (1 credit for every \$1,000 of income).
- ◆ May collect at age 62, but the payments are less than they would be if you waited until 65.
- ◆ **Spouses**
  - marriage to someone who is eligible for 10 years if you yourself have not worked.
  - Spouses and former spouses of qualified workers are entitled to their own benefits based on their own employment histories **or** 50% of their spouse's benefit, whichever is greater.
  - A **surviving spouse** is entitled to the greater of his own benefits **or** 100% of his spouse's benefits.

### 2. Tax Treatment: Generally, social security benefits are not taxable. **Exception: see § 86.**

## • ESTATE TAXES

### 1. Establish the Gross Estate, which includes the FMV of:

- **2033:** property owned at death
- **2035:** certain property transferred near death
- **2036:** property transferred before death to which decedent still has right of enjoyment
- **2037:** property transferred before death conditioned upon surviving the donor
- **2038:** revocably transferred property
- **2039:** certain annuities
- **2040:** certain jointly held property
- **2041:** property over which decedent had general power of appointment
- **2042:** certain life insurance proceeds on decedent's death

- **2044:** property in which decedent had life interest from spouse
  - 2. Deduct the following:**
    - **2053:** creditor's claims and expenses of the estate
    - **2054:** casualty losses during administration
    - **2055:** charitable deduction
    - **2056:** marital deduction
  - 3. Multiply the taxable estate by the applicable rate (§ 2001), the highest of which is 45%.**
  - 4. Subtract the Unified Credit**
    - **\$3.5 million.**
  - 5. Calculate Basis for Heirs**
    - **1014:** step-up in basis under estate tax
    - **1015:** carryover basis for gifts
    - **1022:** applies in years when there is no estate tax
      1. start with carryover basis
      2. then get partial step-up
        - ◆ \$1.3 million: allocate it to whatever asset you want. You get that amount of step-up to apply to the assets transferred after death. Up to FMV.
        - ◆ \$3.0 million **additional** amount to property given to spouses. So if it all goes to a spouse, they would have \$4.3 million to divide among assets.
- **GIFT TAXES**
    - \$13,000 annual exception **per donee**, without tax, under § 2503.
      - The moment you give one penny more (ex. Xmas gifts, birthday gifts in the same year), you have to claim it on the return.
    - \$1.0 million **lifetime exclusion** for taxable gifts.
      - So you could give \$1,013,000 to one person in one year, or \$1 million total to everyone collectively.