**TAX POLICY**

Two functions of the tax system: pay for public goods is the other function, and redistribution (see below)

1. **EFFICIENCY** (has multiple parts)
   1. We want to choose a base and design a system that uses the base that has the smallest effect on behavior. An efficient system is one that affects behavior as little as possible. It’s also sometimes described as “neutral”
   2. Administrability. There’s no point in adopting a law that the IRS cannot administer.
   3. Compliance – we want a law that people can and will comply with.
2. **EQUITY**
   1. We want to choose a base and design a system that has some relevance to people’s ability to pay—which means some people will owe more than others.
   2. **Vertical equity:** a feature of a tax system in which those with more ability to pay actually pay more—people are “lined up” in the right order. (e.g. Buffett, teachers, janitors, disabled)
   3. **Horizontal equity** (a sub-feature of vertical equity): two people with the same amount of *x* (whatever we decide) are taxed equally. If we have vertical equity, then we also have horizontal equity; any violation of horizontal equity is a violation of vertical equity.
3. **TAX EXPENDITURES**
   1. **The basic idea:** you can convey a benefit or subsidy to someone either through a handout or through the tax system, and economically the two methods are exactly the same.
   2. **“Normative income tax”:** We’re looking for exclusions or deductions that are subsidizing some activity as opposed to being an integral part of the income tax itself, so we therefore need to know what’s right in a tax as a frame of reference.
   3. If the goal could have been accomplished through a direct subsidy, it’s probably a tax expenditure.
   4. If the litmus test for whether something is a tax expenditure is whether something represents economic income, then the exclusions of returns of capital and loans would not be expenditures, because they are not net accretions to wealth.
   5. **Two meanings of “good or bad” expenditure:**
      1. Should we be spending money on this at all? (We’re not concerned with this question)
      2. Are we accomplishing what we want to accomplish efficiently?
         1. E.g. if we want to subsidize state and local gov’t, is there a reason to choose tax spending over direct spending?
   6. **The tax expenditure budget** is intended to create a running account of the benefits we provide through taxes in the same way we account for direct budgeting. The difficulty is that it’s not clear what should go into this budget.
      1. To figure out how much is spent through tax expenditures is much more difficult than determining amounts directly spent, because you need to figure how much less revenue you’ll collect with the expenditure provision
         1. You need to determine the normative tax system,
         2. Figure out who’s going to use the exclusion/deduction
         3. Know the applicable rates for the income of that year of the TPs who use it.
      2. **Tax expenditures affect behavior**, which makes it even harder to calculate. People will move into the now-subsidized widget industry. It’s impossible to predict such “dynamic effects.” It’s assumed in the tax expenditure budgets that there will be no change in behavior, which is very perverse because it’s known that the expenditure will affect behavior (this is why they’re adopted!).
   7. A big political difference between direct spending and tax expenditures: reductions in taxes look like we’re just keeping more of our own money.
   8. **The value of tax expenditures** to TPs depends on their tax bracket, whereas with direct subsidies you can give the same amount to everyone regardless of their brackets. (It’s really hard to imagine giving out spending-subsidies according to tax brackets; but this is how it’s done by tax expenditures.)
   9. There’s much less government control over tax exclusions. The TP claims the exclusion and only gets investigated if they get audited, which is very improbable. Even when they do get audited, IRS agents generally don’t know that much about the technicalities of different industries. Subsidies administered by agencies like Defense and Agriculture are given out after the recipients show receipts or proof for the widgets; and the agencies have employees who understand the industries.
   10. Religious organizations are subsidized through the tax code, even though direct subsidies to them would be illegal under the 1st amendment.
   11. **TPs who can’t take advantage of tax expenditures:** Those with no income to declare. E.g. non-profits, people whose income falls below a certain line (though they can be given benefits through refundable credits), foreign TPs.
   12. **WHY § 103 IS A TAX EXPENDITURE**
       1. Interest from a bond should be income, but § 103 arbitrarily allows you to exclude interest from State and local bonds from your income
       2. Things to consider:
          1. States and municipalities decide on their own the value of their bond issuance. A direct subsidy would probably be a lump sum, determined by the fed gov’t or in negotiation with the state/municipality, and the fed gov’t would probably attach conditions to the use of the money. States/municipalities can generally use money borrowed through bonds however they want.
          2. The bond market sets the interest rate, and the federal gov’t subsidizes whatever it is.
       3. **Illustration.** Suppose there’s a corporate bond for $1,000 at 10% interest and a Peoria bond for $1,000 at 10%. The bonds are equivalent in risk. In a world without tax, you’d be indifferent between the bonds.
       4. One way the fed gov’t could help Peoria out would be to send them a check for $100, or $90, or $30. Instead, it’s done through § 103, which excludes interest on state and local bonds. Peoria will save money by being able to set a lower interest rate.
       5. If it sets an interest rate of 7.2%, and I’m in a 28% tax bracket, I’m indifferent between the corporate bond and the Peoria bond. I get $72 in post-tax income from each of them. The fed gov’t loses $28 by giving this subsidy to me. Peoria gets a subsidy of $28.
       6. But if I’m in a 35% bracket, the gov’t will lose $35, Peoria gets a subsidy for $28. This is a **deadweight loss.** Peoria should have set the interest rate at 6.5%, which would have given them the full subsidy. Why does this happen? Because Peoria is targeting more than just 35% TPs. If they set it at 6.5%, 28% TPs won’t purchase them.
       7. Nonprofits, lower income TPs, and foreign TPs won’t purchase state and municipal bonds because they can’t take advantage of the preferential tax treatment.
       8. Suppose Peoria wants to raise just a little money. Then set the rate at 6.5% and raise it all from 35% TPs. If it wants to raise a lot of money, it needs to set the interest rate higher to attract lower bracket TPs. **35% TPs will buy these too, and get a windfall.**
       9. We need to figure out how much we need to raise and what brackets of TPs we need to raise the money from. **The TPs are the ones who take the extra money on the table** (the money that creates the deadweight loss)
4. **PROGRESSIVE TAX SYSTEM**
   1. As your income increases, you have the **ability to pay a larger share** than someone whose income is less because of **the declining margining utility of money.**
   2. Using the tax system for **redistribution.** (One of the two functions of the tax system. To pay for public goods is the other function.) Even those bitterly opposed to redistribution acknowledge that we shouldn’t expect everyone to pay for public goods in an equal way. Even if we had a flat tax there’d be a form of redistribution—everyone isn’t equally charged for public goods. It’s not clear what theory of redistribution our tax system operates on.

**What is Income?**

1. Income is an accretion to your wealth; something you didn’t have before.
2. **§ 61(a):** Except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) the following items:
   1. **(1)** Compensation for services, including fees, commissions, fringe benefits, and similar items
      1. [cash; property; someone paying your taxes (*Old Colony*); someone paying your liabilities; discount on property (§ 83);]
   2. **(2)** Gross income derived from business;
   3. **(3)** Gains derived from dealings in property;
   4. **(4)** Interest;
   5. **(5)** Rents;
   6. **(6)** Royalties;
   7. **(7)** Dividends;
   8. **(8)** Alimony and separate maintenance payments; [See § 71 – you can elect out of it]
   9. **(9)** Annuities;
   10. **(10)** Income from life insurance and endowment contracts;
   11. **(11)** Pensions;
   12. **(12)** Income from discharge of indebtedness;
   13. **(13)** Distributive share of partnership gross income;
   14. **(14)** Income in respect of a decedent; and
   15. **(15)** Income from an interest in an estate or trust.
3. **Reg. 1.61-1(a):** Gross income means all income from whatever source derived, unless excluded by law. **Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.** Gross income, however, is not limited to the items so enumerated.
   1. Reg. 1.61-14(a): **In addition to the items enumerated in § 61(a), there are many other kinds of gross income.** For example:
      1. Punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud
      2. Another person's payment of the TP's income taxes constitutes gross income unless excluded by law.
      3. Illegal gains
      4. Treasure trove, to the extent of its value, constitutes gross income for the taxable year in which it is reduced to undisputed possession
   2. Also, provision of services—e.g. medical services not charged for. Income = FMV
4. **IMPUTED INCOME**
   1. Why not tax imputed income to eliminate violations of equity?
      1. Privacy: the IRS would have to come inside your house and see who’s taking care of the child, how you comb your hair, etc.
      2. Administrability: If we’re really going to create equity, we’d have to track every single service people perform for themselves.
      3. Compliance: self-reporting would not work—people would lie a lot, as well as simply forget. They’d underestimate their own proficiency at services.
      4. Efficiency consequences: People wouldn’t care for their children; cook bad meals; not clean their homes; comb their hair badly.
      5. How to tax it? The Beachcomber Problem: everyone has a wage rate, and if a person chooses to stay at home and wash the floors, they’ve forgone the opportunity to go to a law firm—say the wage they’re forgoing is $500. If you tax the imputed income on the assumption that the value of the hour working at home is $500 (on the assumption that otherwise they’d be at the law firm), the person would *have* to work at the firm in order to pay their tax bills.
   2. Another solution to solving the inequity between paying for a service and getting it through imputed income: allow deductions for payments for all these services. You could apply this to everything—make paying someone to comb your hair, read you a book, deductible. Then you’d want to pay people to do everything for you. If we allowed you to deduct everything you consume, there’d be a tax on savings. Almost no one thinks that tax on savings only is a good idea for a country; it encourages excessive consumption.

* 1. **Housekeeping Violation of Equity.** Suppose Katie and Tom are married; Katie makes $100k a year, and Tom is a full-time homemaker. Ralph and Karen are married; Ralph has income of $100k, Karen has income of $24k, and they pay $20k for childcare. Both couples have $124k of value before tax. After tax, if we assume a flat 30% tax rate, Ralph and Karen will pay $37.2k in taxes and be left with $86.8k = $20k childcare + $66.8k consumption. Katie and Tom will pay $30k taxes on $100k and be left with $70k = $20k childcare (from Tom) + $70k consumption. This is a violation of horizontal equity.

1. **§ 119 – MEALS OR LODGING Furnished for the Convenience of the Employer.** Excludable for the employee, his spouse, or any of his dependents.
   1. **Meals:**
      1. The meals are furnished on the “business premises” *of the employer* 
         1. E.g. The meal is provided in the firm dining room because that’s the employer’s business premises
      2. Given *for the convenience of the employer*
         1. There must be *some non-compensatory reason* for the provision of the meal. There are things that employers give you that are primarily for you to do your job and are not primarily compensatory (or sometimes not compensatory at all).
      3. The *meal* must be directly furnished in kind.
         1. Thus supper money would not be excludable.
   2. **Lodging:**
      1. The employee is *required* to accept such lodging *on the business premises* of his employer *as a condition of his employment*
   3. (b)(1): Employment contracts and state statutes aren’t determinative of whether the meals or lodging are intended as compensation
   4. (b)(4): All meals furnished on the business premises of an employer to such employer’s employees shall be treated as furnished for the convenience of the employer **if more than half of the employees** to whom such meals are furnished on such premises are furnished such meals for the convenience of the employer.
   5. **POLICY:** We aren’t sure the employee will use the cash to pay for a meal. Cash is fungible. We need to be careful with it because it looks so much like compensation. Congress was concerned that the IRS could not monitor or enforce rules on cash. Another possibility is that the $20 in cash is not the same as a $20 meal.
      1. Is there a violation of equity in the taxation of the person who gets $20 meal money and the non-taxation of the person who gets a $20 meal. Depends on whether they’re in the same economic position. Argument that it is: The $20 in cash could be used to purchase a meal that’s worth more than $20 to the person, whereas the person can’t increase the value of the $20 meal to him if it’s worth $20 to him.
      2. It would create a nightmare to consider everyone’s utility and treat it differently. Generally Congress does not treat in-kind benefits differently from cash.
2. **FRINGE BENEFITS - § 132**. Use by spouses and dependent children are treated as use by the employee. (h)(2). Use of **air transportation** by a parent of the employee is treated as use by the employee. (h)(3)
   1. **Exclude** fringe benefits that qualify as a
      1. **(1)** **No-additional-cost service**
         1. any service provided by an employer to an employee for use by such employee if—
            1. **(1)** such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, **and**
            2. **(2)** the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).
      2. **(2)** **Qualified employee discount**
         1. Any employee discount (= difference between price for customers and price for the employee) with respect to qualified property or services to the extent such discount does not exceed—
            1. **(A)** in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or
            2. **(B)** in the case of services, 20 percent of the price at which the services are being offered by the employer to customers.
      3. **(3)** **Working condition fringe**
         1. Any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under Section 162 (trade or business expense) or 167.
      4. **(4)** **De minimis fringe**
         1. Any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer’s employees) so small as to make accounting for it unreasonable or administratively impracticable.
      5. **(5)** **Qualified transportation fringe.** Any of the following:
         1. Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee’s residence and place of employment. – together with the below, up to $100 per month.
         2. Any transit pass – together with the above, up to $100 per month.
         3. Qualified parking – up to $175 per month
         4. Any qualified bicycle commuting reimbursement.
      6. **(6)** qualified moving expense reimbursement,
      7. **(7)** qualified retirement planning services, or
      8. **(8)** qualified military base realignment and closure fringe.
   2. **On-premises GYMS and other athletic facilities**
      1. **Exclude** the value of the facility to the employee
   3. A taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. Reg. 1.61-21(a)(4).
3. **GIFTS AND INHERITANCES - § 102**
   1. **(a)** General rule – **Exclude** *the value of property* acquired by gift, bequest, devise or inheritance. [“gift etc.”]
   2. **(b) BUT:** **Not excludable:**
      1. (1) the **income from any gift** etc. property
      2. (2) where the gift etc. is of income from property, the amount of such income
   3. **(c) Employee gifts** are **not** **excludable** (“any amount transferred by or for an employer to or for the benefit of an employee”) (But see § 132(e) – fringe benefits)
   4. How do you know whether something is a gift?
      1. Where there’s consideration in return, the property isn’t given in detached and disinterested generosity, so it’s not a gift (*Duberstein*)
   5. Services are included under the definition of “property”
4. **QUALIFIED SCHOLARSHIPS - § 117**
   1. **(a)** General rule – **Exclude** any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization…
   2. **(b)** “Qualified scholarship” = any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for “qualified tuition and related expenses” = tuition and fees required for enrollment, and fees, books, supplies, and equipment required for courses of instruction
      1. Scholarship money used for room and board **cannot** be excluded.
         1. Policy: you’ll incur those expenses even if you don’t go to school
      2. Scholarships can’t be provided by an individual
      3. If something is compensation for services, it’s not a scholarship (thus work-study payments aren’t scholarships under § 117)
      4. If you get a $1k scholarship for books but don’t buy books with it, you can exclude it as long as it was intended for books (IRS’s position)
   3. **EQUITY**
      1. Repealing § 117 would improve equity among people who get qualified scholarships (no tax), and people who pay for their own tuition (they pay for it w/ after-tax income) or get it paid by their employers (they pay tax).
      2. But it would create a violation of equity between all 3 of these people, and people who get their tuition paid by their parents or grandparents (these people pay no tax on it, since it’s intra-family support or a gift)
5. **ANNUITIES - § 72**
   1. **Exclude**: Exclusion ratio ( = Investment/Expected Return) \* Each Amount Received. **Include** the rest of each payment received.
      1. E.g. for a $10k 10-year annuity that costs $7k: $700 of each payment is excludable.
      2. The rationale is that the excluded portion is a return of capital
      3. But § 72 mischaracterizes your investment economically—it allows you to say that more of each payment is a return of capital and less is income than is actually true economically
      4. This annuity gives you a $72.83 tax benefit over $7k invested in a 7.07% savings account over $10 years from which you withdraw $1k each year
   2. For a **life annuity**, exclusion ratio = investment/life expectancy. § 72(c)(3)(A)
      1. **Mortality loss:** if you don’t live long enough to collect the expected return, you get a loss deduction equal to unrecovered investment, i.e. the amount of capital not yet returned. (E.g. for the $7k annuity, if you die after 5 years, you get a $3.5k loss deduction because you’ve already received $3.5k return of capital). § 72(b)(3)(A)
      2. If you **outlive** **your life expectancy,** the full amount of each payment is taxable (because all your capital has been returned)
         1. Two advantages of outliving your life expectancy when you have an annuity that pays you until you die: (1) The formula is attributing too much capital to the beginning years; (2) The formula is based on the assumption that you will only earn the expected return (and the exclusion ratio is therefore higher than it should have been).
6. **LIFE INSURANCE - § 101**
   1. Beneficiary **excludes** payments from a life insurance policy
7. **§ 83 ELECTIONS – RESTRICTED PROPERTY COMPENSATION**
   1. **§ 83(a) default rule:** If, *in connection with the performance of services*, property is transferred to any person other than the person for whom such services are performed, the excess of—
      1. **(1)** the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over
      2. **(2)** the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm’s length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.
   2. **§ 83(b) Election:** Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of—
      1. **(A)** the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over
      2. **(B)** the amount (if any) paid for such property.
      3. If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.
         1. The fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election. Reg. § 1.83-2(a)
         2. **BASIS of the property:** Amount paid for the property + amount included in gross income under 83(b).
         3. **Loss on forfeiture:** You’re limited to taking a loss = excess of the amount you *paid* over the amount you receive on forfeiture (You *don’t* take a loss that includes the amount you originally included in gross income). Reg. § 1.83-2(a)
   3. **Substantial risk of forfeiture** **=** if such person’s rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.
   4. **Transferable =** only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.
   5. **(h) Deduction by employer.** Amount allowed = the amount included in the gross income of the person who performed such services; allowed for the taxable year in which such amount is included in the gross income of the person who performed such services.
   6. **Ownership; Income from property under 83(a).** Until the property becomes substantially vested, the transferor is regarded as the owner of the property, and any income from the property (e.g. dividends) received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and is included in the gross income of the employee or independent contractor for the taxable year in which the income is received or such use is made available. Reg. § 1.83-1(a)
      1. **This doesn’t apply to 83(b);** you’re deemed to be the owner of the property under 83(b), so dividends etc. aren’t taxed as compensation
   7. **TAX PLANNING**
      1. What you want to know: when you might sell the property; whether you have adequate liquidity to pay tax (in year 0 if you make an election); your tax rate; whether you plan to resign, or whether you’ll get fired; whether you think the property will go up (and if so, how much?) or down in value
      2. If the property isn’t likely to go up much in value and it won’t vest for a while, it’s better to let 83(a) apply because you benefit by deferring tax
      3. Take the present value of the tax obligations and add them up under each alternative. Need to know the appropriate discount rates, applicable tax rates, and the probabilities of the relevant events.
8. **LOANS & CANCELLATION OF INDEBTEDNESS INCOME - § 108**
   1. **Exclude amounts received as a loan**, unless you have **CoD** income. (Rationale: there’s no net accretion to wealth)
   2. **Include COD Income unless** (§ 108(a))
      1. (A) the discharge occurs in a title 11 case (**bankruptcy),**
      2. (B) the discharge occurs when the TP is **insolvent**…
         1. The amount excludable is limited to the amount by which TP is insolvent
   3. “Indebtedness” means any indebtedness (A) for which the TP is liable, or (B) subject to which the TP holds property. § 108(d)(1).
      1. In order to have CoD income, **there must be an enforceable debt** under state law. (***Zarin***) Otherwise there’s no debt in the 1st instance
   4. **Policy** of not taxing discharge of bankrupts’ debts**:** (1) It’s a way of taking the gov’t out of line and letting more of the money flow to the other creditors; (2) Bankruptcy is supposed to allow people to have a fresh start. Taxing them on the discharge would be like kicking them while they’re down.
   5. **EXCLUDE Purchase-Money Debt Reduction for Solvent Debtor** - **§ 108(e)(5)**
      1. Only applies to the acquisition of property
         1. Generally must be tangible property, though it may apply to some intangibles. Doesn’t cover opportunity to gamble (chips) (*Zarin*)
      2. TP must be solvent
      3. TP’s debt must be to the seller of the property
      4. Debt must have arisen out of the purchase
      5. It’s treated as a renegotiation of the purchase price, not CoD income.
         1. **Policy Rationale**: a “lemon provision”—assumption is you never got the full value in the first place
      6. **Statute:** If
         1. the debt of a purchaser of property to the seller of such property that arose out of the purchase of such property is reduced,
         2. the reduction does not occur—
            1. **(i)** in a title 11 case, or
            2. **(ii)** when the purchaser is insolvent, **and**
         3. but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,
      7. then such reduction shall be treated as a purchase price adjustment, so **NO CoD INCOME.**
9. **IMPROVEMENTS BY LESSEE TO LESSOR’S PROPERTY - § 109**
   1. **Exclude** income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.
      1. But include the income if it’s a **rent substitute**.
   2. **§ 1019 BASIS RULE: Basis is unaffected –** neither increased nor diminished on account of income derived by the lessor in respect of such property and excludable from gross income under § 109.
      1. **Effect:** TP will effectively pay tax on the value of the improvement on disposition because it will presumably cause the value of the property to go up.
   3. **POLICY:** Extremely TP friendly provisions. Another example of **tax deferral.**
10. **LEASE/RENT SETTLEMENTS; RENT – *Hort v. Commisioner***
    1. Upfront payments to settle leases are **treated as rent and taxed as ordinary income.** They **cannot be used to offset the cost of the underlying property.**
       1. Hort exchanged a release from the obligation to pay rent for money. He got less than the PV of rent payments because he can still rent out the property.
       2. The court said the fact that he’s getting it up front and we’re labeling it a lease extinction payment doesn’t matter—lessor can’t offset any of his cost by what he’s getting. It’s essentially the same as rent.
    2. **RENT** cannot be used to offset the cost of the underlying property (even if it’s a payment for a **perpetuity)**
    3. One of the things the case stands for is that **you don’t have a loss when you don’t get money you thought you were going to get;** the failure to collect what you hoped to collect is never a loss for tax purposes.
11. **GAMBLING WINNINGS**
    1. **Include** in gross income. Can be offset with gambling losses (up to the amount of gambling gains - § 165(d))
12. **ILLEGAL INCOME**
    1. **Include** in gross income
    2. Gains from **theft** are deemed income even if the thief intends to pay it back because the SC held that it’s assumed thieves don’t intend to pay it back. They have **dominion and control over the property** so they must include it. ***Collins***
       1. When you pay back gains from theft/make restitution, you can take a deduction for that amount (theft works the opposite way from loans) (*James*)
       2. If you steal money, gamble with it, and pay it back, there are 3 separate transactions (*Collins*)
13. **INTEREST FROM STATE AND LOCAL BONDS - § 103**
    1. **Exclude** from gross income

**Business/Trade Expenses - § 162** (above-the-line deductions)

1. **§ 162(a):** Deduct **all ordinary and necessary expenses** paid or incurred during the taxable year in carrying on any trade or business, **including—**
   1. **(1)** **a *reasonable* allowance for salaries or other compensation** for personal *services* actually rendered
      1. Reg. **§ 1.162-7**: The test of deductibility of compensation payments is whether they are reasonable and are in fact payments *purely for services.* 
         1. Can’t deduct any amount paid in the form of compensation, but not in fact as the purchase price of services. An ostensible salary paid by a corporation may be a distribution of a dividend on a stock; e.g. if there are a few shareholders.
            1. If the salaries are in excess of those ordinarily paid for similar services and the excessive payments bear a close relationship to the stockholdings of the employees, it’s likely the salaries are not paid wholly for services.
            2. If the employee is only receiving compensation when there are profits, then it looks more like a dividend (though it could just be compensation tied to performance)
         2. The allowance for the compensation paid may not exceed what is reasonable under all the circumstances: in general, reasonable and true compensation is only such as would ordinarily be paid for like services by like enterprises under like circumstances (at the date when the contract for services was made)
         3. In the case of a shareholder-employee, ask: What is the pattern of her compensation over the years? Are other SHS employed? How much are they being paid? How much work is the employee actually doing? What is
      2. Reg. **§ 1.162-8:** In the case of **excessive compensation**,
         1. If the payments bear a close relationship to stockholdings and are found to be a distribution of earnings or profits, the excessive payments will be treated as a **dividend**.
         2. If the payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the payor as **part of the purchase price.**
         3. Otherwise, they’re simply included in the gross income of the recipient.
         4. If it’s a **publicly held corporation**, no deduction is allowed for salary over $1,000,000 to the CEO and the 4 highest compensated officers (other than the CEO) - **§ 162(m)**
      3. As long as management is producing a sufficient return, then anything the manager is paid should be deductible. (***Exacto Spring***)
   2. **(2) traveling expenses** (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
   3. **(3) rentals or other payments** required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the TP has not taken or is not taking title or in which he has no equity.
2. **“NECESSARY”** means **“appropriate and helpful”** to producing profit/income, *not* “essential.” *Welch v. Helvering*
3. **“ORDINARY”** means that a reasonable person in the same circumstances would have made the expense; it *doesn’t* mean that the TP *regularly* makes the expense (it could be a once-in-a-lifetime expense)
4. **RENT** is deductible under § 162(a)(3)
5. **UTILITIES** are deductible under § 162(a) as an ordinary & necessary business expense
6. **ATTORNEYS’ FEES** (and related expenses) are **deductible** under § 162(a) if the ***origin of the charge***, *not* the outcome, is related to the TP’s business. (*Gilliam*, *Tellier*), and if they’re ordinary and necessary. You can deduct only the cost of defending against prosecutions that stem from profit-seeking activities.
   1. It doesn’t matter whether the matter is civil or criminal. Reg. § 1.162-21.
7. **ENTERTAINMENT, AMUSEMENT, OR RECREATION** - **§ 274**
   1. **(a)** **No deduction allowed**, **unless** the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that **such item was associated with, the active conduct of the TP’s trade or business**
      1. Very easy to meet this requirement. You basically can just take a client to dinner and say “I thought it would get me more business.”
8. **BUSINESS MEALS – § 274(k) says:**
   1. No deduction allowed ***unless***
      1. Such expense for food and drink is not lavish or extravagant under the circumstances, and
      2. The TP (or an employee of the TP) is present at the furnishing of such food and beverages.
   2. ***Moss*:** Daily meals during firm meetings are not deductible; routine meals are personal expenses, even if you do work during them.
   3. **50% haircut on meal and entertainment expenses - § 274(n)**
      1. **If the TP is reimbursed** for the cost of business meals or entertainment, **the 50% limitation applies to the reimburser** (so if a law firm bills clients for meals, then the client is subject to the 50% limit). The employee isn’t taxed at all on the cost.
      2. If the employee isn’t reimbursed, the expenses are subject not only to the 50% limitation, but also the 2% floor of § 67 (b/c they’re misc. itemized)
9. **FINES AND PENALTIES** paid to a government for the violation of any law are **not deductible**. **§ 162(f)**
   1. **Policy:** Otherwise, Congress would be subsidizing fines, and they’d have less of a deterrent effect. For a 30% TP, a $20k fine would only have the deterrent effect of a $14k fine.
10. **LOBBYING & POLITICAL EXPENDITURES – § 162(e)**
    1. **(1)** Generally, **no deduction** is allowed amounts paid or incurred in connection with—**(A)** influencing legislation, **(B)** participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, **(C)** any attempt to influence the general public, with respect to elections, legislative matters, or referendums, or **(D)** any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official.
       1. **(2) Local legislation exception:** Can deduct ordinary and necessary expenses **(i)** in direct connection w/ appearances before, submission of statements to, or sending communications to the committees, or individual members, of such council/body w/ respect to legislation or proposed legislation of direct interest to the TP, or **(ii)** in direct connection w/ communication of information between the TP and an organization of which the TP is a member w/ respect to any such legislation or proposed legislation that’s of direct interest to the TP and such organization
          1. Newspaper advertising wouldn’t be deductible under this exception or under the general rule
       2. A newspaper ad that doesn’t specifically refer to elections, legislative matters, or referendums can be deductible—e.g. an ad by the oil industry that says “what’s good for oil is good for America.” Won’t be barred by 162(e)(1)(A) or (C). You’re free to talk about the issues alone.
11. **ILLEGAL BRIBES, KICKBACKS, AND OTHER PAYMENTS**
    1. **No deduction allowed -**  § 162(c)
       1. For any payment made, directly or indirectly, to an official or employee of any gov’t, or any agency or instrumentality of any gov’t, if the payment constitutes an illegal bribe or kickback, or if it’s unlawful under the FCPA
       2. If it’s an illegal bribe, kickback, or other illegal payment under any law of the US or any State that subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. A kickback includes a payment in consideration of the referral of a client, patient, or customer
       3. Medicare and Medicaid kickbacks
12. **ILLEGAL TRAFFICKING OF DRUGS –** expenditures cannot be deducted. 280E.

**§ 179 Deduction – Election to Expense Certain Business Assets**

**\*\* Expensing the cost in the year of purchase = Exempting the Yield\*\*, which means the pre-tax rate of return = after-tax rate of return**

1. TP may elect to expense the cost of any § 179 property in the year placed in service.
   1. **§ 179 property = Tangible property** or computer software used in the active conduct of a trade or business (essentially equipment)
2. **Limitations**
   1. $500k maximum on costs you can expense
   2. If you put into service more than $2m, every dollar over $2m that you spend on 179 assets reduces the $500k deduction by $1. So if you buy $2.5m of 179 assets, you get $0 deduction. Thus big businesses don’t benefit at all from 179; neither do businesses with no taxable income (e.g. startups, companies that have so many tax benefits in the first place that they’ve eliminated their taxable income; struggling companies that don’t have any income. It’s also not very beneficial to companies that don’t have high tangible personal property expenses (financial services, companies that deal in IP or real estate, etc.))
   3. Limited to taxable income

**Employee Business Expenses** - **§ 62(a)(2)**

If an employee has deductible expenses that the **employer reimburses**, the deduction is above the line. Otherwise, it’s a miscellaneous itemized deduction.

Above the line deductions: (as § 62(a)(2) lays them out):

1. (A) Reimbursed expenses of employees - consist of expenses paid or incurred by the TP, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer.
2. Deductions allowed by § 162 which consist of expenses paid or incurred by a **qualified performing artist** in connection with the performances by him of services in the performing arts as an employee.
3. Certain **expenses of officials** - The deductions allowed by § [162](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000162----000-.html) which consist of expenses paid or incurred with respect to services performed by an official as an employee of a State or a political subdivision thereof in a position compensated in whole or in part on a fee basis.
4. (D) Certain expenses of **elementary and secondary school teachers** - the deductions allowed by section[162](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000162----000-.html) which consist of expenses, not in excess of $250, paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.
5. **CLOTHING AND UNIFORMS**
   1. ***Pevsner Objective Test*:** Is the clothing adaptable to general wear? If not, the expenses are deductible.
      1. If it has a work-related logo on it or is a uniform, it’s assumed that it’s not adaptable to general wear.
      2. Business suits aren’t deductible b/c they’re adaptable to general wear.
   2. **Policy:** A subjective test based on the employee’s preferences and lifestyle would allow almost everyone to deduct the costs of their work clothes.
      1. **Tax expenditure** for people who love wearing uniforms etc.
      2. **Tax penalty** for people who wear suits to work and hate wearing them.
6. **TRANSPORTATION EXPENSES**
   1. When the TP is **traveling on business/in business status**, transportation expenses such as airfare, taxicab fare, and the cost of operating a car are generally deductible.
      1. This may be the cost of traveling from one city to another or the cost of traveling from one business engagement to another within 1 metropolitan area.
      2. When you’re in travel status, say going to another city, all costs are deductible, even the cab to the airport to get to travel status.
   2. The costs of **commuting from home to work** and back are nondeductible personal expenses. Reg. § 1.162-2(e).
      1. **Policy:** The work location is fixed, and the decision to live beyond walking distance is a personal one. (But this penalizes people who aren’t able to live near work even if they wanted to (e.g. people who work at bomb test sites in deserts).
      2. **Exception:** additional expenses incurred transporting job-required tools and material to and from work. Can deduct only the portion of the cost of transporting the work implements by the mode of transportation used that’s in excess of the cost of commuting by the same mode of transportation without the work implements. *Fausner*
   3. **Commuting to Temporary Employment**. IRS rules:
      1. May deduct daily transportation expenses incurred going between your residence and a temporary work location outside the metropolitan area where you live and normally work. However, daily transportation expenses incurred going between your residence and a temporary work location within the metro area are nondeductible commuting expenses.
      2. If you have one or more regular work locations away from your residence, you may deduct daily transportation expenses incurred going between your residence and a temporary work location in the same trade or business, regardless of distance.
      3. If your residence is your principal place of business, you may deduct daily transportation expenses incurred going between your residence and another work location in the same trade or business, regardless of whether the other work location is regular or temporary and regardless of the distance.
         1. “**Temporary place of business**” = a location at which you perform services on an irregular or short-term basis.
7. **TRAVEL EXPENSES** = lodging, meals, tipping—expenses incident to travel
   1. Only such travel expenses as are reasonable and necessary in the conduct of business and directly attributable to it may be deducted.  **Reg. § 1.162-2**
   2. If you engage in both business and personal activities at the destination, the expenses are only deductible if the trip is **primarily related to your trade or business**. However, expenses while at the destination that are properly allocable to your trade/business are deductible even though the travel expenses to and from the destination aren’t.
   3. **OVERNIGHT RULE**: Interpretation of 162(a)(2).
      1. “Away from home” = the trip requires sleep or rest, and the destination is outside the metropolitan area of your principal place of business.
      2. **Policy:** Deciding to stay overnight in the same metropolitan area is more of a personal consumption choice.
   4. **TEMPORARY VS. INDEFINITE EMPLOYMENT**
      1. You’re temporarily away from home as long as you *expect* to be away from home for less than a year, and you *are* in fact away from home for less than a year.
         1. If your employer transfers you to a temporary location and says, “You’re probably going to be there for 18 months,” you can’t deduct the expenses no matter how long you’re there.
         2. If you expect to be there for 8 months and in fact are there for 8 months, you can deduct all the expenses. If you expect to be there for 8 months and are in fact there for 18 months, you can deduct the first year’s expenses but not the expenses for the last 6 months.
         3. **Efficiency:** People will want to come home on the 364th day away from home and work to get around this. The employer would also have an incentive to tell you that they expect you to be away for less than a year. This is basically just a deduction of consumption.
      2. ***Hantzis*:** The law student lost her case because Boston wasn’t her home, so she wasn’t away from home. Her principal place of business was NY because she was only working in NY.
   5. **Policy:** The Code has made the presumption that the meal while away on business is *not* consumption. The entire cost of the meal is deductible. This can be exploited: e.g. take a client to a lunch that you would have gone to anyway. In a normal income tax system, you wouldn’t be able to deduct the value of the meal you’d eat at home, but only the excess of the amount you spend on the meal while away on business.

**Personal Deductions & Credits**

1. **§ 262** - **never deduct** **personal, living, or family expenses.**
2. **PERSONAL EXEMPTION - § 151**
   1. **Deduction.** Starts at $2k. Indexed for inflation
   2. H&W filing jointly are entitled to 2 personal exemptions. If they file separately, one spouse may take an allowance for another spouse only if that spouse has no gross income and is not someone else’s dependent.
   3. TP entitled to an exemption for each **dependen**t = [§ 152]
      1. **Qualifying child:** grandchild, brother, sister, descendent of grandchild. Under 19, lives with PT, and has not provided more than half of their own support
      2. **Qualifying relative:** pretty much everyone but cousins. Can’t provide more than half of their own support. Can’t have gross income greater than the exemption amount.
   4. An individual claimed as a dependent by another TP can’t take an exemption for dependents. (A dependent can’t have dependents. 152.)
   5. **Exemptions are** **phased out** by 2% for each $2.5k over the threshold.
   6. **Policy of dependency exemptions.** Idea: if we as a country believe that we can’t allow people to starve in the streets, someone has to support them. When it’s an individual, those dollars are not available to pay tax, so we arbitrarily take an amount and say that this amount that mom spends on her child is not money we can tax, so we allow her to subtract another personal exemption. It obviously doesn’t cover all of the costs of supporting a child (not even close), but it’s meant to represent the subsistence level of supporting a child.
3. **CHILDCARE TAX CREDIT - § 21** – Not refundable
   1. TPs with AGI of $15k or less may offset tax liability by 35% of their employment-related dependent care expenses. This percentage is reduced by 1% for each additional $2k of AGI, until it reaches 20% for TPs with AGI above $43k. The amount of creditable expenses is limited to the income of the lower-earning spouse or, in the case of a single person, to earned income. (If one spouse stays home and has 0 wages, they can’t use the credit at all. Rationale: the babysitting etc. must be consumption. This has the effect of encouraging people who can’t use the credit to stay home.)
      1. **“Employment-related expenses”** = expenses incurred to enable the TP to be gainfully employed (if you have wages, they assume the expenses are to enable you to work; but care and household service expenses that enable consumption aren’t deductible):
         1. Expenses for **household services**, and
         2. Expenses for the **care** of a qualifying individual. [Overnight camp doesn’t count]
   2. There’s a **ceiling** on creditable expenses of $3k for one dependent and $6k for more than one. (This means the credit cannot exceed $1,050 for one dependent or $2,100 for two or more dependents)
   3. People who have no taxable income can’t use the credit b/c it’s **nonrefundable**. After deductions, there are many of these people—and they’re probably the ones who need it most.
   4. **POLICY:**
      1. Very few low-income TPs will be able to take advantage of it and virtually no one would get the maximum credit. A single mother with two children who earns only $15k is not likely to pay a babysitter $6k, and even if she does, she has no tax liability against which to offset any credit!
      2. **Expenditure?** 
         1. **Yes:** This is really a consumption expense. (Definitely so for people who would go to work whether they get the credit or not; it’s pure consumption for them.) Babies are just one of the things you can spend money on. Sign that it’s an expenditure: there’s a dollar limit on the credit. Congress probably limits it because it wants to cut out some of the consumption element.
         2. **No:** If the cost of providing childcare is a cost of producing income, then it ought to be deductible. You could also argue that the gov’t would otherwise have to take care of children if parents didn’t, so they might as well provide a tax credit or allow the expenses to be deductible. (Though this point admits that it’s an expenditure made through the tax system)
      3. **Penalty?** To the extent that the amount of the childcare expense that’s actually a cost of producing income exceeds the amount of the credit.
      4. Congress has chosen to deal with this joint business-and-consumption expense (inextricably contains elements of both) by imposing a cap.
4. **ALIMONY PAYMENTS - § 215**
   1. **Deduct** payments made as alimony or separate maintenance
5. **EARNED INCOME TAX CREDIT - § 32**
   1. **Requirements:**
      1. TP must have earnings from work
      2. TP must have a qualifying child, or if not, be between age 25-65 and not be a dependent of another TP
   2. The credit is a percentage of earned income, with both the credit percentage and the earned income varying with the number of children. The credit increases as earned income increases until it hits a maximum amount, and then is phased out by a percentage of the income exceeding the phase-out amount. The maximum amount and phase-out amount are indexed for inflation.
   3. **POLICY:** The EITC is **probably the most egregious marriage penalty**. If the couple is earning $44k total ($22k earned by each), the EITC will disappear and they lose $8k total. This is huge for them.
6. **EXPENSES FOR PRODUCTION OF INCOME (FOR INDIVIDUALS) - § 212**
   1. In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
      1. **(1)** for the production or collection of income;
      2. **(2)** for the management, conservation, or maintenance of property held for the production of income; or
      3. **(3)** in connection with the determination, collection, or refund of any tax.

**Itemized Deductions**

TP has a choice: either take the **standard deduction** or **itemize deductions.**

1. **CHARITABLE CONTRIBUTIONS - § 170** [(a)(1), (b)(1)(A), (c)]
   1. **General rule:** deduct any charitable contribution (to qualified charitable orgs.). Deduction is **limited to your contribution minus benefits received**. [If you win an auction for a $3k vacation and pay $3k, you have a 0 deduction.]
   2. **LIMITATION:**The aggregate of contributions **cannot exceed 50% of TP’s AGI.**
      1. **Deduct** **cash donations**
      2. **Don’t deduct donations to individuals**
         1. Policy: Administrative (we can’t keep track of this); TP might be giving to people we don’t want to subsidize; TP might be giving to his children etc. and effectively deducting support of them. The charitable organization serves as a monitoring intermediary
      3. **Don’t deduct** **contributions of services**
         1. Policy: We’d have to figure out the value of what you contribute; you’d have people donating the same services and getting different deduction amounts if foregone labor costs is the measure of value; to prevent negative tax results (you have 0 income for the hour, but you have a deduction of positive value = negative taxation)
         2. Perverse incentive to contribute cash when TP’s services might be worth more
      4. **Don’t deduct contributions that are contingent on e.g. your kid getting into school**
      5. Donations to **religious institutions**
         1. **Deduct contributions even if you get** **intangible religious benefits** in return (something that can only be attained in the religious marketplace as opposed to the nonreligious marketplace)
         2. Otherwise if there’s a **quid pro quo exchange**, don’t deduct contributions. ***Hernandez.*** (Scientology established fixed price schedules for auditing and training session; calibrated prices to the length and level of sophistication of the sessions—this is prepayment for services). However, pew rents and other things that look like quid pro quos are deductible as intang. relig. benefits
   3. **POLICY**
      1. **Is charitable giving consumption?** 
         1. **Yes:** it makes you feel better—you get personal utility, joy, happiness, prestige, whatever. Could compare it to buying an iPod—both give happiness.
         2. **No:** it’s not consumption because it’s money that you can’t use for your own consumption—when you transfer the money to someone else, it’s *they* who consume, and income is generally defined as the year’s earnings that are *available for consumption or savings*.
         3. Why not tax the charitable organization? Because they’re a pure conduit for charitable donations.
         4. Why shouldn’t the ultimate recipient be taxed? Whereas in the gift context, we tax the giver and exempt the recipient, here we tax neither the donor nor the donee. We could be theoretically pure by saying that the ultimate recipient of the charity should be taxed unless their income is low enough that they don’t have to pay taxes. In some cases recipients of money from charitable organizations would have to pay income—e.g. recipients of full scholarships to law school.
         5. Sometimes it’s very hard to measure who the ultimate beneficiary is—e.g. in the case of a museum.
      2. **Is it a tax expenditure?**
         1. **Yes:** you get to choose what to do with your income, and donating it is one way of consuming. Expenditures are spending through the tax code as opposed to direct spending. Most people think the charitable deduction is a tax expenditure and that it’s designed to incentivize certain behavior.
      3. **Efficiency**
         1. Two possible situations
            1. TP gives $1 no matter the tax treatment.
            2. TP otherwise would have given $1, but he sees that he can give more for the same ultimate cost because of the value of the deduction, so he gives more.
         2. In the latter situation, we’re transferring more money to charity than we otherwise would have transferred. The deduction provided an incentive.
         3. In the former, we’re subsidizing donors through the tax system. The charity isn’t receiving more than they otherwise would have received. The deduction didn’t provide an incentive to the TP to give more.
      4. **Alternatives to the charitable deduction:**
         1. Replace the charitable deduction w/ a tax credit
         2. Replace it with a matching grant program under which the federal gov’t would provide the charity a direct grant equal to a specified percentage of TP’s gift
         3. Repeal the charitable deduction and lower tax rates generally to offset the revenue increase
         4. Replace the charitable deduction with direct subsidies
      5. The charitable deduction is an **upside-down deduction** because it provides a much larger benefit to the wealthy. People who take the standard deduction (80%~won’t be affected by this deduction. There’s no subsidy to them. The wealthier are allocating a larger portion of the subsidy to charities than people who are low and middle income. This may or may not present problems depending on where the high-income people’s donations are going. However, there’s empirical evidence that the incentive effect is much greater as income goes up (so it’s prob. efficient)
2. **DONATIONS OF CAPITAL GAIN PROPERTY - § 170(e)**

**Note: 170(e) never applies to real estate or stock.**

* 1. If TP donates property to a charity, **reduce the charitable contribution by any gain that’s would not have been LTCG** if the property had been sold for FMV,
  2. **AND,** 
     1. If the use by the charity is unrelated to its **charitable purpose**, **or**
     2. If the charity sells, exchanges, or **disposes** of the property **in the year of contribution,**

**THEN** reduce the contribution by the amount of gain that would have been LTCG if the property had been sold for FMV.

* 1. If the property doesn’t sell it within the year of contribution but sells within 3 years, then the excess of the FMV over basis gets recaptured in the year of sale.
  2. If it’s ordinary income property, or the property has a STCG, then your deduction is AB (by (e)(1)(A)). If the property has LTCG, you will want to make sure the charity uses it in its charitable function. If they don’t, then the deduction is limited to AB. If the charity will hang onto it for 3+ years, then your deduction is FMV, and there’s no recapture. If charity sells in the next 3 years, then when the charity sells it, the donor has extra gross income that year.
  3. Charitable deductions always offset ordinary income, so they’re worth the deduction times your tax bracket.
  4. **POLICY:**
     1. **The gains disappear. Charities never pay tax on the gains because they’re tax-exempt.**
     2. There’s a huge incentive to donate capital gains property to charities
     3. Congress was concerned about was donations of property to charities that they didn’t use in their charitable functions to create benefits for the donor without a corresponding benefit to the charity
     4. Why 3 years? It’s just an arbitrary way of making sure the charity’s really using it.
     5. The right normative rule would be to have the deduction limited to your basis, because that’s your cost. Why do you get a deduction for the appreciation you never paid taxes on? Because charitable organizations lobby for this rule.

1. **MEDICAL EXPENSES - §§ 213; 104, 105, 106** 
   1. **Deduct** **unreimbursed** (by insurance or otherwise) **expenses that exceed 7.5% of AGI** for medical care of TP, his spouse, or a dependent.
      1. **“Medical expenses” =**
         1. payments for the diagnosis, cure, mitigation, treatment, or prevention of disease
         2. Costs of transportation primarily for and essential to medical care
         3. Amounts paid for medical insurance
   2. **Cosmetic surgery** (and similar procedures) **is not deductible**
   3. **§ 104: Reimbursement by non-employer** does not count as income (e.g. your own insurance policy; **damages from a tortfeasor**; workman’s comp, etc.
   4. **§ 105 and 106:** The premiums your employer pays are excludable (106), and the amounts paid for medical care by the insurance plan are excludable (105(b)).
      1. Thus, if you pay for your own insurance and go to the doctor, the premiums are not excludible unless they exceed 7.5% of your AGI, whereas if your employer pays the premiums, they are excludable.
   5. **Self-employed** people can take deductions for health insurance (§ 213(l)
   6. **POLICY:**
      1. 7.5% floor is intended to disallow deduction for normal medical expenses such as annual check-ups and supplies for the home medicine chest. The deduction is therefore limited to those taxable years when a person’s medical expenses uncompensated by insurance are extraordinary.
      2. The after-tax cost of health insurance for TPs who don’t work or don’t have employers who provide health insurance is much greater, because their insurance premiums are deductible only if they exceed 7.5% of AGI, and only if they itemize deductions
      3. **Tax Expenditure?**
         1. **No:** Medical insurance is a cost of producing income and it’s involuntary.
            1. **Yes:** So are food, clothes, and shelter. You’d gut the tax base if keeping yourself alive were considered a cost of producing income.
         2. The tax system basically ignores
         3. Argument that it’s **consumption:** you’d buy medical insurance if you didn’t get it from your employer; the insurance your employer provides to you clearly has value to you.
         4. Another argument that it’s **normative:** if you have a hand and lose it in an accident, you don’t have income when you get compensated for the loss of it because it’s equivalent to a recovery of the hand as asset. But: The problem with this is that if you don’t have insurance, you should be able to claim a deduction for the loss of the hand. But by this reasoning, any decline in general wellbeing could be deductible—mental illness, having your life go badly, moving to a place where it’s rainy after living in a place where it’s sunny.
      4. **Efficiency Consequences**
         1. May depress wages because it encourages people to accept less salary in exchange for something else that’s more valuable b/c it’s tax exempt. Congress wants to favor a particular kind of fringe benefit, and they want it structured in a particular way (through employers—otherwise they’d let you deduct premiums yourself).
         2. People are incentivized to take jobs that provide health insurance. (Though 213(l) does allow self-employed people to take deductions for health insurance) This may be good or bad, but it’s definitely changing market behavior.
         3. May encourage employers to do something they may not otherwise do because they won’t be able to compete for skilled labor unless they offer health insurance.
         4. When the employer is providing health insurance that’s tax free, there’s much less need to monitor your costs for your behavior; we’re exacerbating the costs of insurance generally because you bear little cost. There are ways to counter this through deductibles and copays, but people still generally take more insurance than they need. If everything is reimbursed, people tend to purchase through insurance more medical care than they would otherwise take (lot of empirical evidence that people don’t make calculations when they’re fully insured, and particularly when there are no tax consequences to the calculations). Thus the result is over-insurance, and very little monitoring by the consumer.
         5. Discourages you from purchasing your own policy (perhaps because it’s more efficient and cost-effective to have a larger pool. Avoid moral hazard and adverse selection)
2. **CASUALTY LOSSES - § 165(c)(3)**
   1. **Must not be de minimis:** Only casualty losses greater than $100 are taken into account
      1. The theory is that regular life involves losing items of de minimis value.
   2. **Can deduct casualty and theft losses equal to casualty and theft gains,** 
      1. **Any excess** casualty losses are limited to the amount that **exceeds 10% of AGI**
3. **Miscellaneous Itemized Deductions** – \*\*\* can only include the **excess of 2% of AGI!!\*\*\* § 67**
   1. Unreimbursed employee business expenses
   2. Tax preparation fees
   3. Income-producing expenses that are not in connection with rental activity. E.g. 212(3) allows you a deduction for the cost of preparing your tax return. Also: Investment fees you pay; the cost of investment newsletters; etc. You have an activity that produces income, but it’s not in connection with a business. The reason expenses in connection with rental activity aren’t included is that such expenses are above the line.

**Capitalization**

**Question:** Do you expense or capitalize the asset? Capitalization entails giving the asset a basis, not deducting it in the year of acquisition, and accounting for it in the future.

**Basic idea:** The Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable to achieve a more accurate calculation of net income.

1. **§ 263(a) - No deduction allowed for**
   1. Amounts paid for **new buildings** or for **permanent improvements or betterments** made to increase the value of any property or estate,
   2. Amounts expended **restoring property** or in **making good the exhaustion** thereof for which an allowance is or has been made.
2. **COSTS OF REAL OR TANGIBLE PROPERTY PRODUCED BY TP - § 263A** 
   1. **Capitalize**
      1. the direct costs of such property, and
      2. such property’s share of those indirect costs (including taxes) part of all of which are allocable to such property.
         1. **Property taxes** are expensed
         2. **Employee compensation** – capitalize the portion attributable to the production of the property into the cost of the property
         3. **Use of asset to construct another asset:** capitalize the cost of using that asset in the construction (= the amount of depreciation you could have taken on the asset over the period of use), and add that to the basis of the property constructed. (E.g. if you use a backhoe for 3 days, you depreciate 3/365 of the 1-year depreciation amount). If the construction asset has a 0 basis, you can’t add any cost to the basis of the new asset ***Idaho Power*.**
            1. **Basis of construction asset - § 1016:** When you capitalize the cost of use of the construction asset, you reduce its basis by that amount.
   2. Doesn’t apply to property produced for use other than in a trade or business or an activity conducted for profit
3. **Amounts paid to ACQUIRE OR PRODUCE TANGIBLE PROPERTY** – Reg. § 1.263(a)-2
   1. TP **must capitalize** amounts paid to acquire or produce a unit of real or personal property, including leasehold improvement property, land or land improvements, buildings, machinery and equipment, and furniture and fixtures.
   2. Includes invoice price, transaction costs, and costs for work performed prior to the date the property is placed in service by TP.
   3. Must capitalize amounts paid to acquire real or personal property for resale and to produce real or personal property
4. **Amounts paid to IMPROVE TANGIBLE PROPERTY** – Reg. § 1.263(a)-3
   1. TP **must capitalize** the aggregate of related amounts paid to improve a unit of property, whether the improvements are made by TP or 3rd party, and whether TP is an owner or lessee of the property.
   2. **A unit of property is improved if** the amounts paid for activities performed after the property is placed in service by TP**:**
      1. Result in a **betterment** to the unit of property; or
         1. “Betterment” = ameliorates a material condition or defect that existed prior to TP’s acquisition or arose during production; results in a material addition to the property or a material increase in capacity, productivity, efficiency, strength, quality, or output
      2. **Restore** the unit of property; or
      3. **Adapt** the unit of property to a new or different use.
   3. **Safe Harbor for ROUTINE MAINTENANCE**
      1. Routine maintenance is deemed not to improve the property
      2. “Routine maintenance” = recurring activities that TP expects to perform as a result of TP’s use of the unit to keep the unit in its ordinarily efficient operating condition. Includes inspection, cleaning, testing, replacement of parts. Activities are routine **only if**, at the time TP places it in service, he reasonably expects to perform the activities more than once during the class life,
5. **Amounts paid to ACQUIRE OR CREATE INTANGIBLES** – Reg 1.263(a)-4
   1. TP **must capitalize** an amount paid to
      1. Acquire an intangible;
         1. [Examples: ownership interest in a corporation, partnership, trust, estate, LLC, etc.; a patent or copyright]
      2. Create an intangible
         1. [Includes **prepaid expenses** (such as prepaid insurance and rent), amounts paid to another party to defend or perfect title to intangible property]
      3. Create or enhance a separate and distinct intangible asset
         1. “**Separate and distinct intangible**” = a property interest of ascertainable and measurable value in money’s worth that’s subject to protection under law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged separate and apart from the trade or business.
      4. Create or enhance a future benefit identified
      5. Facilitate an acquisition or creation of an intangible
   2. **12-MONTH RULE - EXCEPTION**
      1. Expense amounts paid to create (or facilitate creation of) any right or benefit for the TP that does not extend beyond the earlier of—
         1. 12 months after the first date on which TP realizes the right or benefit
         2. The end of the taxable year following the taxable year in which the payment is made
      2. The duration of a right includes any renewal period if all the facts and circumstances during the taxable year in which the right is created indicate a reasonable expectancy of renewal.
   3. **Treatment of capitalized costs:** Generally added to the basis of the intangible
6. **Amounts paid or incurred to FACILITATE AN ACQUISITON OF A TRADE OR BUSINESS** – Reg. § 1.263(a)-5
   1. TP **must capitalize** an amount paid to **facilitate an acquisition of assets that constitute a trade or business** (whether TP is the acquirer or the target)
   2. **“Facilitate”** = if the amount is paid in the process of investigating or otherwise pursuing the transaction (based on all facts & circumstances),
      1. The fact that an amount would/would not have been paid but for the transaction is relevant, but not determinative.
      2. Includes paid to determine the value or price of a transaction
      3. Doesn’t include an amount paid to another party in exchange for tangible or intangible property (e.g. the purchase price paid to the target in exchange for its assets, or price paid to target’s SHs for their stock)
      4. **If not inherently facilitative,** capitalize only if activities are performed **on or *after*** the earlier of (1) the date of execution of a letter of intent, exclusivity agreement, or similar written communication, or (2) the date on which the material terms of the transaction are approved by TP’s board or a binding contract is executed.
         1. **“Inherently facilitative” =** Amount paid for [Always capitalize]
            1. Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction
            2. Structuring the transaction, including negotiating the structure and obtaining tax advice
            3. Preparing and reviewing the documents that effectuate the transaction
            4. Obtaining regulatory approval (including preparing and reviewing regulatory filings)
            5. Obtaining SH approval of the transaction
            6. Conveying property between the parties to the transaction
   3. If you **abandon a transaction**, you can expense the costs.
   4. **Don’t capitalize** (for purposes of these rules on acquisitions of businesses)
      1. **Employee compensation**
      2. **Overhead**
      3. **De minimis costs** (Amounts < $5k)
         1. Amounts > $5k must be entirely capitalized (if facilitative)
         2. Amount paid in property is valued at FMV at time of payment
7. If you **fail to deduct any appreciation allowance**, you can’t increase your depreciation allowances in later years. Reg. § 1.167(a)-10(a)
   1. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the TP for such property or under the straight-line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if TP's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account.
8. **Costs of Disposition of property** (e.g. broker’s selling commission) are not deductible under § 162 or 212 as ordinary and necessary business or investment expenses. Rather, they **are capitalized and are offset against AR,** thereby reducing the amount of gain or increasing the loss from the asset’s disposition. Thus if the asset, qualifies for capital gain treatment, the broker’s commission will reduce that gain rather than offset ordinary income.
9. **Repairs – Expense** **the cost of incidental repairs** which neither materially add to the value of the property nor materially prolong its life, but keep it in an ordinarily efficient operating condition, provided the cost of acquisition or production or the gain or loss basis of TP’s plant/equipment/other property isn’t increased by the amount of such expenditures. Reg. § 1.162-4
10. **POLICY: NORMATIVE CAPITALIZATION AND EXPENSING**
    1. It would be right to allow expensing of things that produce income only in year 1. (e.g. raw materials to make products to be sold in that year; employee salaries (though it’s possible to have salaries produce income in the future, e.g. in the case of a big project whose income comes in in the future); rent; utilities; insurance; office supplies)
    2. It would be right to require capitalization of things that produce income over multiple years (e.g. property (not including land, because it doesn’t dissipate), plant, equipment, generally.)
    3. It would be right to allow deduction only on disposition of those assets that produce income only on disposition (land, stock (it doesn’t dissipate over a fixed period of time), your primary residence, your car, your furniture, goodwill, art and collectibles.

**Depreciation**

**§ 167:**

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

**(1)** **of property used in the trade or business, or**

**(2)** **of property held for the production of income.**

**How To Do Depreciation - § 167, § 168, § 197**

1. Capitalize or expense? If capitalize, do depreciation.
2. What’s the **depreciable basis** = Adjusted Basis. § 1011
3. **Recovery period.** § 168(e) [The overwhelming majority of assets are 5 year property]

|  |
| --- |
|  |
| **Property shall be treated     as:** | | **If such property has a class   life (in years) of:** |
|  | |  |
|  | |  |
| 3-year property | | 4 or less |
| 5-year property | | More than 4 but less than 10 |
| 7-year property | | 10 or more but less than 16 |
| 10-year property | | 16 or more but less than 20 |
| 15-year property | | 20 or more but less than 25 |
| 20-year property   |  |  | | --- | --- | | ------  Residential rental property |  | | Nonresidential real property  Intangibles |  | | | 25 or more.  27.5 years  39 years.  15 years (§ 197) |

1. **Convention.** Asset is treated as
   * **All property except real estate** **= half year convention** (property is treated as placed in service, or disposed of, on the mid-point of the taxable year of the year in which it’s placed in service or disposed of)
   * **Real estate = mid-month convention** (property is treated as placed in service, or disposed of, on the mid-point of the month in which it’s placed in service or disposed of)
     + (Nonresidential real property and residential rental property)
   * **Intangibles =** Take the **whole month in which acquired/disposed**
2. **Depreciation Method**
   * **Everything else: 200% declining balance method**, and switch to the straight line method for the 1st taxable year for which using the straight line method will yield a larger allowance (divide AB at that point equally over the remaining life of the asset)
     + = Depreciable amount for each year = (AB) \* (2 \* straight line rate)
   * **Real Estate: straight line method** 
     + **=** Depreciable amount for each year = (AB)/Recovery Period
   * **Intangibles: straight line method** (§ 197)
3. Deduct whatever’s left in the **last year**
4. Salvage value is treated as 0. You can recover the entire cost through depreciation.

**INTANGIBLES - § 197**

1. **“§ 197 intangibles”** means: [must be held in connection w/ trade or business]
   1. Goodwill
   2. Going concern value
   3. Workforce in place
   4. Business books and records, operating systems, or any other info base
   5. Patent, copyright, formula, process, design, pattern, knowhow, format, or similar item
   6. Customer-based intangible
   7. Supplier-based intangible
   8. License, permit, or other right granted by a governmental unit/agency
   9. Covenant not to compete
   10. Franchise, trademark, trade name
2. **POLICY:**
   1. It’s clearly wrong to amortize goodwill, because it doesn’t dissipate
   2. **Tax expenditure** for people who buy businesses with goodwill; patents, copyrights that last longer than 15 years.
   3. **Tax penalty** for people who buy businesses with intangible assets that last less than 15 years.
   4. **Exactly right** for people who buy businesses with intangible assets that last exactly for 15 years, and cost the exact same each year; very few people. But business accepted this because it put an end to litigation.
   5. **Administrative simplicity**: everything gets depreciated over 15 years, so no more arguments about whether cost goes to workforce in place or goodwill, etc.
3. If you **fail to deduct any appreciation allowance**, you can’t increase your depreciation allowances in later years. Reg. § 1.167(a)-10(a)

**Acquisition & Disposition of Property**

1. **\*\*\* WHEN YOU DISPOSE OF A PIECE OF PROPERTY, YOU MUST ASK:**
   1. Is there a realization event?
      1. No: STOP
      2. Yes: Go to 2.
   2. Calculate Realized Gain or Loss.
      1. If it’s 0, STOP.
      2. If it’s nonzero, go to step 3.
   3. Recognized? [Means you put them on your tax return]
      1. No? STOP – nothing to put on the return
      2. Yes: 4
   4. Capital or Ordinary? [Every recognized gain or loss is categorized as one or the other. Different rates apply.]
2. **Gain/Loss** = [Amount Realized – Adjusted Basis.]§ 1001(a).
   1. Gain/Loss is measured by what you *actually get*, not by what you *hoped* to get.
3. **Amount Realized =** [Cash + FMV of property received + FMV of services received + Mortgages assumed or “taken subject to”]. § 1001(b) (first sentence only)
4. The entire amount of gain or loss is recognized, except as otherwise provided. § 1001(c)
   1. **Realization Events:**
      1. Exchange of property
      2. Payment of TP’s indebtedness
      3. Relief from a liability (Including foreclosure)
      4. Other profit realized from the completion of a transaction.
5. **Adjusted Basis** = [Basis + Capital Expenditures – Cost Recovery]. § 1012, § 1016 (how adjustments to basis are made).
   1. § 1016(a): Proper adjustment in respect of the property shall in all cases be made
      1. (1) for expenditures, receipts, losses, or other items, properly chargeable to capital account…
      2. (2) for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount allowed as deductions
6. **BASIS RULES –** \*\*\***Basis represents cost/investment, not value. Multiple basis rules can apply.**
   1. Cash (cost) - § 1012. Your basis is the amount you pay for the property.
   2. Performance of services: whatever you included in income becomes your basis.
   3. If you acquire property for property, your basis in new property = FMV of property received (*Philadelphia Park*)
   4. Gift = § 1015: carryover basis from donor.
      1. This has the effect of transferring any appreciation on the property during the period the donor held the property.
      2. \*\* Note that losses cannot be transferred by gift—if the donee sells the property at a loss [i.e. the AR is less than the AB], then the donee’s basis is the FMV at the date of the gift)
   5. Inheritance = § 1014 = FMV
   6. Transfer between husband and wife: transferee takes carryover basis, regardless of whether FMV is greater or less than transferor’s AB § 1041
   7. Loans, whether recourse or nonrecourse, are included in the basis of the asset they finance. *Crane*, **UNLESS** the amount of the debt exceeds FMV of the property when the debt is first incurred—then the mortgage is included in neither basis nor amount realized. ***Estate of Franklin***
   8. Assumption of a mortgage on acquisition increases TP’s basis in the property by the amount of the unpaid debt.
      1. Second mortgages taken out subsequent to acquisition are not a cost of acquisition, so they don’t get added to the basis.
   9. If you acquire the property in a § 1031 exchange, your basis is determined under 1031(d): Basis = AB[old] – Recognized Loss + Recognized Gain - $ received
   10. Reg. § 1.61(d)(2)(i): **If property is transferred by an employer to an employee or independent contractor, as compensation for services,** for an amount less than FMV, then regardless of whether the transfer is in the form of a sale or exchange, the difference between amount paid and FMV at the time of transfer is compensation and included in gross income of the employee/IC. The basis = amount paid + amount included in gross income
   11. **If you exchange property with a greater FMV than the FMV of the property you receive,** the AR is still the FMV of the property you receive (e.g. if you have property with a basis of $180k and FMV of $300k and exchange it for property worth $280k, AR = $280k. The extra $20k of appreciation isn’t taxed in this realization event.)
7. **GIFTS - § 1015**
   1. Donee takes the donor’s basis in the property,
   2. **BUT** **if AB > FMV** of the property at the time of the gift, then for the purpose of determining **loss** the basis is FMV. (\*\*\*\*This **loss rule only applies if the property is ultimately sold at a loss by the donee.**)
      1. Planning: Thus, if a loss has accrued that the donor could recognize, the donor should sell the property, take the loss, and either give the cash to the donee or buy the property back at FMV (or the donee could buy it back).
   3. If the loss rule produces a gain and the gain rule produces a loss, you report nothing. (e.g. if you donor’s AB in the property is $500k, the FMV is $300k when you receive it, and you sell it for $340k, there’s neither gain nor loss.) Reg § 1.1015-1(a)(2)
   4. **POLICY:**
      1. The net effect of the donee taking the donor’s basis is that the donee is responsible for paying tax on the appreciation that accrued while the donor held the property.
      2. The code could have given the donee a zero basis and treated the gift transfer as a realization event. But then we’d be taxing them earlier rather than later, which is worse for both. So although it looks like the donee is getting screwed, you have to look at it as a “family unit": they’re able to defer the tax on the gain.
8. **INHERITANCE - § 1014. Death is not a realization event.**
   1. Beneficiary’s basis in the property is the FMV at the date of decedent’s death, whether the FMV is greater or less than the decedent’s AB.
   2. Neither the beneficiary nor the estate has to report any income, and the beneficiary gets a stepped up value.
   3. **Planning:** If a loss that would be recognized has accrued and you expect to die soon, you should sell the property to take your losses, because you can’t pass them on through inheritance. Or, if you think appreciated property will decline in value and produce a loss by the time of your death, you’ll want to sell the property.
   4. **POLICY: BIGGEST LOOPHOLE IN THE CODE!**
      1. This rule has **enormous efficiency consequences**: it provides an incentive for old people nearing death not to sell appreciated property, because the tax consequences are likely to trump other considerations. **Lock in effect:** for each year that passes, the incentive to hold onto the appreciated property goes up. If you sell it, you pay a “toll charge”, whereas if you hold onto it until death, the toll charge disappears. You’re far better off passing the assets onto your children rather than selling it. There’s a lot of empirical evidence that this rule really does affect people’s behavior. They’ll forgo selling assets to buy better assets because of the tax consequences.
9. **Transfers Between Spouses / after Divorce - § 1041** 
   1. **Doesn’t trigger income or deductions. No realization event.**
      1. “No gain or loss shall be recognized on a transfer of property from an individual to
         1. a spouse, or
         2. a former spouse, but only if the transfer is incident to divorce.
            1. “Incident to divorce” =

occurs within 1 year after the date on which the marriage ceases, or

is related to the cessation of marriage

* 1. **BASIS RULE**
     1. The property is treated as acquired by the transferee by gift, and
     2. **Basis of the transferee in the property is the AB of the transferor, REGARDLESS OF OF FMV**
        1. **\*\*\*\* LOSSES CAN BE TRANSFERRED!** It’s different from a gift
  2. **Doctrine:**
     1. The transfer isn’t a gift because it’s not given with disinterested generosity (it’s a divorce property settlement). Transferring property to a spouse as part of a property settlement satisfies a legal obligation: the spouse’s claim on your property. It’s likely that there *is* a realization event, but the transferor doesn’t have to report anything because of 1041(a).
     2. What if it were cash? Then it might be alimony, and if so, transferee would have to report it under § 71, whereas property settlements aren’t taxable to the recipient under § 71; neither is child support.
  3. **TAX PLANNING:**
     1. Transferor should not transfer property whose value has fallen below his basis. He should sell that property, take the losses for himself, and then give transferee cash, or buy back the property at FMV.
     2. Or, the parties could make the losses part of the obligation. If transferee is going to get the losses for herself, then transferor should transfer less property than he otherwise would. Transfer less than $200k and make up the difference with the tax benefits transferee will get. (This is best if she’s in a higher bracket than he is).
     3. If there are gains on the property, transferee will want to negotiate for more property because she’ll have to pay tax on the gains when she disposes of it.
     4. If both lawyers are tax savvy, they’ll negotiate this to an equilibrium. **Tax liabilities and benefits should be thought of just another marital asset. The effect of this is that you can elect your tax treatment in a divorce.**

1. **ANTENUPTIAL TRANSFERS; RELEASES OF MARITAL RIGHTS**
   1. If TP receives property in exchange for surrendering her marital rights, **her basis in the property received is its FMV at the time of transfer** (not the transferor’s basis) ***Farid-Es-Sultaneh***
      1. Theory: TP’s basis in her marital rights is assumed to be equal to the FMV of the property. (It’s not clear why this should be so, since the rights don’t really “cost” her anything. The court may be saying that Farid should be in the same position as a purchaser of property with cash.) No statutory authority for this.
   2. **Transferor of the property does not have a realization event, so he does not report a gain or loss** (even though theoretically he should). No statutory authority for this; it’s just what the IRS and Supreme Court say.
2. **MORTGAGES/LIABILITIES**

**Basis**

* 1. **A loan is included in the basis of the asset it finances** regardless of whether the loan is recourse or nonrecourse, ***Crane*, UNLESS the amount of the debt exceeds FMV of the property** when the debt is first incurred—then the mortgage is included in neither basis nor amount realized. ***Estate of Franklin***
  2. **POLICY:** This creates parity between a purchaser who borrows from a bank and pays the seller cash and a purchaser who uses seller financing.
     + 1. These rules create significant benefits for TP:
          1. If the property is eligible for depreciation deductions, including the borrowed amount in basis enables TP to recover costs he hasn’t yet paid or assumed directly.
          2. If the money for buying the property is borrowed through a nonrecourse mortgage for which TP has no personal liability, it may be possible for him to recover through depreciation putative acquisition costs for which he may never have to put up any of his own money.
          3. Although the amount of the outstanding debt will be included in TP’s AR upon disposition (offsetting the earlier depreciation deductions), TP enjoys the time value of the depreciation deductions.

**Realization**

* 1. When property subject to a **NONRECOURSE DEBT** is disposed of, **any balance of the debt is included in the amount realized** (regardless of FMV of the underlying property) (***Tufts***)
     1. **POLICY:** Otherwise, you could take out a nonrecourse mortgage in excess of the FMV of the property with a balloon payment at the end, take depreciation deductions, and you wouldn’t have to pay back the depreciation deductions you took on realization. The TP who does this still comes out ahead when including nonrecourse mortgages in his basis because he took deductions earlier in time and pays them back later.
  2. Where the property is subject to a **RECOURSE DEBT**, **the transaction is** **bifurcated** **if the amount of the indebtedness exceeds the FMV of the property:**
     1. Where TP transfers property with FMV greater than AB, but less than the outstanding debt, **AR = FMV, and the extent to which AR exceeds AB is gain.**
     2. **Any excess debt that is discharged** is **COD income.** If the lender takes additional assets to satisfy the debt, there are no consequences; it’s treated as repayment of the debt.
        1. [See Reg. § 1.1001-2
  3. **Example:** Suppose A has property with AB = $10, and it’s subject to a recourse mortgage of $45. At a time when the FMV = $30, the lender forecloses. The disposition of the property will satisfy $30 of the debt and the borrower will have a $20 gain. If the lender is unable to obtain assets to satisfy the remainder of the debt, A will have $15 of COD income
  4. A loan, even when secured only by untaxed appreciation in property, does not constitute realized income to the borrower. The borrowing is not a realization event. ***Woodsam Associates***

1. **SALE OF A PART OF A LARGER PROPERTY** **– Reg. § 1-61-6(a)**
   1. “When a part of a larger property is sold, the cost or other **basis of the entire property shall be *equitably apportioned* among the several parts**, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part.”
      1. “Equitably apportioned” = the relative value of that part. Different parts of a property can be worth more than other parts.
      2. If you don’t know how to apportion the basis of the property, you can credit the consideration received on the sale against the basis for the entire property. ***Inaja Land*.**
         1. If you can convince a court to use this logic, it’s highly pro-taxpayer, because it results in **tax deferral** – you pay no gain on the sale of the piece of the property until you dispose of the larger property

**Recognition**

**-Gains are included in gross income under § 61(a)(3) by default** unless there’s some exception.

-For **losses,** it’s the opposite: you **must find a specific provision that allows deduction of losses.** Even if there’s a loss that would be deductible under 165, there are other sections that override it.

1. **LOSSES - § 165**
   1. There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. **Limited to:**
      1. Losses incurred in a **trade or business,**
      2. Losses incurred in any **transaction entered into for profit**, though not connected with a trade or business, and
      3. Losses of property not connected with a trade or business or a transaction entered into for profit, if such loses arise from **fire, storm, shipwreck, or other casualty, or from theft**. Except as provided in § 165(h):
         1. **If personal casualty losses exceed personal casualty gains,** such losses are only allowed to the extent of the sum of the amount of personal casualty gains plus so much of such excess as exceeds 10% of AGI
   2. **Personal losses not arising from casualty aren’t deductible** under § 165.
2. **TRANSACTIONS BETWEEN RELATED TAXPAYERS - § 267**
   1. **No deduction for any loss** from the sale or exchange of property, directly or indirectly, between **family members =** brothers and sisters, spouse, ancestors, and lineal descendants (see § 267(b) for other relationships, but probably don’t need to know)
      1. Like the gift rule: losses don’t transfer
   2. **Amount of gain where loss previously disallowed - § 267(d)**
      1. The gain is reduced by the amount of loss that disappeared when the family member sold the property at a loss.
      2. Has the effect of putting TP in the same position he’d be in if he’d received the property as a gift. However, the mechanism is different: your gain is offset by the loss that disappeared (though this has the same effect as changing your basis)
3. **LOSSES FROM WASH SALES OF STOCK OR SECURITIES – § 1091**
   1. **No deduction allowed** for losses sustained from a disposition of stock or securities where, **within a 30 day period before or after the date of disposition**, TP has acquired or has entered into a contract or option so to acquire, **substantially identical** stock or securities.
   2. **Basis in the repurchased stock** = basis in the stock sold plus any excess of the price paid on repurchase over the price at which the stock was sold.
      1. **Example:** If TP sells for $500 a share of XYZ stock he purchased for $700 and repurchases a share of XYZ stock 15 days later for $550, the $200 loss on the sale is disallowed and the basis in his new share is $750 [$700 Basis + $50 excess of the repurchase price over sale price]
   3. **POLICY:**It’s not really a realization event if you’re only not holding the stock for ~30 days. The number is arbitrary, but they had to pick some number. You can get around the rule by simply waiting 31 days. People who are doing short-term speculation in good faith within 30 day periods are harmed by this rule.
4. **CASUALTY LOSSES –** 
   1. **Business casualties** are above-the-line deductions and are considered t/b losses
      1. If the property is completely destroyed, the loss = AB (destruction is equivalent to 0 AR). FMV is irrelevant; if FMV is higher than AB, you only get a loss equal to AB because you already got credit for the difference by depreciating it earlier. The AB represents leftover cost not accounted for.
      2. Your deduction is reduced by the extent to which you’re **compensated by** **insurance**—it’s treated as though you sold the car to the insurance company in exchange for the amount of compensation
   2. **Personal casualties**
      1. Itemized deductions.
      2. Each individual casualty must be more than $100. (The theory is that regular life involves losing items of de minimis value.)
      3. Casualty losses can be taken up to the amount of casualty gains, and any excess can only be taken to the extent it exceeds 10% of your AGI plus casualty gains.
5. **BAD DEBT LOSSES** **- § 166**
   1. When it’s a **business transaction**, we assume that there was a real loan that was expected to be paid back, and the creditor suffers a loss when it’s not paid back.
   2. **Nonbusiness debts:** The loss is treated as a short-term capital loss
      1. **Definition:** **Any debt other than**
         1. A debt created or acquired in connection with a trade or business of TP, or
         2. A debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business
6. **LIKE-KIND PROPERTY EXCHANGES - § 1031. NON-RECOGNITION**
   1. No gain or loss recognized on the exchange of property **held for productive use** in a **trade or business** **or for investment** if such property is **exchanged *solely* for property of like kind** which is to be held either for productive use in a trade or business or for investment.
      1. **Exceptions:**
         1. Stock in trade or other property held primarily for sale (inventory);
         2. Stocks, bonds, notes, or other securities or evidences of indebtedness;
         3. Interests in a partnership; certificates of trust or beneficial interests; choses in action
      2. **Gain from exchange not solely in kind** - § 1031(b)
         1. TP recognizes gain equal to money received and the FMV of the non-like kind property
      3. **Loss from exchange not solely in kind** - § 1031(c)
         1. **No loss recognized**
   2. **TP’s** **basis in the new property** is TP’s AB in the property exchanged (may be multiple pieces of property, or property + cash),decreased in the amount of any cash received by TP and increased in the amount of gain or decreased in the amount of loss to the TP that was recognized on the exchange. § 1031(d).
      1. BasisNew = BExchanged – Recognized Loss + Recognized Gain - $ received
      2. We add recognized gain to the basis of the new property so that TP isn’t taxed twice on it. We subtract cash because cash always carries a basis equal to face value
      3. **If you receive multiple pieces of property**, **allocate basis between them** by assigning FMV as the basis of the boot; give the rest to the like-kind property
   3. **When there are multiple assets exchanged, they’re treated as separate transactions.**
      1. Allocate the total AR to each asset based on its FMV
      2. Note: multiple trucks for one truck is still a like-kind exchange
   4. **§ 1031 applies separately to each TP.** Both parties to an exchange need not qualify for 1031 treatment in order for one of them to qualify.
   5. **POLICY:** 
      1. Why it can’t be used for stocks, securities, publicly traded partnerships, etc.: otherwise, we’d basically just have a tax on labor.
      2. The benefit you get from a § 1031 transaction is the deferral of taxable gains.

**Character: Capital And Ordinary Gains & Losses**

**\*\*\* IF THERE’S NO SALE OR EXCHANGE, IT’S NOT CAPITAL.\*\*\***

**Generally look at § 1245, then § 1231, then § 1221**

Net Capital Gains are taxed at 15%. [Some real estate 28%; collectibles 15%]

Net Capital Gains = Net Long-Term Capital Gains – Net Short Term Capital Losses

NLTCG = LTCG – LTCL NSTCL = STCL – STCG

* **If NSTCG > NLTCL**, the excess STG is taxable in full as ordinary income.
* **If NLTCG > NSTCL**, the excess (“net capital gain”) is taxed at 15%.
* If TP has **both NSTCG and NLTCG**, NSTCG is taxed as ordinary income and NLTCG is taxed at 15%.
* **If capital losses exceed capital gains,** the excess capital loss **offsets up to $3k of ordinary income** each taxable year. **Any excess** not allowed in one taxable year is **carried forward** indefinitely until it is completely utilized. The losses carried over keep their character (e.g. the excess of NSTCL over NLTCG is a STCL).
* For purposes of determining the character of the losses carried over to a subsequent year, any STCL are deemed to offset ordinary income before LTCL. (§ 1212(b); don’t need to know details)

**Holding period** to make a capital asset long term = **12 months**

“**Short-term capital gain/loss”** = gain/loss from the sale or exchange of a **capital asset not held for more than 1 year.**

1. **§ 1245- Gains from Dispositions of Depreciable Tangible Personal Property** (Doesn’t apply to real property)
   1. If you such property ***at a gain***, the character of your gain is
      1. **Ordinary to the extent of depreciation taken,**
      2. And for any gain above that amount, you deal w/ it in the next section: **§ 1231.**
   2. If you sell at a loss, § 1245 doesn’t apply.
      1. TP lost because of the time value of money; the asset declined in value more than the depreciation schedule allowed the taxpayer to take deductions for.
   3. **Policy:** This provision recaptures as ordinary income previously deducted depreciation. The ordinary gain “pays back” the excess depreciation, although the TP has enjoyed the time value of the earlier depreciation deduction. The amount recaptured represents the amount by which his depreciation deductions exceeded the economic cost of holding the asset. (Conversely, if a loss is realized, the depreciation allowance was too limited.)
2. **§ 1231: PROPERTY USED IN TRADE OR BUSINESS; INVOLUNTARY CONVERSIONS**

Two netting processes. [What would otherwise be ordinary can get turned into capital]

**1. FIREPOT – Put in, and net, recognized gains and losses from:**

1. **Casualties and thefts of § 1221(a)(2) property** (business property) held more for more than 1 year
   1. [Examples of casualty gains: insurance greater than your basis; payment by tortfeasor greater than your basis].
2. Recognized gains and losses from casualties of capital assets held for more than 1 year in connection with a trade or business or a transaction entered into for profit.
   1. [Very small category of things. Maybe a bearer bond that you held for more than 1 year that was set on fire.]

* If losses > gains, everything is treated as ordinary.
* If gains > losses, put every gain and loss into the Hodgepot.

**2. HODGEPOT – Put in, and net, recognized gains and losses from:**

1. The Firepot *if* G > L in the Firepot.
2. Sales, exchanges, and condemnations of trade/business property held for more than 1 year (which includes property subject to depreciation, and real property used in trade or business)
3. Condemnations of capital assets held for more than 1 year in connection with a trade or business

* If L > G, everything is treated as ordinary.
* If G > L, everything is treated as capital.

**THE GAINS AND LOSSES WILL BE LONG-TERM.**

**POLICY:** § 1231 always results in tax nirvana!

1. **§ 1221 – “Capital Asset” Definition by Exclusion**
   1. “Capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
      1. **(1)** **stock in trade** **or inventory** of TP, or property held by TP primarily for sale to customers in the ordinary course of his trade or business;
      2. **(2)** **property, used in his trade or business,** of a character which is **subject to the allowance for depreciation** provided in section 167, or **real property used in his trade or business;**
         1. Includes machines, trucks, intangibles, anything that can be depreciated or amortized, and land. **BUT *this is largely overridden by §1231***
      3. **(3)** a **copyright, a literary, musical, or artistic composition,** a letter or memorandum, or similar property, **held by**—
         1. **(A)** TP whose personal efforts created such property,
         2. **(B)** in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or
         3. **(C)** a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);
      4. **(4)** **accounts or notes receivable** acquired in the ordinary course of trade or business for services rendered or from the sale of inventory/stock in trade
         1. If TP *buys* accounts receivable, it’s a capital asset for him.
      5. **(5)** a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—
         1. **(A)** a taxpayer who so received such publication, or
         2. **(B)** a taxpayer in whose hands the basis of such publication is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);
      6. **(6)** any **commodities derivative financial instrument held by a commodities derivatives dealer,** unless—
         1. **(A)** it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and
         2. **(B)** such instrument is clearly identified in such dealer’s records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);
      7. **(7)** any **hedging transaction** which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or
      8. **(8)** **supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business** of the taxpayer.
2. **Hedging Transactions - Reg. § 1.1221-2 –** produce ordinary gains and losses

Basically applies when the property held protects you against price changes with respect to 1221(a)(8) and 1221(a)(1) property.

* 1. (b) *Hedging transaction =* any transaction that a TP enters into in the normal course of the TP's trade or business **primarily**—
     1. (1) **To manage risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the TP;**
     2. (2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the TP; or
     3. (3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (d)(6) of this section).
  2. The gain or loss for the **counterparty to the hedging contract** is capital if it’s not a hedging transaction for them.

1. **Stock is always capital! *Arkansas Best*; Reg. § 1.1221-2**
   1. **Unless** you’re a **dealer in securities.**
2. **Rent, Interest, and Prepayments of Rents/Cancellations of Leases are always ordinary because there’s no sale or exchange.**
   1. If the SC had held otherwise, there would no longer be ordinary income, because people would then always sell rights to streams of ordinary income.
3. **Sales of the rights to streams of ordinary income produce ordinary income. *Lattera*** (even though there’s no statutory authority for this)
   1. Lottery payouts, buying out a tenured professor for a lump sum payment, sales of all coupons to a bond = ordinary income
4. **Capital Real Estate Gains - Depreciation Recapture § 1(h)(6)**
   1. ***Gain*** up to the amount of depreciation allowed on **real property held for more than 1 year** is taxed at a **special capital gains rate of 25%.** The remainder is taxed at the regular capital gains rate of 15%. (So they’re making you recapture, but not as much as you would if it were ordinary income.)
   2. **Two benefits of this:**
      1. You get to defer payment of taxes just as you do with personalty for which you took too much depreciation, and
      2. You also don’t pay the depreciation back at the same rate you deducted it (it’s 10 percentage points less). There’s no justification for this (essentially just “shopping centers are good”).
5. **§ 1221(a)(3) - copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property**
   1. **POLICY:** we don’t want to allow you to turn labor income into capital gains. Artists shouldn’t be treated differently from widget-makers.
6. **DONATIONS OF CAPITAL GAIN PROPERTY - § 170(e)**

**Note: 170(e) never applies to real estate or stock.**

* 1. If TP donates property to a charity, **reduce the charitable contribution by any gain that’s would not have been LTCG** if the property had been sold for FMV,
  2. **AND,** 
     1. If the use by the charity is unrelated to its **charitable purpose**, **or**
     2. If the charity sells, exchanges, or **disposes** of the property **in the year of contribution,**

**THEN** reduce the contribution by the amount of gain that would have been LTCG if the property had been sold for FMV.

* 1. If the property doesn’t sell it within the year of contribution but sells within 3 years, then the excess of the FMV over basis gets recaptured in the year of sale.
  2. If it’s ordinary income property, or the property has a STCG, then your deduction is AB (by (e)(1)(A)). If the property has LTCG, you will want to make sure the charity uses it in its charitable function. If they don’t, then the deduction is limited to AB. If the charity will hang onto it for 3+ years, then your deduction is FMV, and there’s no recapture. If charity sells in the next 3 years, then when the charity sells it, the donor has extra gross income that year.
  3. Charitable deductions always offset ordinary income, so they’re worth the deduction times your tax bracket.
  4. **POLICY:**
     1. **The gains disappear. Charities never pay tax on the gains because they’re tax-exempt.**
     2. There’s a huge incentive to donate capital gains property to charities
     3. Congress was concerned about was donations of property to charities that they didn’t use in their charitable functions to create benefits for the donor without a corresponding benefit to the charity
     4. Why 3 years? It’s just an arbitrary way of making sure the charity’s really using it.
     5. The right normative rule would be to have the deduction limited to your basis, because that’s your cost. Why do you get a deduction for the appreciation you never paid taxes on? Because charitable organizations lobby for this rule.

1. **CAPITAL GAINS POLICY**
   1. Congress wants to encourage you to hang on to assets for a period of time rather than churning them, so they give a preference to assets held for more than a year.
   2. There’s a little bit of logic to capital treatment. The general idea with respect to the definition is that we want to provide preferential treatment to investment assets and non-preferential treatment to business assets. The bulk of 1221 is trying to make this distinction.
   3. There’s not a very good reason why Congress would want to favor one kind of asset over another. But the general idea is that they want to encourage people building up portfolios to dispose of and allocate assets efficiently by giving them a lower rate of tax on dispositions of the capital assets.
   4. Congress doesn’t want to give preferential treatment to recurring income. E.g.: salary (always ordinary because no sale or exchange); interest (always ordinary because there’s no sale or exchange. You could sell the bond, which could produce capital income); dividends (never produce capital income, but they still get other preferential treatment); rents (always ordinary b/c lack of sale/exchange); royalties (same).

**Accounting**

Deals with income and deductions; gains and losses are almost always reported in the year realized.

1. **CASH METHOD**
   1. **INCOME**
      1. You’re taxed when you have *actual or constructive* *receipt* of the cash or property. If you don't have actual receipt until the following year, you won’t have income until then.
      2. **Constructive receipt -** Reg. § 1.451-2
         1. Income although not actually reduced to a TP's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.
         2. However, income is **not constructively received if the TP's control of its receipt is subject to substantial limitations or restrictions.**
      3. **Exception:** you have income even if you don’t have actual or constructive receipt so long as you have **cash equivalents or the “economic benefit”**
         1. An **IOU** doesn’t rise to the level of a cash equivalent; it’s merely evidence of a debt.
         2. A **bond** is a cash equivalent because TP can sell it on the market.
         3. An **unsecured note**: it’s as if TP received nothing. TP won’t be taxed at all, even on the discounted market value. However, if it’s secured by at least the face value of the note, then TP has cash income on receipt.
         4. **Escrow account:** it’s a cash equivalent if the limitations on the escrow are self-imposed and not part of a bona fide agreement between the buyer and the seller-taxpayer.
      4. **TAX PLANNING:**
         1. There’s nothing in the rules for cash basis accounting that prevents you from turning your back on the ability to get income so long as you have no ability to get possession. Therefore you never want to be offered the check/cash if you want to defer it. This is generally worked out as part of a contract.
   2. **DEDUCTIONS**
      1. **General rule:** cash basis TP has a deduction when it’s **actually paid.**
         1. Reg. § 1.461-1: amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a TP using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.
      2. **Prepayments of e.g. management fees**
         1. You have to capitalize intangibles that will last more than 12 months. It has to be attributed to the period in which it’s actually owed.
         2. When she’s paying management fees in advance, she has to capitalize them
2. **ACCRUAL METHOD**

Rules are found in Reg 1.451-1

* 1. **INCOME**
     1. **General rule:** accrual TP has income when he has a
        1. **fixed right to receive it,**
        2. **all events have occurred that fix his right** to receive income, **and**
        3. The amount can bedetermined with **reasonable accuracy** (in principle)
     2. Possession is totally irrelevant for accrual basis TPs (except in one case)
     3. ***AAA* -** AAA had to include **prepayments for services** in the year received.
        1. The key factor: AAA **didn’t have to refund** the money even if customers never use the services
        2. If prepayments may be refundable, then the payments occur over the years (e.g. if $10k for 5 years of services, $2k accrues year). If not, the rights accrue when payment is made
     4. ***Indianapolis Power and Light***—The right to **security deposit** only accrues **when events occur that entitle the holder to the deposit.**
        1. ***Westpac*: -** Cash advance trade discounts are like the security deposits in that they are **SUBJECT TO REPAYMENT**, and the store can’t keep the money regardless of what happens after receipt; their keeping the money was contingent on meeting volume requirements. Thus the cash advance trade discounts DO NOT ACCRUE in the year received, because they’re liabilities.
  2. **DEDUCTIONS**
     1. Reg. § 1.46-1: a liability is incurred, and generally is taken into account for income tax purposes, in the taxable year in which **all the events** have occurred that establish the fact of the liability, the amount of the liability can be determined with **reasonable accuracy**, and **economic performance** has occurred with respect to the liability.
        1. The mere fact that the exact amount of the liability cannot be determined does not prevent you from taking into account that portion of the amount of the liability that can be computed with reasonable accuracy. (Example: A renders services to B during the taxable year for which A charges $10,000. B admits a liability to A for $6,000 but contests the remainder. B may take into account only $6,000 as an expense for the taxable year in which the services were rendered.)
     2. **Economic Performance occurs when… - §461(h)**
        1. **Services & property provided to TP:**
           1. Deduction for paying for **services:** the deduction is taken when the services are performed.

Only until Derek actually performs the services can they deduct the payments. If the contract is guaranteed and no one shows up, then you could argue that that’s the performance of services.

They’d deduct $2k for every class he teaches ($20k for 10 classes)

* + - * 1. Deduction for payment for **property**: when the property is provided
        2. Deduction for payment for **use of property**: when TP uses such property.
      1. **Services & property provided by TP:**
         1. Economic performance occurs when TP provides property/services
    1. This last part ends the tort settlement tax scheme.
    2. Accrual basis taxpayers figured out they could deduct something long before they would actually make any payment, as long as there was no way they could get out of the payment. Common in structured settlements—Tortfeasor agrees to make some payment that’s structured in a way that avoids taxation.
    3. Unit 15, 2(d): Assume the company is going to pay $2m each year for 10 years. They’ll pay $20m total. If not for 461(h) (it wasn’t in the Code at the time of Ford Motor), the company would take a deduction in year 1 for $20m, because all the events had occurred and there’s no way they can get out of the obligation. If the company is in the 35% bracket, the $20m deduction is worth $7m in year 1. Suppose the company invests the $7m at 7% over 10 years; they’ll get a return of $490k in year 1. They’ll be able to cut their year 1 $2m payment by $490k, which really comes from the gov’t.
    4. The company will have an incentive to say, we’ll pay you $1m a year for 40 years ($40m); this gives them a deduction worth $14m. At 8%, they’ll make $1.12m a year in simple interest, which actually gives them a profit of $120k a year. This kind of transaction got Congress’s attention; until the adoption of 461(h), you could profit off a tort.
    5. **What’s wrong with this is that you’re deducting an amount that’s greater than the present value of the payments.** One proper way would be to deduct the present value of the payments in year 1, but it’s impossible to compute the present value because discount rates are unknown.
    6. **\*\*\* Instead, 461(h) says you deduct the amounts only when there’s economic performance: when services are performed, when you actually make payments in settlements, etc.**
    7. The annuity in Ford Motor was purchased in order to provide the funds to make payments they were actually out of pocket (the $1.51m in the example here). The annuity produced the tax advantage that a greater portion of the annuity payments is treated as a return of capital than is economically true.

1. **POLICY:**
   1. All timing issues would be eliminated if income tax were computed at death. Why don’t we do this? Because we want to get tax money from you while you have it. There would be a huge incentive to spend money before you expect to die.
   2. Why do we care about accounting? The taxpayer wants to defer income and accelerate deductions; the IRS wants to defer deductions and accelerate income. (But note that a taxpayer would want to put income in an earlier year if they have a lot of deductions or were in a lower bracket in the earlier year.)
   3. We basically have a 3 year statute of limitations. Suppose some event occurs in 2010. It has to be reported on the 2010 return, which is filed 4/15/11. The gov’t has 3 years, until 4/15/14, to challenge this. The date something’s reported is not only important for TVoM purposes, but also because of the statute of limitations. If the IRS challenges the taxpayer in 2015, it would want to argue that it’s part of the 2011 return, and the taxpayer will want to argue that it’s properly part of the 2010 return.

**INTEREST - § 163**

1. **DEDUCTIBLE INTEREST - § 163(a) et seq**
   1. **Business interest** – indebtedness used to operate a trade or business.
      1. Deductible without limit.
      2. Deductible unless it must be capitalized, e.g. when allocable to an asset TP is constructing. § 263A(f)
   2. **Investment interest** – Limited to net investment income. § 163(d).
      1. Net investment income = total investment income minus investment expenses
      2. You can’t have both interest deduction and take advantage of the capital gains rate. You can either deduct the interest, in which case the dividends or capital gains will be taxed at 35%, or you can forgo the interest deduction and have the capital gains and dividends taxed at 15%. That’s a combo of 163(d) and (h).
      3. **No interest deduction for loans used to purchase muni bonds.** § 265
         1. **Policy:** § 265 actually doesn’t make sense because purchasers of muni bonds are paying implicit taxes that the market sets. (e.g. a 6.5% muni bond equivalent in risk to a 10% corporate bond includes a 35% implicit tax)
   3. Interest on **education loans** (up to $2.5k of interest). § 221
2. **PERSONAL INTEREST – no deduction allowed**. § 163(h).
   1. = any interest allowable as a deduction under § 163 other than:
      1. (A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),
      2. (B) any investment interest (within the meaning of subsection (d)),
      3. (C) any interest which is taken into account under § 469 in computing income or loss from a passive activity of the TP,
      4. (D) any qualified residence interest (within the meaning of paragraph (3))
         1. = any interest paid/accrued on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of TP
      5. (E) any interest payable under section [6601](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00006601----000-.html) on any unpaid portion of the tax imposed by section [2001](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00002001----000-.html) for the period during which an extension of time for payment of such tax is in effect under section [6163](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00006163----000-.html), and
      6. (F) any interest allowable as a deduction under section [221](http://www.law.cornell.edu/uscode/html/uscode26/usc_sec_26_00000221----000-.html) (relating to interest on educational loans).
3. **QUALIFIED RESIDENCE INTEREST - § 163(h)(3)**
   1. 2 kinds of interest on a home mortgage are deductible
      1. Acquisition indebtedness: (interest is deductible on up to $1m of debt used to acquire, construct, or substantially improve either a principal residence or second home)
      2. **Home equity** indebtedness of up to $100k
         1. Doesn’t matter what you do with the proceeds; it can be consumption.
         2. **Policy**: this might actually increase the risk that people lose their houses
4. **Tax Arbitrage** – turn a losing proposition into a winning proposition or make a winning proposition even better after tax
5. **POLICY:**
   1. **Suppose I’m a trade or business** that produces widgets. My gross receipts for widgets are $100k. Cost of goods are $60k. I borrowed money to pay payroll and paid interest of $4k. I should only be taxed on $36k, because the $64k is composed of ordinary and necessary business expenses. Now suppose I borrow $10k and buy stock for $10k. The stock produces $1k of dividends, and the loan requires me to pay $1k of interest. I have no increase in wealth at all, so I should be able to deduct the interest—the interest was a cost of producing income.
   2. **If you borrow to finance consumption**, you shouldn’t be able to deduct the interest. consumption produces 0 income, so there’s no reason to deduct interest paid for consumption.
   3. The after-tax cost of borrowing for business is different from that of borrowing for consumption. She should take the business loan, not the car loan.
   4. As an incentive, the education interest deduction is an utter failure. There’s a $2.5k cap; the deduction goes to the borrower, who is often a student with no income to offset.

**The Taxable Unit – who should be taxed?**

Why this is a problem: **we have a progressive tax system.** It’s not a proportional tax system (where the tax of someone who makes $20k is equivalent to the tax of two people who each make $10k).

1. **MARITAL STATUS- § 7703**
   1. **Determined at the end of the year** 
      1. Sham divorce—getting divorced solely for tax purposes
      2. If spouse dies, determined at spouse’s death
      3. Legally separated from spouse not considered married
   2. **Three possibilities:**
      1. You’re married under state law;
         1. DOMA conflicts with this
      2. You’re clearly not married under state law and not married for tax purposes
      3. You’re married under state law but **not** **married for tax purposes, if**
         1. Married under state law
         2. TP maintains a household that constitutes the home of a dependent child for at least ½ the year
         3. TP pays more than ½ the cost of maintaining the household during the year,
         4. Spouse is not a member of the household during the last 6 months
         5. (§ 7703(b))
2. **FILING STATUS - § 1**
   1. **MFJ** – both husband and wife put income on one return. The rates are the lowest or best. More income is taxed at a lower rate.
      1. **Rationale:** Can be attributed to community property states, which say that the earnings of either spouse will be attributed to the other. SC decided in *Poe v. Seaborne* that the tax system had to respect this. This meant that if we have H and W living in a community property state and H earns $100k, for tax purposes this is treated as $50k earned by H, $50k earned by W. In a common law state, by contrast, it would be treated as $100k earned by H, $0 earned by W. The common law state couple will pay more taxes because of the progressivity of the tax system. Congress created MFJ so that states weren’t forced to become community property states.
   2. **MFS** – two spouses who continue to be married but cannot file on one return (i.e. they refuse to do so). Worst status to be in. Two possibilities for why people do it: one spouse has disappeared (MFJ requires two signatures), or it’s so acrimonious one spouse refuses to sign the return. You lose all kinds of benefits as a consequence of MFS.
   3. **Single** – not as good as MFJ but better than MFS.
   4. **HOH** – Must be unmarried for tax purposes and maintain a household that’s also the principal place of residence for more than ½ the year of a qualifying child or dependent. The rates and the amount of the standard deduction lie between those for a married couple and a single person.
      1. It’s not clear why they put the child requirement in there—why shouldn’t it also apply to married people in the same situation who don’t have kids?
      2. HOH is something of a misnomer.
3. **Marriage Penalty & Bonus**
   1. Suppose A is a single person who has $44k income, and his tax liability (as a single taxpayer) is $9460. Suppose A lives with B, and they’re not married; they have $44k total income, but A earns $22k and B earns $22k. A and B will each have tax of $3.3k filing as single taxpayers. If A & B marry and file jointly, we combine their two incomes and apply the MFJ rates; their tax liability is $7,523. If C & D are married, and C earns $44k and D earns $0, they will also have tax liability of $7,523.
   2. **Marriage penalty:** solely by virtue of the fact that A & B got married, their taxes go up. This is happening because of the progressivity of the tax system and the horizontal equity between married couples with equal aggregate incomes.
      1. We’ve made some progress in solving the marriage penalty. Under current law, SD for married couples is twice the deduction for two singles. The EITC is probably the most egregious marriage penalty. If the couple is earning $44k total ($22k earned by each), the EITC will disappear and they lose $8k total. This is huge for them.
   3. **Marriage bonus:** solely by virtue of the fact that A&B got married, their taxes go down. [If C & D were not married, C would have tax liability of $9,460.] It’s impossible to solve this problem**. We need MFJ to have equity between common law and community property states; and we want progressivity for reasons stated above.**
   4. **EFFICIENCY CONSEQUENCES**
      1. Creates incentive for lower earner not to enter the labor force because imputed income isn’t taxed.
      2. Disincentivizes roughly equivalent earners from marrying
      3. Incentivizes people with very disparate incomes to marry.
4. **KIDDIE TAX - § 1(g) –** restricts intrafamily shifting of income and tax benefits
   1. The child’s **net unearned income** (income in excess of standard deduction plus deductions connected w/ the production of the unearned income) **is** **taxed at parents’ top marginal rate**. “Unearned income” is essentially anything other than wages.
      1. Child must be under 19, or between 18 and 24 and a full-time student (for the later, the kiddie tax applies only to those whose income does not exceed ½ the amount of their support)
   2. **The source of the unearned income is not taken into consideration**. Even if the kid makes the investment income through his own diligence, or just makes interest from a savings account containing his wages, he’s taxed at his parents’ marginal rate.
   3. **POLICY:** Why not tax the first dollar at the parents’ marginal rate? One possibility is that Congress doesn’t want to tax investment income from kids’ earned income. Another rationale is that it encourages a reasonable amount of saving for college. Also administrative: we’re not really going after kids who have a couple hundred dollars in a bank account; we’re going after people shifting huge amounts of money
5. **DISSOLUTION OF MARRIAGE**
   1. **ALIMONY - § 71**
      1. **§ 71 – default rule.** You an elect for it not to apply.
         1. **Gross income includes amounts received as alimony.**
         2. Alimony payments are **deductible to the payor**­ -§ 215
      2. Make the election for § 71 not to apply when the total taxes of H&W would be less (e.g. if payee is in a higher tax bracket or the payor has many business losses, the deduction is worth more to the payee)
      3. § 71 treats payments as alimony so long as:
         1. The payments are in cash rather than property or services,
         2. The parties do not earmark payments as nondeductible to the payor and nontaxable to the payee,
         3. There’s a formal agreement of separation or divorce,
         4. The parties do not live in the same household if they are legally divorced or separated [getting at the fact that you can have payments from a husband to a wife in a non-divorce setting],
         5. There’s no liability for any payment after the death of the payee, **and**
         6. The payments do not constitute child support
      4. Labels won’t work for distinguishing gifts from alimony (the recipient would want the payments to be treated as gifts so she has no income; the payor would want them to be treated as alimony so he gets a deduction)
      5. **§ 71(f) – Excess front-loading of alimony payments**
         1. If there are excess alimony payments,
            1. Payor includes the amount of such excess payments in gross income in the 3rd-post separation year
            2. Payee deducts the amount of such excess payments from gross income in the 3rd-post separation year
         2. **Excess 1st year payments =** Excess of the 1st year payment over the average of the 2nd year payment (reduced by the excess for the 2nd year) and the excess 3rd year payments plus $15k.
         3. **Excess 2nd year payments =** Excess of the 2nd year payments over the sum of the 3rd year payments plus $15k
         4. **Example:** Actual payments made by W to H are $40k in Y1, $25k in Y2, and 0 in year 3. The excess alimony for Y2 is $10k [$25k – (0 + $15k)]. The average alimony for Y2 and Y3 is $7.5k [($25k - $10k) + (0)/2]. The excess alimony for Y1 therefore is $17.5k [$40k – ($7.5k + $15k)]. In Y3, W recaptures $27.5k [$10k + $17.5k], which she reports as gross income. H would have a deduction of $27.5k in Y3 as well.
         5. **Purpose:** Prevents the parties from structuring a property settlement to qualify as alimony. Property settlements are usually paid in a lump sum shortly after the divorce while alimony generally is paid over a longer period of time. Arbitrary anti-abuse rule. We’re using this as a surrogate tax: we can’t get at it directly b/c it’s just not knowable, so we’ll presume that this pattern is *probably* property settlement and simply penalize it.
   2. **CHILD SUPPORT PAYMENTS** - **§ 71(c)**
      1. **Nondeductible to the payor and excludable by the payee**
      2. Child support payments are
         1. Sums fixed in the divorce/separation instrument as payable for the support of children of the payor spouse, and
         2. Amounts equal to amounts by which payments to the spouse will be reduced on the happening of a contingency related to the child (e.g. attaining a certain age, marrying, dying, leaving school, etc.) or at a time which can clearly be associated with such a contingency.
   3. **PROPERTY SETTLEMENTS** – **§ 1041 (transfers of property between spouses or incident to divorce)**
      1. **Doesn’t trigger income or deductions.**
         1. “No gain or loss shall be recognized on a transfer of property from an individual to
            1. a spouse, or
            2. a former spouse, but only if the transfer is incident to divorce.

“Incident to divorce” =

occurs within 1 year after the date on which the marriage ceases, or

is related to the cessation of marriage

* + 1. **Basis rule**
       1. The property is **treated as** **acquired by the transferee by gift**
       2. Basis of the transferee in the property is the **AB of the transferor**
  1. **TAX PLANNING**
     1. From the wife’s perspective, alimony is a negative because it’s taxed and child support is a positive because it’s not taxed, but on the other hand, child support terminates, whereas alimony is paid until death. We’ll need to look at applicable state law to determine when child support terminates. Child support is a defined term for both state law and income tax purposes. If a condition of the child support is that it terminates if the husband’s income falls below $50k, then because it’s terminating on an event not related to the child, it wouldn’t meet the tax definition of child support. It would be alimony instead. (See above; § 71(c))
     2. If we really want to treat it as child support, then we need to comply with the tax definition of child support.
     3. The wife can’t get a full sum the husband’s willing to pay in the form of child support because she would then have to use all the money on the child.
     4. We need to consider:
        1. When the payments terminate
        2. Use to which the money is put
        3. Marginal tax rates of H&W (for whether to elect out of § 71 default rule)