***Unit I – Tax Concepts***

1. General Idea:
   1. Step 1: Calculate **gross income** (§ 61)
   2. Step 2: Subtract “above-the-line” deductions to get **adjusted gross income** (§ 62).
   3. Step 3: Subtract “below-the-line” deductions, which is the sum of **personal exemptions** plus either the **standard deduction** (§ 63(c)) or a list of **itemized deductions** (§ 63(e), misc. itemized deductions subject to 2-percent floor per § 67). The result is **taxable income** (§ 63).
   4. Step 4: Apply the **tax rate schedules** (§ 1) to the **taxable income** to determine tentative tax liability.
   5. Step 5: Subtract any available **tax credits**
2. Considerations in Tax:
   1. **Equity** – in order for a tax to be “fair,” it should not impose significantly different burdens on those in similar economic circumstances.
      1. Two-prong test
         1. **Horizontal equity**. Are those in similar economic positions paying the same?
            1. E.g. A & B both make $10,000, both should have the same tax burden

Some argue this is wrong, and consumption is a better measure.

* + - 1. **Vertical equity**. Are those with higher ability to pay paying more?
         1. E.g. A/B make $10k, taxed equivalently; C makes $50k, should pay a higher proportion of income

Again, controversial. Consumption may be more relevant; others argue in favor of “if have same opp. to earn $X, should pay tax on that, regardless of how much is actually made”

* 1. **Efficiency** – a tax should interfere as little as possible with people’s behavior
     1. *Underlying difficulty with this analysis*: there cannot be a market without government, and a government cannot run without money
        1. This, however, is not seen as too big a problem, and it is the primary way in which tax efficiency is thought of
     2. Can also refer to two other forms of efficiency:
        1. Promotion of economic growth – should promote, not inhibit
        2. Net benefit – if someone gains more than the government loses, in the case of a tax reduction (through deduction, credit etc.); reverse, if the government gains more than others lose (although this may be difficult to imagine)
  2. **Simplicity** – not necessarily a separate norm, but a feature of any equitable/efficient tax system
     1. Complexity bad for efficiency b/c wastes time of both taxpayer to file and gov’t to eval.
     2. Complexity bad for equity b/c people w/ equal income may have unequal ability to understand or manipulate tax rules
     3. Three types of complexity
        1. **Rule Complexity** – Inability to understand the rule
        2. **Compliance Complexity** – Inability to comply with the rule (e.g., keep required records)
        3. **Transactional Complexity** – Need to organize affairs due to tax (e.g. structuring a deal as X and not Y due to the tax consequences)
  3. Progressivity in Tax
     1. Rationale: diminishing marginal utility; the ability to pay is higher with more income, since $100 will not mean as much to the $100k earner as it does to the $10k earner

1. Constitutional Authority to Tax
   1. Art. I, § 2 – forbids laying of a “direct tax” unless apportioned based on state population (direct tax would be either a land tax or a head tax, unsure what else)
      1. Passing of Sixteenth Amendment allowing Congress to tax income however it wants
   2. Art. I, § 7 – Origination Clause; all tax bills must start in House, but Senate can add as it wishes
   3. Art. I, § 8 – Congress shall have the power to tax “to pay the Debts and provide for the common Defence and general Welfare of the United States”; taxes must be uniform
   4. Art. I, § 9 – No taxing interstate commerce
   5. Art. I, § 10 – Only tax imports/exports to extent necessary to fund execution of inspection laws
   6. Fifth Amendment
      1. No property taken for public use without just compensation
   7. Tenth Amendment
      1. Powers not delegated to the United States are reserved for the States
   8. Sixteenth Amendment
      1. “**Congress shall have the power to tax incomes, from whatever source derived, without apportionment among the several States**”
      2. Taxes as a penalty OK, beginning in the 1930s w/ *Mulford v. Smith*, 307 U.S. 38 (1939).
2. Challenging a tax
   1. Cannot get an injunction per *Bob Jones University*
   2. Will not have standing per *Eastern Kentucky*

***Unit II – What is Income?***

1. What is income?
   1. *Glenshaw Glass*: income can be defined as “undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.”
2. § 61
   1. § 61(a), non-comprehensive list of income sources:
      1. Compensation for Services; Gains derived from business; Gains derived from dealings in property; Interest; Rents; Royalties; Dividends; Alimony and separate maintenance payments; Annuities; Income from life insurance and endowment contracts; Pensions; Income from Discharge of Indebtedness; Distributive share of partnership income; Income in respect of a decedent; Income from an estate or trust.
      2. § 1.61-2(d)(1): compensation paid other than in cash, use fair market value
      3. § 1.61-2(d)(2)(i): property received at a discount in exchange for services, must pay the difference between that and fair market value
      4. § 1.61-14(a): examples of income that should be included – treble damages (punitive damage awards); having someone else pay your taxes (*Old Colony*); illegal gains constitute gross income as well; treasure trove, when reduced to undisputed possession
   2. Compensation for Services (past, present & future)
      1. *Old Colony –* Paying an employees taxes constitutes income
      2. *Gotcher* – Man avoid taxing his trip to visit the facilities, his wife is taxed because of the benefit this brings to him (relieving him of her expenses)
         1. Wife non-exclusion now codified in § 274
         2. Takeaway: can argue for more than just exclusions
            1. Might not be ***within scope of § 61*** itself
      3. § 1.61-21(a)(1) – Fringe Benefits should be included unless exclusion applies
         1. § 1.61-21(a)(2) – List of exclusions: 117d, 119, 129, 132, 134
         2. § 1.61-21(a)(3) – Non-performance can qualify as Performance of Svcs (such as signing a non-compete agreement)
         3. § 1.61-21(a)(4)(i) – Benefit taxable to the employee, even if spouse/child is the receiver of the benefit
         4. § 1.61-21(b)(1)-(2) – Benefit will be taxed at fair market value, *subjective value* plays no role.
      4. Exclusions:
         1. § 117 – In general, allows scholarships to be excluded from income
            1. 117(d) allows for an employer to grant an employee a tuition reduction, which will be treated similarly and will not be taxed.
            2. Req. of **non-discrimination** in favor of *highly compensated* employees.
         2. § 119 – meals or lodging provided by the employer
            1. Requirements: **on premises**, for the **convenience of the employer**, and it must be **in-kind**.
            2. *Kowalski*: no cash (police troopers trying to exclude cash rec’d for meals eaten while on duty.
         3. § 129 – Up to $5,000 in dependent care assistance programs may be excluded
            1. Requirement: exclusion **cannot exceed income of spouse** (if married)
         4. § 132 – certain fringe benefits
            1. 132(a)(1): no-additional-cost service

Requirements: an item/service that the **employer sells to customers** in the ordinary course of business, sold **in the line of business in which the employee typically provides services**, and must be **no additional cost** to providing this item/service.

* + - * 1. 132(a)(2): qualified employee discount

Requirements: 1) an item/service that the **employer sells to customers** in the ordinary course of business, 2) sold **in the line of business in which the employee typically provides services**, 3a) must be **<20% of the price available to customers [only applies to services]**, 3b) **cannot be sold at less than cost [only applies to goods]**, and 4) cannot be **real property or investments** (e.g., stocks or bonds).

* + - * 1. 132(a)(3): working condition fringe

Requirements: will be excludable if deductible under § 162 or 167

“Ordinary and necessary business expenses” and property depreciation (computer, pens, paper, etc.)

§1.132-5(v)(i) – Cash reimbursement requires proof the money was used for the excludable expenses.

162 or 167 says not deductible if adaptable for everyday use

* + - * 1. 132(a)(4): de minimis fringe

Requirements: Value of service/good provided is so small that it would make accounting for it unreasonable or administratively impractible.

§ 1.132-6(c): If easy to account for, it should be included. Example: cash will almost always be (exception below)

§ 1.132-6(d)(2): meal money excludable as long as it 1) is on an **occasional basis**, 2) is meant to **allow the employee to work overtime**, and 3) the **consumption actually happens during that overtime work**.

§ 1.132-6(e):

Ex. of qualifying de minimis fringes: coffee, occasional birthday gifts, sports tickets

Ex. of non-qualifying de minimis fringes: gym membership, use of company car for more than 1 day per month, use of company real property (although this may be excluded on other grounds)

* + - * 1. 132(a)(5): qualified transportation fringe

Requirements: Allowed to exclude benefit from **commuter highway vehicle** or **transit pass** up to $100/month; exclude **qualified parking** valued at up to $175/month; bicycle commuting reimbursement

Cash reimbursement OK only if a transit pass isn’t readily available to the employer for purchase for the employee

* + - * 1. 132(h)(2-3): who qualifies for this?

Spouse and dependent child qualify as an employee for purposes of No-Additional-Cost Service or Qualified Employee Discount (can receive birthday gifts from the company, for example)

Parents qualify only with regard to air transportation.

* + - 1. § 74
         1. Employee achievement awards excluded up to $400 (unless part of a qualified plan award, which is up to $1600 per year – per § 274(j))
      2. Announcement 2002-18
         1. Frequent flier miles will be excludable even if used personally
         2. However, if converted to cash or otherwise seen as a compensation substitute, then they should be included
      3. General rule: must be an employee to be compensated. So firms can fly out students b/c they pay for all students, not just those who get a position.

***Unit III – More exclusions, you say?***

1. § 61: Income from *whatever source derived*.
   1. *Glenshaw Glass*: an accretion to wealth is income; includes services rec’d in exchange for svcs
   2. The exclusion of **Imputed Income**
      1. No tax on the imputed rental income of owner-occupied homes
         1. No tax on imputed income provided by homemakers
      2. More questionable: consumption of produce by the farmer (held not to be taxable, although the reverse for a grocery store manager)
      3. **Equity concerns**: A makes $10 from overtime to pay a dog-walker, B walks her own dog, A will pay more in tax
      4. **Efficiency concerns**: A can choose between making $10 in overtime and paying for a dog walker or getting off early and not earning or paying anything. Will choose the latter.
         1. Result: less value added to society, people pushed into using their talents less efficiently when tax becomes the reason they do not enter the workforce.
      5. Why not tax?
         1. Privacy issue
         2. Enforcement issue (where to stop? Should we tax leisure?)
         3. Compliance issue (incentive to lie and inability to accurately value services)
         4. Efficiency issue of its own: incentivize people to do things poorly so their services are worth less
         5. Taxing imputed income would force people to the occupation which would maximize their earning power.
      6. Why not allow deductions then?
         1. Incentivizing consumption; will pay people to do everything rather than do it yourself
   3. § 102: The gift exclusion
      1. Requires “**detached and disinterested generosity**” – *Duberstein*
         1. Mere absence of a legal obligation to make the transfer does not make it a gift for tax purposes
      2. Some relationships with presumption of generosity (e.g. intra-familial relationships)
         1. Concurrence in *Duberstein*: presumption of non-gift in business relationships
      3. There can never be a “Gift” from an employer to an employee § 102(c) (may be excludable on other grounds, however)
      4. Political contributions deductible under this heading as well
         1. Rev. Rul. 68-512
      5. § 74: employee achievement awards OK up to $400
   4. Government Benefits Exclusion
      1. “[D]isbursements from a general welfare fund in the interest of the general welfare are not includible in gross income” Rev. Rul. 75-271 (p. 141 in CB)
      2. Ex. Unemployment includible under § 85 but excludible based on Rev. Rul. 70-280
      3. **Why?** Because it is very difficult to distinguish between gifts and support. Same reason why parental support is excluded as well.
         1. **Enforcement issue** (where to stop? How much is protection of the army worth?)
   5. § 117 – Exclusion for Scholarships used for Qualified Tuition and related expenses
      1. Requirement: only excludible to the amount it is used on tuition, fees, books, supplies, and equipment required for enrollment and participation in courses
         1. Cannot be a *quid pro quo*, meaning they must not be required to participate in a sport or other activity (§ 117(c))
   6. § 262 – Personal, living, and family expenses are non-deductible (but support is non-taxable)

***Unit IV – Change in Wealth***

1. Basic concept: a taxpayer has no income until they have recovered more than their cost in the asset
   1. § 61(a)(3): include in income “gains from property derived from dealings in property”
   2. § 1.61-3(a): gross income means total sales minus costs of goods sold
   3. *Doyle v. Mitchell Brothers Co.* – must account for initial capital outlay (background for basis)
   4. § 1001: Gain/loss computed by subtracting the adjusted basis from the amount realized
      1. Amount realized includes anything rec’d in exchange
      2. **Realization requirement**
   5. § 1011: adjusted basis shall be the basis (depending on taxpayer status – e.g., corporation, individual) adjusted by means of § 1016
      1. § 1012: for individuals, the basis will be cost
      2. Cost rule applies every if over- or underpaid for the property; *however*, in the case of bargain purchase as compensation, the difference will be includible in income in the year of acquisition and the basis will not be the cost but the fair market value at that time.
   6. § 109: improvements made to property by lessee will be excludable
      1. § 1019: any exclusions under this section will disallow adjustment to basis
   7. Basis for Gifts, § 1015
      1. Gain: basis is the donor’s basis in the property
      2. Loss: basis is the donor’s basis *or the fair market value at the time of transfer*, whichever is lower
   8. Basis for property acquired from a decedent, § 1014
      1. Basis becomes fair market value on the date of decedent’s death
         1. **Great** for unrealized gains; **Bad** for unrealized losses
         2. One **benefit**: avoids “lock-in” affect that may happen if basis is set to decedent’s
      2. § 1022 – slightly alters this to a carryover basis, *but only for 2010*, and the estate can make an election whether to apply this or the standard estate tax w/ $5m exemption
         1. The carryover basis will be the fair market value at the time of death or $1.3 million, whichever is smaller
   9. Allocation of Basis, § 1.61-6(a)
      1. Basis allocated “equitably apportioned” among the parts sold
         1. Means equally only if the parts are worth equal amounts at time of purchase
      2. However basis is adjusted, it can be reflected on only one part
         1. E.g. land is harmed and $10 damages rec’d, if $3 is claimed to have been the value, then taxpayer would report $7 gain, but the *basis* would drop by $3 so that it would be accounted for upon disposition
   10. Rents do not have a basis, § 61(a)(5) & *Hort*
       1. May be able to depreciate a building, but rents are fully taxable
       2. *Hort*: Man has premium lease from pre-Great Depression, lessor wants to get out of it and they settle. Tries to exclude and even claim a loss.
          1. Holding: Payment to release a lessee is a rent substitute, and is taxed fully
       3. Rent is the *sale of the right to occupy*, but tax system treats it as income without basis
   11. Treasure Trove must be reported
       1. *Cesarini* and piano jackpot
          1. Same with baseballs. They are taxable upon finding them. Court may be sympathetic and may allow a crazy argument like the ticket being an investment, but did not apply in cases that have happened because they sold.
       2. §1.61-14 supports this; must report value
       3. Exceptions:
          1. Free samples. Not req’d to report (e.g. teacher receiving textbooks in *Haverly*), but then cannot take a deduction later even if eligible. No **double-dipping**.
          2. Bargain purchase & couponing does not qualify, as long as the opportunity is available to everyone in the market.
2. The Realization Requirement
   1. Recognition of gain/loss postponed until the taxpayer’s investment is significantly altered
   2. Means that Time Value of Money will play a role in decision-making
      1. Investment with 8% return may be worth more than one with 10% return if you can pay later. Example of property appreciating vs. string of cash flows (10% return may get pushed below 8%, tax on 8% may be so far in the future as to make it negligible)
   3. Why do this?
      1. Compliance problem: people may need to sell the asset to pay the taxes
      2. Enforcement problem: need to get appraisal every year, incentive to hire low-ballers
      3. Unpredictable revenue for the government
         1. Would be paying out a lot some years, getting windfalls during others
      4. Political Impossibility
   4. What is a realization event?
      1. § 109 – no realization just because lessor builds on the property (unless rent substitute)
         1. § 1019 – no adjustment to basis either, but still good b/c TVOM
         2. 109 overturned *Bruun* which had said realized when gain possession of land
      2. Sale of right to land?
         1. Result: No way to correctly apportion, so untaxed, but then it reduced the basis in the property
      3. *Cottage Savings Ass’n v. Commissioner*
         1. Banks trading low-value mortgages to try and realize a loss while avoiding closure mandated from putting those losses formally on their books.
         2. SCOTUS says…**material difference requirement** for a realization event means that even if they are the same in substance, if the **legal entitlements are different in kind or extent, then there is a realization event**; here, the mortgages were for different people and secured by different properties.
            1. Means trading shares of stock in the same company would not be
         3. Relevance today: debt swaps
3. Annuities
   1. Options: Assume all recovery of capital happens in the beginning, all recovery at the end, or split up recovery evenly over all the years
   2. § 72 says…Exclusion (Capital Recovery) = Annuity Amount \* Exclusion Ratio
      1. Exclusion Ratio = Investment / Expected Return
      2. Example: $10k annuity, $1k per year, bought for $7k
         1. Exclusion Ratio = 7/10; therefore: Exclusion = $700; Report: $300 income/yr
      3. § 72(b)(3)(A)
         1. When annuities cease before full recovery of investment, remaining unrecovered investment will be deductible in the last taxable year.
         2. § 72(b)(4): unrecovered investment is equal to original investment minus any amounts excluded from income in prior years
      4. § 72(c)(3)
         1. Expected return when based on life expectancy will be determined by tables in § 72; when based on installment payments, should just be the aggregate of those payments
      5. Result: Better than bank account, which would have more tax at the beginning because interest income would be higher
   3. Life insurance: under § 101, proceeds will not be taxed if payable by reason of death
      1. Annuity would only be better if it cont. to be paid into the future, to the point where the after-tax amount is greater than the full amount of the life insurance (both discounted)

***UNIT V*** ***– Restricted Property***

1. Transfer of Restricted Property, Governed by § 83
   1. Two Options:
      1. 83(a) – pay when there is no longer a substantial risk of forfeiture
         1. Good idea when property will be stable in value or if it may go down
         2. However, if it has gone down in value, cannot take a loss at that time because the terms of 83a say the “excess of”
            1. In other words, not a realization
            2. Cash paid would still be the basis, however
         3. Implications: pay tax on the rental value!
      2. 83(b) – must *elect to do this*, pay at the time of initial transfer
         1. Would not take a loss or gain at time of transfer, would not be a realization event
         2. If property is subsequently forfeited, no loss may be taken either
            1. § 1.83-2
         3. Do this when property is expected to rise in value
   2. Tricks to § 83
      1. 83(h) – When the employer takes the deduction, the employee must realize the income
      2. Treas. Reg.
         1. § 1.83-1(b)(1) – if you sell nonvested property, then you must realize the gain as the excess of the amount received over the amount paid. (*Means cannot recognize loss on sale of nonvested property*)
         2. § 1.83-1(b)(2) – if you sell nonvested property, and the property is not vested, then the buyer is allowed to treat his cost as the basis in the property.
         3. § 1.83-1(f)(Ex. 1) – Stock dividends paid to 83(a) stock (no election) will be treated as additional compensation to taxpayer and deductible as such by the corporation.
            1. Implies giving a good deal on a house, coupled with not taking an 83a election, will lead to taxation of the rental value of the property!
         4. § 1.83-2 – details 83b election
            1. Implication: if forfeited, *basis is amount paid*, regardless of the amount included in income due to the election
      3. Why doesn’t § 119 apply?
         1. Ownership interest to be transferred, and not a condition to employment
   3. Ask about last question for Unit V.
      1. Convenience of the employer: must have taken it as a condition of employment & must be premises of the business.
         1. Japanese guy gets to claim convenience of the employer when they host people. “Functional, rather than spatial” (if extension of job is entertaining clients, then it would extend to his living space). *Adams*.

***UNIT VI – Loans, Thefts, and Windfalls, Oh My!***

1. Loans
   1. Not treated as income or a loss at the time of transfer, because it is assumed to be an even exchange of an asset for a liability. See balance sheets.
2. Loan Forgiveness & Discharge of Indebtedness
   1. If paid by a Third Party
      1. Can be seen as income under *Old Colony*, or it may be an untaxable gift
   2. If cancelled for less than its face value, income to the debtor (§ 61(a)(12))
      1. From *Kirby Lumber* case as well: seen as a freeing up of assets that would have otherwise been required to pay the debt
      2. See § 108 for exceptions
         1. 108(a) – may exclude debt forgiven if the debtor is insolvent
            1. 108(a)(3) – can ***only exclude up to the amount of insolvency***. Meaning, if I am insolvent by $10, but $20 of debt is forgiven, then I still have $10 of income via 61(a)(12).
         2. 108(d) – debt incl. normal debt, and debt subj. to which taxpayer holds property
         3. 108(e)(5) – Purchase-money price reduction
            1. If **property**, and the **seller is the creditor**, and the **purchaser is solvent**, then the reduction in debt may be seen as a purchase price reduction.
            2. Must be property (see *Zarin*, chips don’t count)
      3. Other Exceptions
         1. Lost Deduction: if the payment would have given rise to a deduction (then the deductible amount forgiven may be excluded altogether)
         2. Corporate Debt to Shareholder
            1. Amount includable in income is only SH’s basis, rather than the full amount owed
         3. Corporate Stock issued in Exchange for Debt
            1. Allowed to pay debt with stock; still taxable on amount stock is less than the face value of the debt
         4. Discharge treated as Gift
            1. Can not apply in a commercial setting
         5. Qualified Principal Residence Indebtedness
            1. If mortgage on principal residence forgiven, no COD income
            2. Capped at $2m, meant to help people who were upside down in homes
         6. Real estate business debt
            1. Can exclude COD income of business property owners, but will reduce basis in the property by that amount
         7. Student Loan Forgiveness
            1. Loan forgiveness for working in the public sector is nontaxable
         8. Not an exception: Forgiven Interest
            1. Forgiven interest, as long as not otherwise deductible, is a taxable event
   3. *Zarin* (Third Cir.) – big gambler, ends up $3m in the hole, settles for $500k, what to tax?
      1. Where the *debt was unenforceable*, could not have income from discharge of that debt
         1. Contrast Tax Court opinion saying this doesn’t matter; not great logic, but probably troubled by the idea that he benefitted from having $3m in chips, but only paid $500k
         2. Problem: If unenforceable, then he received a benefit at the time of getting the chips (no balance sheet logic to explain it away as with loans)
            1. Difference: Gambling. Can offset gambling losses with winnings; in this case, unlike if someone makes an actual loan, the Casino is giving away **nothing but an opportunity**, so their balance sheet is not altered either
      2. Also brought up *contested liability doctrine*, by which when the amount of the debt is in dispute, the subsequent settlement is treated as the actual amount
         1. Doesn’t seem like the true basis of the case, however
         2. Much like the Purchase Price Reduction exception
      3. ***Does not matter what you use the money for***.
3. Illegal Income
   1. *Collins* – 2nd Circuit case, man places bets without paying for them, $80k one day, ends up down $38k. Turns himself in, question is whether or not he is taxable and on how much.
      1. Taxable on the full amount taken, but also allowed to deduct any payments made in restitution, in the year that those payments were made (from *James*).
      2. Choice of where you use the money is consumption; doesn’t matter what you use the money for.
      3. Income = Consumption + Change in Wealth
   2. *Gilbert* – pays margin call with company money, adds in promissory notes; says that may not be illegal income if:
      1. Expected “with reasonable certainty” to repay the sums
      2. Believed withdrawals would be approved
      3. He made prompt assignment of assets sufficient to secure the amount he owed
   3. § 6321: IRS has a claim to taxes before victim has a claim to stolen funds

***UNIT VII – Tax Expenditures = HUGE!***

1. Three Avenues for Government Expenditure
   1. Direct Payment
      1. Note: if taxable, then would have to give more
      2. Then it is on the books, though, and people are aware that money is going to a certain place; this may be prohibited: can’t give money to religious institutions, but may be able to give preferential tax treatment (?).
   2. Allow deduction such that they pay X (subsidy amount) less in taxes
      1. This is a *tax expenditure*.
   3. Allow exclusion such that they pay X (subsidy amount) less in taxes
      1. This is a *tax expenditure*.
   4. How to spot a tax expenditure?
      1. Would not be “normative,” e.g., return of capital (not taxing costs incurred) is not taxed but that is not a tax expenditure.
   5. Problems and Implications of a Tax Expenditure:
      1. Tax expenditures will only work to incentivize ***tax-paying*** entities.
      2. Higher bracket taxpayers will be more incentivized than lower-bracket payers
         1. Due to Value of Exclusion = Excluded Amount \* Marginal Tax Rate
         2. See odd “Upside-down” subsidy: mortgage exclusion benefits those paying bigger mortgage and in higher brackets
      3. Unsure of actual change in Tax Revenue ex ante because it is unclear how much of an incentive this will provide.
      4. Less control than a subsidy, but also less costs to administer
   6. Tax expenditures > entire non-defense budget
2. 26 U.S.C. § 103
   1. Exclusion from income of interest earned from state and local bonds.
   2. Move of tax revenue from the Federal to the State/Local level
      1. Local/State gets to pay less interest, but Federal loses revenue
      2. However, result is that only 2/3 of the loss is recognized as savings, why?
         1. Because the yield needs to be as high as the lowest bracket investor would need to find it attractive. So if you need 100 investors, and the lowest is a 15% payor, could only be 15% below market, even though some are in a 35% bracket and receiving a 20% windfall.

***UNIT VIII – Deductions: A matter of Legislative grace, not a right, Pt. 1***

1. The Rationale
   1. Want to allow some costs to be deducted, or else it would be a tax on gross receipts, not income
   2. Don’t want to allow all expenses to be deducted or it would be a *tax on savings*.
   3. Therefore, deductions for some, tax for others.
   4. *Keep in mind*: only valuable **if there is income to offset**.
2. § 162 – “Ordinary and necessary” business expenses; in pursuit of a ***trade or business***.
   1. 162(a) – all deductions for all ordinary and necessary business expenses, including:
      1. 1) Reasonable allowance for salaries and other compensation to employees
         1. Limited to $1 million for executives of publicly held corporations, unless performance based (§ 162(m))
            1. Rock stars are in the clear
            2. Also known as the Lawyers’ Employment Act
      2. 2) Traveling expenses while away from home in the pursuit of a trade or business
         1. See Reg. § 1.162-2
         2. Must be outside of your metropolitan area
         3. Must stay overnight
            1. No overnight – nothing will be deductible; *Correll*
            2. But, once you go into “Travel Status” 🡪 everything deductible
         4. Primary purpose of business
            1. Otherwise, can deduct incidental costs if engaged in some business
         5. *Hantzis* & summer work away from home
            1. Court says: she wasn’t “away from home,” because she only had one home, which was defined as her principal place of business
            2. Must *maintain two homes* for this to apply; and it must be a business, and not a personal decision to do so
      3. 3) Rentals or other payments required to be made to continue to use the property, presuming to title has been transferred (or is in the process of being transferred)
      4. Not allowed:
         1. Commuting expenses. 1.162-2(e)
            1. Exception: If two places of work (incl. home office), then you can deduct the costs incurred in going to the temporary workplace (Rev. Rul. 99-7)
         2. Meal expenses. *Moss* and the law firm feeding people everyday while working
            1. Not under § 119 because not on business premises
   2. Definitions
      1. Necessary = appropriate and helpful
         1. Comes from *Welch* case; man goes BK, then goes back into business and ends up paying back creditors despite earlier BK filing
         2. Does not actually mean “Essential”
      2. Ordinary = customary within that business
         1. Another Q to ask: would a profit-seeking business engage in this behavior?
3. Origin of the Claim
   1. *Gilliam* – artist traveling to show, goes crazy on the plane; trying to deduct legal fees in defense as a business expense since he was on a business trip
      1. Court disallows deductions since the *travel* was not part of his trade or business
      2. Later, SCOTUS in *Gilmore* begets the ***origin of the claim*** analysis
         1. Applies in criminal contexts, court is supposed to ask whether or not the actions giving rise to the liability stemmed from profit-seeking activities (*Tellier*).
4. Reasonable Allowance for Salary
   1. *Exacto Spring* – CEO paid $1m & $1.3m in salary, IRS claims much less would be reasonable salary, lower court creates crazy test and then splits the difference in the end.
      1. Posner says: ***Independent Investor test***. If you get a better-than-market return, will be very hard to claim a salary is unreasonable.
         1. Only thing to watch out for: a disguised dividend (wasn’t the case here, since the other shareholders voted in favor of the salary as well)
   2. Why would a Corp. want to classify something as salary?
      1. Want to avoid double-taxation that happens with dividends (only public companies)
         1. Big thing courts look for: have they failed to pay a dividend despite profitability
            1. Note: only would apply to salary paid to shareholders
      2. Want to transfer wealth to the lower bracket taxpayer (closely-held companies)
         1. Want to make a gift, in a sense, which is typically taxable to the donor
      3. Disguised capital expense
      4. Unless under an abuse category, will not look into unreasonable salary except 162(m)
   3. Split on Interpretation
      1. Second and Seventh Circuits
         1. Independent Investor Test
      2. First, Ninth, and Tenth Circuits
         1. Multi-factor test (re: type of services rendered, replaceability, qualifications, net earnings of the employer, etc.)
      3. *McCandless* test: “**automatic dividend**” test (p. 243)
         1. No dividend, presumption of unreasonable salary
   4. Must have compensatory intent
      1. Tying compensation to stock-ownership, even where the actual amounts are not unreasonable, does not count as compensation.
   5. No penalty for *undercompensation*
      1. Might allow shifting of income from higher-bracket earner to lower bracket earner (or even just dividend income)
      2. IRS technically has the authority to prevent such a shift
5. Other Questionable Expenses
   1. Interest paid to SH for loan may be considered a dividend (even if fees match prevailing rates)
   2. Fees paid for SH guarantee on company loan may not be though (if otherwise loan is unavail.)
   3. Excessive rent paid to a related lessor will be disallowed.
6. Expenses Contrary to Public Policy
   1. Pre-*Tellier*: IRS tries to make a lot of “contrary to public policy claims”
   2. Post-*Tellier*, 162 amended, adds a lot of “contrary to public policy” exceptions, which actually *prevents* the IRS from raising the claim with regard to any other expenses normally deductible.
      1. 162(f) – fines not deductible
      2. 162(g) – treble damages post-conviction under antitrust laws not deductible
      3. 162(c) – bribes not deductible
   3. *Tellier* – violates SEC Act of 1934, company claims defense expenses
      1. IRS argues public policy problem
      2. Justice Stewart & SCOTUS says: ***No***. Tax is not a sanction against wrongdoing, not a means to reform men’s moral characters.
         1. No public policy is offended when a man employs a lawyer in his legal defense. Would only impose a sharpen burden than Congress intended through the criminal code.
   4. Oddity: *Tank Truck Rentals* – fines incurred by following customary practice and going through PA despite odd weight laws were found to not be a allowable expense
      1. Why? Would have been an odd result to impose a fine, but then subsidize the amount. However, the amounts are going to different entities…
   5. These disallowances would be ***tax penalties***, as mentioned above, since they are incident to producing income
   6. Lobbying
      1. § 162(e): local lobbying deductible, also de minimis exception (if < $2k, deductible)
      2. Officer O’Smarty: if you spend money to influence public, nondeductible
      3. ***Loophole***: Reg. § 1.162-20 says institutional advertising OK. Just don’t talk about a particular ballot issue, then you can call it “Advertising” and deduct.
   7. § 280E
      1. No expenses shall be deductible for businesses engaged in the illegal sale of drugs
         1. Tax on gross receipts: poor California
7. Taking Deductions
   1. § 62 – Adjusted Gross Income Defined
      1. § 62(a)(2): employees may take deductions ***above the line*** only for reimbursed expenses, performing artists and government officials may take ***above the line*** deductions as well
   2. § 274 – Entertainment Expenses OK
      1. § 274(a) says no deduction unless *somehow related* to business
         1. Exception in (e) says if it is a compensation substitute, then it is deductible
      2. “Protections”
         1. § 274(d) says substantiation req’d (if you keep receipts, you must be serious)
         2. § 274(n) says only 50% of the expenses will be allowable as a deduction (trying to get at the consumption aspect of things)
      3. 50% cap applies to ***whoever bears the ultimate economic cost***, so a reimbursed employee will be able to exclude the full amount, but the employer is limited.
   3. § 67 – Miscellaneous itemized deductions
      1. Subject to 2-percent floor; applies primarily to unreimbursed expenses, and those incurred in the production of income per § 212
         1. Notice, however, employee fringe benefits allowable under § 132, despite referring to this provision, do not require application of the 2% floor
      2. § 212 includes misc. ordinary and necessary business expenses as well as costs of filing the return. Random provision that most people can never take advantage of
      3. Non-misc. itemized deductions
         1. Interest losses, tax losses, theft losses, casualty losses, charitable, medical, dental, etc. See § 67(b).
   4. § 68 – 3% haircut applied
      1. Calculated by (AGI - $100k) \* 3%
         1. Cannot be below 80% of the actual deduction
      2. Had been in effect, but no longer, extended to 2012
   5. § 21 – Child credit
      1. Can get a credit for child care up to $3,000 per child (up to $6k); but the amount cannot exceed the income of either parent
      2. Must enable the parent to be gainfully employed
      3. Maximum Credit:
         1. $1050 for 1 children
            1. 35% of $3,000 of expenses allowable
            2. 35% reduced by 1% for every $2,000 over $15,000

BUT: not below 20%

* + - 1. $2100 for 2+ children
         1. 35% of $6,000 of expenses allowable
         2. 35% reduced by 1% for every $2,000 over $15,000

BUT: not below 20%

1. Limitations for Employee Business Expenses
   1. *Pevsner* – lady works at YSL, has to wear their clothes for works, otherwise doesn’t like them
      1. Even if required for work, clothing that can be adapted for general use is not deductible
      2. Rocky Wolverine boots worn at trial illustrative of this

***UNIT IX – Capital Expenditures, the “When” of Deductibility***

1. § 263
   1. 263(a): prohibits deductions for expenses made to build onto or improve property
      1. § 1.263(a)-1(a): does this mean after I depreciate a piece of property to 80% of its original value, then I can only make improvements that leave it at that value. Cannot mean this…
      2. § 1.263(a)-1(b): “Coordination with 263A” – § 263(a) generally requires capitalization for acquisition, production and improvement payments; § 263A generally describes which direct and indirect costs are to be capitalized
      3. § 1.263(a)-1(c): Examples of items req’d to be capitalized:
         1. Costs to Acquire/Produce Tangible Property
         2. Costs to Improve Tangible Property
         3. Costs to Acquire/Create Intangible Property
         4. Costs to Facilitate the Acquisition of a Business, or Costs to ∆ Cap. Structure
         5. Costs to Acquire Interests in Land, e.g., easements, life estates, timber rights, etc.
      4. § 1.263(a)-2(d)(1): Must capitalize all costs of acquisition or production of real property, including transactions costs, furniture and fixtures, etc.
      5. § 1.263(a)-2(d)(3)(i): ***Transactions costs*** to facilitate a transaction must be capitalized
      6. § 1.263(a)-3(d)(1): Capitalize amount paid to improve property
         1. Improvement = betterment (f), restoration (g), or adaptation for other use (h)
      7. § 1.263(a)-3(e)(1): Routine maintenance = ***safe harbor***, as long as it just keeps the property in ordinary operating condition
      8. § 1.263(a)-3(f)(1): ***Betterment*** if 1) ameliorates a material defect existing prior to acquisition, 2) material addition is made, or 3) results in a material increase in capacity, efficiency, quality, etc.
      9. § 1.263(a)-3(f)(2): Consider all factors to determine if it was a betterment including:
         1. Availability of equal replacement parts (unavail., maybe better is OK)
         2. Appropriate comparison (compare before and after; minor changes or changes to reverse an unexpected problem are OK)
      10. § 1.263(a)-4(a): Deals with amounts paid to create/acquire intangible assets
      11. § 1.263(a)-4(b)(1): Must capitalize amount paid to create/acquire an intangible asset, enhance a separate and distinct intangible asset, or facilitate an acquisition or creation of such an asset
      12. § 1.263(a)-4(b)(3)(i): Separate & Distinct Intangible Asset Defined
          1. Means a property interest of ascertainable value
      13. § 1.263(a)-4(c)(1)(i): Deals with ***acquired intangibles***. Example given here:
          1. Ownership interest in a corporation, LLC, partnership, or other business
      14. § 1.263(a)-4(c)(1)(vii): Another example of an ***acquired intangible***:
          1. A patent or copyright.
      15. § 1.263(a)-4(d)(1): Deals with ***created intangibles*** – must capitalize
      16. § 1.263(a)-4(d)(3): More dealing with ***created intangibles*** – examples:
          1. Prepaid expenses qualify for capitalization (e.g. insurance, rent)
      17. § 1.263(a)-4(d)(9)(i): More on intangibles – example:
          1. Must capitalize **expenses to perfect title** to intangible property
      18. § 1.263(a)-4(f)(1): ***12-Month Rule***, not req’d to capitalize **intangible assets** if the right or benefit does not extend beyond the earlier of:
          1. 12 months after the first date on which the taxpayer *realizes the benefit*, or
          2. The end of the taxable year following the year in which *payment is made*.
      19. § 1.263(a)-4(f)(5)(i): The 12-Month Rule also includes ***any renewal period***, if there was a ***reasonable expectancy of renewal***.
      20. § 1.263(a)-4(f)(8)(Ex. 1): Insurance as a prepaid expense; 12 month rule applies to say cannot expense if benefits felt after the following taxable year
      21. § 1.263(a)-4(f)(8)(Ex. 2i): Prepaid = if w/in 12 months, then the rule should apply
      22. § 1.263(a)-4(g)(1): An amount req’d to be capitalized *cannot be deducted*, and instead the capitalized amount should be ***added to basis***.
      23. § 1.263(a)-5(a)(1): Must capitalize amount paid to facilitate acquisition, whether an acquirer or an acquiree
      24. § 1.263(a)-5(b)(1): Scope of facilitative – amount paid in investigating or otherwise pursuing a transaction. Check but-for cause for incurring the cost, but not determinative
          1. Pricing costs are to be capitalized
          2. Amounts paid to acquiree’s SHs are not facilitative
      25. § 1.263(a)-5(d)(1): ***Simplifying conventions,*** do not need to be capitalized:
          1. Employee compensation, overhead, de minimis costs
      26. § 1.263(a)-5(d)(3)(i): **De minimis exception** for facilitation costs
          1. If less than $5k, deductible
          2. If more than $5k, to be fully capitalized
      27. § 1.263(a)-5(e)(1): [***Timing***] Facilitation of the transaction ***can only happen if***:
          1. Letter of intent or exclusivity agreement has been executed

OR

* + - 1. Material terms of the transaction have been authorized by the taxpayer’s board
    1. § 1.263(a)-5(e)(2): *Inherently facilitative amounts*, even if not under (e)(1), *supra*.
       1. Appraisal, costs incurred to get advice on structuring, preparation of transaction documents, obtaining regulatory or SH approval, costs of conveyance
    2. § 1.263(a)-5(e)(3)(i): The above covers the ***taxable acquisition of assets that constitute a trade or business***.
    3. § 1.263(a)-5(*l*)(Ex. 4): Once the ***possibility of acquisition has been abandoned***, then **all costs associated with it** become deductible.
  1. 263A(a)(1)(B): Direct and indirect costs - unless it is inventory, capitalize.
  2. 263A(a)(2): Should capitalize *direct costs* fully and apportion a share of any *indirect costs*
  3. 263A(b)(1): If the costs produce real or tangible property, then they also req. capitalization
  4. 263A(c)(1): Only applies to ***property used in a trade or business***; not for personal property
  5. 263A(g)(1): Capitalize if taxpayer “construct, build, install, manufacture, develop, or improve”

1. Tax Deferral: The Implications of the Capitalization Requirement
   1. Tax deferral is a huge benefit, such that being able to deduct now will allow you to offset income that would otherwise require taxes be paid.
   2. Three Equivalencies
      1. *Interest-free Loan*: most straightforward, the amount of taxes you owed was loaned to you, and you don’t have to pay it back until later, so it is a tax free loan in the interim.
      2. *Reduction of Tax Rates*: present value of tax savings is the equivalent of reducing your tax burden by that amount, thereby reducing your effective tax rates.
      3. *Exclusion of Yield from the Investment*: can add present value of the tax savings to your initial investment, thereby increasing your return by the amount of the tax rate, which in turn, would leave you with the same return you started off with.
         1. Requires scalability of investment and constant tax rates
         2. Example: Tax rate 15%, that means I can put *more than* 15% ***more*** into my investment; when I then earn the same return, the amount I get in the end will be 15% more (based on the end number) than I would have gotten, which will be the amount of taxes I will pay.
            1. Ex. w/ $100; w/ 15% tax, could afford to do $117 (b/c 15% tax break would bring my out-of-pocket back down to 110).
            2. Then 100% return would yield $234, which is 15% more than $200 (based on the $234, not the $200).
         3. Compare: IRA to Roth IRA
            1. IRA: Don’t tax (deduct) input, tax output

Would not want to do this if not very much income to offset

Would want to do this if you expect to be in a lower bracket later

* + - * 1. Roth IRA: Tax (don’t deduct) input, don’t tax output

Would want to do this when you expect to be in a higher bracket later.

* 1. Implications: Timing is the only difference between an income tax and a consumption tax
     1. Because allowing immediate deduction is the same as a consumption tax which would simply subtract all investments and savings from receipts. Since the investments would be exempt from tax, the return would be the same, much like the exclusion equivalence mentioned above.

1. Other Implications of the Capitalization Requirement: Why bother?
   1. Concern over **conversion**. Expenses will offset income that would be taxed at one’s MTR. Even though basis will be lower, the *taxes on that amount will be taxed at capital gains rate*.
      1. Courts have **used this logic to allow deductions** instead of capitalization. If they are going to be taxed at the ordinary rate later on, then there is no concern of conversion.
      2. Implications

1) Costs of Disposition must be deductible at the MTR for gains from the disposition

Means: if capital gain rate applies, must count the expense as a cap. loss

2) Costs of Demolition similarly must be added to basis

3) Costs of Defense to Title must be capitalized for the same reason

Where does the line get drawn? Over what period to capitalize?

1. Capitalization of Expenses incurred in Acquiring/Producing Assets
   1. Facilitation

*Woodward* – Some SHs req’d to buy out other SHs who voted against a perpetual extension of charter, could not agree on a price, so they began appraisal proceedings in state court. Tried to deduct the expenses of those proceeding.

* + 1. **Court says no!** Appraisal is facilitative, and any part of the cost of acquisition is to be capitalized.
    2. Begets the **origin of the claim** test, similar to *Gilliam*, in that the court will ask what prompted the cost, and if it was a capital expenditure, then it should be capitalized
  1. Capitalize if ***Inherently Facilitative***: § 1.263(a)-5(e)(2) – appraisal *of a specific company*; getting regulatory approval for a deal, etc.
     1. IF NOT: Look to **timing issue** –
        1. If it happened after a LOI was signed or the board of the taxpayer approved the acquisition/deal, then it will be treated as facilitative
     2. Intangible v. Tangible Distinction
        1. Employee compensation in the ***acquisition of an intangible asset*** is wholly exempted
        2. If ***tangible asset***, however, then you must ***apportion costs*** for capitalization.
  2. Construction Costs

*Idaho Power* – Equipment used in construction of facilities, tried to depreciate the equipment over its useful life of 10 years, IRS says **no**, to the ***extent used for construction***, the *value of the equipment used should be added to the basis of the facility*, and therefore depreciated over the **longer time frame**.

* + 1. Applies to ***all costs of construction***, including *wage for construction workers*, etc.
    2. “[T]he exhaustion of the construction equipment does not represent the final disposition of the taxpayer’s investment in the equipment”
    3. 🡪 Codified in § 263A
  1. Result

All capitalized costs are *added to basis* and accounted for over time with depreciation, rather than expensing.

1. The Oddly Intangible Assets
   1. *INDOPCO* – Expenses incurred by a target corporation in a friendly takeover
      1. “deductions are exceptions to the norm of capitalization”
      2. Test for capitalization: ***does the taxpayer realize benefits beyond the year in which the expenditure occurred***.
         1. A separate and distinct asset is sufficient for capitalization, but not necessary.
      3. ***BUT***: Treasury responds with regulations
         1. Allows deductions for several things that produce income over time
         2. § 1.263(a)-4
            1. Says only time you will need to capitalize an expense to create an intangible is under the circumstances of (d), or if a separate and distinct asset it created/enhanced.
            2. ***Without separate and distinct asset***, **no capitalization for created intangibles**.See p. 311.

Goodwill only capitalized when you acquire a business.

* + - * 1. Also says overhead, employee comp., & de minimis costs are deductible
      1. Despite “***overruling***” SCOTUS, *Brand X* says only a holding about unambiguity of a statute would foreclose a contrary agency construction.
  1. **Advertising** – generally regarded as deductible expense, see § 1.162-20

1. Repairs and Rehabilitation
   1. Revenue Ruling 2001-4
      1. ***Takeaway***: as long as the repairs do not increase the value or prolong the life of an asset, beyond which it was reasonably expected to last, then the costs will be deductible.
      2. ***Further***: Costs may divided b/w capitalized and not if there was a genuine maintenance aspect to the procedure. If, however, there is no genuine maintenance focus, even the repairs made which would be generally deductible, will be capitalized as being part of a more general rehabilitation plan.
         1. ***Is this still the case***? Would likely **not** be true once the proposed regulations enter into effect.
   2. Determine deductibility by asking, did the repairs:
      1. Adapt the property for a new or materially different use
      2. Appreciably prolong the useful life of the good
      3. Materially add to the value of the property
2. Statutory Framework for Recovery of Capital Expenditures
   1. Generally:
      1. Want to expense costs that will only produce income in the current year
         1. E.g., raw materials, salaries, rent, office supplies, etc.
      2. Want to depreciate assets that produce income *over time*, to properly account for them
         1. E.g., buildings, machinery, equipment
      3. Want to capitalize assets and account for *only upon disposition (no depreciation)*, if they do not lose value over time, and they continue to produce income.
         1. E.g., stock, land, [anything that produces **imputed income**], goodwill, art
   2. § 1016
      1. § 1016(a)(1) – adjust basis for expenditures or receipts properly capitalized; no adjustment if a deduction has been taken
      2. § 1016(a)(2) – reduce basis by allowed deduction for depreciation; basis ***will be reduced by the full amount allowable under the section, regardless of whether or not the deduction was taken***.
   3. § 167
      1. § 167(a) – Allow depreciation for property used in a trade or business or property held for the production of income.
         1. § 1.167(a)-1: Depreciation for wear and tear shall ***not reflect*** amounts representing a mere reduction in market value.
         2. § 1.167(a)-10(b): Period for depreciation ***begins when placed in service***, and it ***ends when retired from service***. A proportionate part of the first and last year’s depreciation will be allowable.
      2. Two Depreciation Methods.
         1. § 1.167(b)-1: ***Straight-line method***. Use the cost or other basis upon acquisition, minus the expected salvage value ($0), divided by the expected life (in years) or the property.
         2. § 1.167(b)-2: ***Declining balance method***. Can be up to *double the straight-line rate* (then see § 168(b), where this is used until such time that the deduction is less than would be allowable under the straight-line method, at which time the taxpayer may switch)
         3. In no even shall an asset be depreciated below its salvage value.
            1. But, per § 168(b)(4) – ***salvage value treated as zero***.
      3. § 167(c)(1) – Basis upon which depreciation is to be allowed is the adjusted basis
   4. § 168
      1. § 168(a): In depreciation, must take into account –
         1. Applicable depreciation method
         2. Applicable recovery period
         3. Applicable convention
      2. § 168(b)(1): Use 200 percent double-declining method (double the straight-line rate) *until the deduction allowable is less than the original straight-line rate* would have been, at which time you switch over.
         1. (b)(2): use 150 percent double-declining method for 15- and 20-year property, or property used in a farming business
      3. § 168(b)(3): ***Must apply straight-line method to*** –
         1. Nonresidential real property
         2. Residential rental property
         3. Railroad stuff
      4. § 168(b)(4): ***Salvage value treated as zero***.
      5. § 168(c): Applicable recovery periods –
         1. 3-,5-,7-,10-,15-,20-year properties all depreciated over those years
         2. Water utility property over 25 years
         3. Residential rental property over 27.5 years
         4. Nonresidential real property over 39 years
         5. Railroad grading or tunnel bore over 50 years
      6. § 168(d): In general, ***mid-year convention applies***, except –
         1. For real property, the ***mid-month convention*** applies
         2. When ≥40% of depreciable property is placed in service in the last 3 months of the year, then the ***mid-quarter convention applies***.
      7. § 168(e)(1): How to determine what property is –
         1. ≤4 yr class life 🡪 “3 Year Property”
         2. ≥5, but <10 yr class life 🡪 “5 Year Property”
         3. ≥10, but <16 yr class life 🡪 “7 Year Property”
         4. ≥16, but <20 yr class life 🡪 “10 Year Property”
         5. ≥20, but <25 yr class life 🡪 “15 Year Property”
         6. ≥25 yr class life 🡪 “20 Year Property”
      8. § 168(e)(3): a *race horse is 3-year property*, a *motorsports entertainment complex is 7-year property*, and *any Alaska natural gas line is 7-year property*.
   5. § 179
      1. § 179(a): Can elect to treat certain capital costs under this section as deductible
      2. § 179(b)(1): Limits to the election –
         1. $250k for years 2007-2009
         2. $500k for 2010 and 2011
         3. $125k for 2012
         4. $25k for 2013 and beyond
      3. § 179(b)(2): Limits above ***reduced, dollar for dollar,*** by the amount of 179 property placed in service that exceeds –
         1. $800k for 2007-2009
         2. $2 million for 2010 and 2011
         3. $500k in 2012
         4. $200k in 2013 and beyond
      4. § 179(b)(3)(A): Deduction shall not exceed income
      5. § 179(d)(1): Section 179 Property defined as –
         1. Tangible property to which Section 168 applies
            1. And computer software to which 167 applies
         2. As long as that property was acquired for use in a trade or business
         3. § 179 ***does not apply to real property***.
            1. Nor does it apply to intangibles (e.g., patents, etc.)
   6. § 197
      1. § 197(a): Allows for amortization deduction of **acquired** intangible assets (e.g., goodwill)
         1. Will be amortized over a 15 year period
         2. Straight-line (“ratably”).
      2. § 197(b): disallows any other depreciation for eligible property
      3. § 197(c)(1): intangible must be held in connection with a trade or business
      4. § 197(d)(1): eligible intangible is –
         1. ***Goodwill***, going concern value, workforce in place, business books & records, any ***patent or copyright***, customer list, supplier list, licenses or permits, covenants not to compete, and any franchise or trademark.
      5. § 197(d)(2): Defines customer based intangible as including market share or future sales that will result from pre-existing relationships; for financial institutions, this includes the “deposit base”
      6. Convention to apply: take the whole month’s depreciation on acquisition/disposition
3. Depreciation
   1. §§ 167 & 168 provide a mandatory system of cost recovery for property placed in service in the year 1981 or thereafter.
      1. Relies upon the ***method for depreciation*** and the ***recovery period***.
      2. MACRS lists eight recovery classes
         1. 3,5,7, or 10 year property can use the double-declining method (w/ ref. to their respective class life)
         2. 15 or 20 year property can use the 1.5 method
         3. Other (including nonresidential and residential rental) still must use straight-line
   2. Allows for accelerated recovery, but this is the *opposite of economic loss* actually occurring.
      1. This is based on concept of **future cash flows**. Assuming straight-line depreciation is based on the assumption that it will generate equivalent revenue each year, then with TVOM in mind, the result does not fit. Each year, you lose the *final year of cash flows* that had existed the year before. This number becomes larger as the machine nears the end of its useful life, so the most economic loss happens at the end.
      2. Will be a **tax benefit** for those whose property produces equal income over the years, or those that produce more income at the end of its life (meaning it *actually* depreciates slower).
      3. Will be a **tax penalty** for those whose property actually depreciates faster than the tables, although this is *almost never the case*.
         1. Example: rental cars
   3. Why not ***economic depreciation***?
      1. Administrative/Compliance difficulty, would have to value things every year
      2. Enforcement difficulty, battle of the experts every time
      3. Goes against usual realization requirement (would essentially be allowing a loss)
   4. Methods of Depreciation
      1. ***Straight-line method***.
         1. Amount Depreciable each year = (Cost or Basis) ÷ Expected Useful life
      2. ***Declining balance method***.
         1. Amount Depreciable = [Straight-line method result ÷ (Cost)] \* X \* Cost
            1. X will depend on if it is in the double-declining balance method (in which case it would be 2), or in the 150% category (1.5 in that case)
4. Amortization
   1. Previously
      1. Goodwill could not be depreciated, and there was constant litigation over whether or not an intangible asset could be valued separately and if it actually had a limited useful life.
   2. The § 197 Solution
      1. “Rough justice”
      2. **Acquired** intangibles are depreciable over a 15-year period
      3. Rule Complexity coupled with Transactional Simplicity
5. Non-Depreciables
   1. Property for Personal Use
      1. If used for both, the basis must be allocated between the two
      2. If converted to business use, the basis for depreciation will be the lesser of the FMV or the adjusted basis in the property.
         1. So if it’s gone up, don’t get to deduct a bunch with conversion.
   2. Land
      1. Rationale: no ascertainable useful life, lasts too long
         1. Exception may be granted for very specific circumstances (e.g. hold in ground valuable because it can be a garbage dump, but it is not as useful when it is full)
   3. Antiques
      1. Rationale: no clear useful life
         1. Exception can be made when this can be established. Musician example and antique violins. Since the violins had never been played, if they played them, they could depreciate up to the difference between the unplayed and the played and worn out violins. Cannot depreciate any value attributable to *market conditions*. See *Simon* referred to on p. 344.
         2. Paintings, for example, will not fall into this exception.
   4. Luxury Automobiles
      1. Limits depreciation in the first year to $2,560 for cars up to 6,000 lbs.
      2. Limits depreciation to $25,000 for SUVs (notice huge preference, although on accident)
      3. Both important b/c § 179 likely would allow the full amount to be deductible normally
6. Depreciation as a Subsidy
   1. Aside from trying to accurately measure net income, depreciation also used as a subsidy by:
      1. Allowing an expense for things that should be capitalized (§ 179 “depreciation”)
         1. Supposed to be an incentive for small businesses
      2. Allowing the taxpayer to deduct more than his cost.
         1. At times in the past, ITCs had been granted that, in conjunction with already allowable deductions, allows this.
      3. Allowing shorter lifespans (recovery periods) over which to depreciate the asset
         1. Pushes tax burden into the future
      4. Allowing faster rates of depreciation (method of depreciation, e.g., declining balance method)
      5. Ignoring salvage value; deduction will be larger than economic cost
         1. Pushing tax burden further into the future
      6. Using arbitrary conventions in years of acquisition and disposition
         1. Gives benefit to those who “work the system” by buying/selling at appropriate times; just gotta keep the rules in mind.
   2. Why do this?
      1. Forsake accuracy for simplicity
      2. Provide a stimulus
      3. PAYGO: Tried to say you got to pay for a tax expenditure with a revenue source, but they also can simply neglect to do so if they want (since they are Congress)
7. Structure
   1. Expense or capitalize (§ 263 & 263A)?
      1. Depreciate or recovery on disposition
   2. Need to determine depreciable base?
      1. INDOPCO stuff
      2. § 167

***UNIT X – The Deduction of Consumption & Below-the-Line Deductions***

1. § 63 – Taxable Income Defined
   1. § 63(a): Taxable income means gross income minus the deductions allowed by this chapter
   2. § 63(b): For those who do not itemize, taxable income equals ***adjusted gross income*** minus the ***standard deduction***, and ***the deduction for personal exemptions*** in § 151.
   3. § 63(c): The ***standard deduction*** means the sum of the basic and additional standard deductions
      1. (c)(2): Basic standard deduction is $3,000; $4,400 for heads of household, and $6,000 for a joint return or a surviving spouse.
      2. (c)(3): Additional standard deduction is for the aged and the blind
      3. (c)(4): S.D. will be adjusted for inflation in every year after 1988, based on COLA
      4. (c)(5): ***S.D.*** ***limited for dependents*** to $500 or $250 plus the individual’s *earned* income
      5. (c)(6): ***no S.D. for spouses filing separately if one itemizes***; also no S.D. for nonresident aliens
   4. § 63(d): ***Itemized Deductions*** means deductions other than the above-the-line deductions and the personal exemptions.
   5. § 63(e)(1): Must ***elect to itemize*** in order to get any of the “itemized deductions”
   6. § 63(f): If aged or blind, add $600 to S.D.; if unmarried, increase to $750
2. § 68 – Overall Limitation on Itemized Deductions
   1. § 68(a): If income over the “applicable amount,” then the itemized deductions get reduced by either: 1) 3% of the excess AGI over the applicable amount, or 2) 80% of the amount of itemized deductions otherwise allowable
   2. § 68(b): Applicable amount. Set at $100k in 1991, to be adjusted for inflation.
   3. § 68(c): Limitation will not apply to medical expenses, deduction for investment interest, nor the deduction for casualty and theft losses
   4. § 68(g): **SECTION 68 REPEALED UNTIL 2012**
3. § 151 – Personal Exemptions
   1. § 151(a)-(c): Says individual gets to ***deduct the personal exemption***, married individual filing jointly may deduct double (also if not jointly, as long as the spouse has no income and is not filing), and you also get an ***exemption for each dependent***.
   2. § 151(d): Exemption amount set to $2,000.
      1. Set to ***phaseout*** by 2 percent for each $2,500 an individual is over the threshold amounts ($150k for joint, $100k for single). **PHASEOUT REPEALED UNTIL 2012**.
      2. Phaseout effectively *raises the marginal tax rate* by taking away exemptions.
4. § 152 – Dependent Defined
   1. § 152(a): Must be a “qualifying child” or “qualifying relative”
   2. § 152(b): Exceptions –
      1. Cannot be a dependent and have dependents
      2. Cannot be married and qualify as a dependent
      3. Dependent must be a citizen or national of the U.S.
   3. § 152(c)(1): Qualifying Child
      1. Must share the same place of abode more than half the year
      2. Must not provide half of their own support
      3. Must not be married
      4. Must meet age and relationship requirements
   4. § 152(c)(2): Relationship Req’s
      1. Child of the taxpayer, or
      2. Brother, sister, stepbrother, stepsister, or a descendant of any such relative
   5. § 152(c)(3): Age Req’s
      1. Must be **younger than the taxpayer**, and must be 18 or younger or must be *still a student* and **23** or younger. Exception to all this: permanently disabled
   6. § 152(d): Qualifying relative
      1. Gross income of that person must be less than the exemption amount, taxpayer must provide at least half of that person’s support, cannot be a qualifying child of anyone else
5. § 32 – Earned Income Credit
   1. A refundable credit for low-wage workers that increases when you have children
   2. **No children**: 7.65 % of first $4220 of earned income can be a credit, but reduced by 7.65% of every dollar earned over $5280
   3. **One child**: 34 % of first $6330 earned, reduced by 15.98% of every dollar earned over $11,610
   4. **Two children**: 40% of first $8890 earned, reduced by 21.06% of each $ over $11,610
   5. **Three+ children**: 45% of first $8890 earned, red’d by 21.06% of each $ over $11,610
      1. Only applies until 2012, then goes back down to 40%
   6. **Married**: add $5,000 to the phaseout amount, beginning in 2010 and adj. for inflation thereafter
      1. Only applies until 2012, then goes back to $3,000 addition
6. § 7703 – Determination of Marital Status
   1. § 7703(a) – Determination made at the close of the year, divorced does not count as married
   2. § 7703(b) – If you maintain a household sans spouse for the last 6 months of the year and you support a child for whom the house is the principal place of abode for more than half the year, then you will ***not be treated as married***.
      1. Notice, however, that the spouse would be treated as married in that situation.
7. § 24 – Child Tax Credit
   1. § 24(a) – Tax credit in the amount of $1000
   2. § 24(b) – Tax credit will be reduced by 5% of every dollar earned over the threshold amounts:
      1. $110k for married filing jointly
      2. $75k for single
      3. $55k for married filing separately
   3. Refundable to the extent of 15% of the earned income in excess of $10k (indexed for inflation)
8. The Standard Deduction
   1. Two policy arguments:
      1. The level of income below which no tax should be imposed (an adjustment to tax rates)

🡪 a **normative** argument

* + 1. A substitute for itemized deductions 🡪 a **simplification** argument

1. Five filing statuses
   1. Single
   2. Head of Household
   3. Married Filing Jointly
   4. Married Filing Separately
   5. Surviving Spouse (note: requires child)
2. Personal Exemptions
   1. Two Rationales:
      1. Setting the amount of income that should be taxed at a zero rate
         1. Implies to reduction, regardless of income level
      2. Setting a subsistence level of income
         1. Implies their should be a phasing out
   2. Qualifying Child
      1. In a contest for the exemption:
         1. Goes to parent with whom the child stayed the longest, or
         2. Goes to the parent (if one party vying for the exemption is a non-parent), or
         3. Goes to the claimant with the highest AGI
   3. No otherwise qualifying child or relative will be acknowledged if against state law
3. Earned Income Tax Credit
   1. Leaves room for substantial marriage penalties, since there is only a $5k/$3k addition to the phase-out, rather than the full amount of the phaseout.
   2. Complexity makes it difficult to do what was intended: help the working poor
      1. See how only 10,000 workers opt to receive an advance payment of the credit through reduced withholdings.
4. § 170 – ***Charitable Contributions***
   1. § 170(a)(1): Allowing charitable contributions
   2. § 170(b)(1)(A): Limiting deductions to 50% of adjusted gross income
      1. Applies to most organizations, e.g. churches, hospitals, educational institutions, etc.
      2. All other charitable contributions to other organizations subject to a 30% cap
   3. § 170(c): Defines a “charitable contribution” as a contribution or gift to or for the use of –
      1. A State or political subdivision of the United States
      2. A non-profit organization properly organized and established in the U.S. under 501(c)4
      3. Veteran’s organization
      4. Domestic fraternal organization properly organized and operating for educational, etc.
      5. Non-profit cemetery
      6. ***Note***: corporate donations must be put to use within the United States to be deductible
   4. § 170(f)(8): Donors should not if ***solely intangible religious benefit*** received in return
      1. Would need to be exclusively for religious purposes, generally w/o an outside market
      2. Any amounts paid must > FMV of any marketable good also received to be deductible
5. Charitable Contributions
   1. Can deduct contributions made in cash or the FMV of property transferred
      1. ***Cannot*** deduct FMV of a contribution of services
   2. Cap on giving may be lifted in times of crises
   3. Can only take if you itemize
      1. So then rationale of non-consumption or other normative reason for allowing the deduction may go out the window, unless the S.D. is seen as a stand-in for the actual amount that would be deductible (rather than a minimum standard of living)
         1. Most likely just trying to incentivize giving (but is it even effective at this?)
      2. Furthermore, ***majority of donations given by those who do not itemize***, since ***salvation has inelastic demand***.
6. *Quid pro quo* and Religion – Deductible!
   1. *Hernandez* (p. 436) says that wherever there is a quid pro quo, then it cannot be deductible
      1. Categorically barred from giving the lessons for free, so Court was concerned
      2. IRS likely concerned of the slippery slope, YMCA gym membership becomes deductible?
   2. IRS says, well, hold on there, if there is only an ***intangible religious benefit*** rec’d, then it’s OK!
      1. Ex. *Sklar* – religious education held not deductible b/c no payment above and beyond the market value of the secular education rec’d.
         1. Concern: to allow a deduction would be to violate the Establishment Clause.
   3. Religious Schooling
      1. Parents can deduct a contribution only when made with no expectation of receiving a commensurate benefit (p. 445)
      2. Presumption against deduction if: otherwise no tuition was charged, pre-existing agreement, the contribution was earmarked for a particular individual
         1. I.e., any indication that the attempt was to characterize tuition as a contribution
   4. Taxpayer’s Motive is of Primary Importance
      1. But, also cannot earmark for use by an individual, since the charity must have possession *or* control of the funds (Mormon payments)
      2. *Davis v. United States*, p. 446
7. When to use the FMV
   1. IRS sticks with general position that the gift must be of detached & disinterested generosity
      1. Means that any goods with an FMV rec’d in return must be subtracted from the deduction.
   2. Result: buy at a charity auction 🡪 the market valued the good at the price you purchased
      1. So no deduction
      2. *However*, interesting result: **naming rights** are fully deductible, because there is no real “market” for such things.
   3. Must show that you ***could have paid less*** for an item in order to get a deduction
      1. (outside of intangible religious benefit context)
   4. **Sidenote:** IRS allows a deduction of 80% for contributions that qualify donors for sports tickets
      1. *Only applies to colleges* (and only b/c of a crazy court victory)
      2. Otherwise, § 274(*l*) limits the deduct. to the face value of the tickets (not the box lease)
8. No Deduction for Gift of Services
   1. Consistently held that this is the case
      1. Very hard to value (use opportunity cost? use FMV of labor? etc.)
   2. However, can deduct unreimbursed expenses in connection with donating services to a charitable organization. (*McCollum* – p. 446)
   3. Giving blood counts as a service, and if when it doesn’t, no basis to determine value
9. The Substantiation Requirement
   1. For gifts of $250 or more, the IRS requires written proof from the charity
   2. Cash donations, regardless of size, must be substantiated by a receipt
10. § 104 – ***Compensation for Injuries or Sickness***
    1. § 104(a): Gross income does not include –
       1. Workmen’s comp; Non-punitive damages received from injury; Amounts received from a health insurance plan; Annuity received due to injury in the Armed Services; Disability income
       2. *However, anything deducted under § 213 must be included.*
    2. § 104(c): Punitive damages also excludable if it arises from a ***wrongful death*** action.
11. § 105 – Amounts received under ***accident and health plans***.
    1. § 105(a)-(b): amounts received by an employee through a health plan of the employer, or by direct reimbursement for medical costs, may be excluded from income.
    2. § 105(c): payments excludable where they are computed with reference to the injury
12. § 106 – Contributions by employer to accident and health plans
    1. § 106(a): gross income does not include employer-provided coverage
    2. ***HUGE tax expenditure***. Big incentive to employers to provide health insurance.
13. § 213 – Deductibility of certain ***medical, dental***, etc. expenses
    1. § 213(a): Deduction allowed for expenses not compensated by insurance or otherwise
       1. Includes medical insurance premium
    2. Subject to 7.5% floor (must exceed the floor, and will only be deductible to that extent)
       1. About to increase to 10% in 2013 (for AMT purposes, already at 10%)
    3. § 1.213-1(a)(1): Medical expenses are allowed to be deducted when ***actually paid*** during the taxable year. (Incurring the costs is insufficient)
    4. § 1.213-1(e)(1): (i) Medical care includes diagnosis, cure, treatment, etc.; (ii) also includes operations as long as they were undergone to alleviate a defect or illness; (iii) can also include a capital expense – eyeglasses would be fully deductible, an elevator only so much as its cost exceeds the increase in value of the property; (iv) expenses paid for necessary transportation; (v) cost of in-patient hospital care, which also includes costs incurred re: meals and lodging if staying in the institution is required.
14. Damages for Personal Injuries
    1. § 104 limited to *personal physical injuries*.
       1. Amounts received for sexual harassment, defamation, etc. are all now taxable
       2. So, settlements and damages received will be ***apportioned among physical and nonphysical*** to determine how much is excludable.
          1. HOWEVER, often very difficult, will require the Rodman-esque silence agreement that would go along with the payment.
          2. Would be easy if there were multiple claims presented in suit.
       3. Emotional distress resulting from physical injury may be excludable
       4. Physical injury resulting from emotional distress likely taxable
          1. May be excludable if clearly substantiated.
    2. Punitive damages are now ***explicitly NOT excludable*** (not so before a mid-90’s amendment).
    3. Interest that is awarded on the damages is taxable
       1. Even applies to lump sums that are not to be paid for some time
       2. *Compare* annuities, which are fully excludable.
    4. Jury instructions regarding exclusion is allowed per Justice Blackmun
    5. Why exclude?
       1. “Offensive” (not great)
       2. Recovery of expenses – but what about when this is a recovery of income (back pay)
       3. Recovery of human capital should not be taxed – offsetting loss
          1. BUT, this creates an inequity b/w those with insurance and those without (one may get fixed and the other will not, and yet both damage awards excludable)
       4. Recovery of nontaxable items should be tax-free
          1. But the reason they were nontaxable is b/c imputed and hard to quantify. Very easy to quantify here, because there was a market transaction.
          2. Further, does not make sense in light that non-physical injuries are taxed
15. Medical Expenses
    1. When is it a medical expense?
       1. Medical care – obvious
       2. A capital expense to improve a property can be a medical expense, but only to the extent the ***cost exceeds the increase in value to the property***.
          1. However, if it is clear that some part of the expense was not necessary, it may be disallowed (such as if incurred for aesthetic reasons), Rev. Rul. 87-106 (p. 456)
          2. MUST BE: 1) an **essential element** of treatment, and 2) not incurred for **nonmedical** reasons
       3. Just because a Doctor prescribes, does not mean that it is deductible
          1. Need to prove that costs were incurred for medical reasons, and that the minimum amount necessary was incurred (in order to avoid deducting consumption)
    2. Birth Control – deductible
    3. Cosmetic Surgery – not deductible
    4. Gender Reassignment Surgery – deductible (gender identity disorder is a disease)
       1. Breast augmentation, however, is still considered a cosmetic aspect
    5. Medical Marijuana – not deductible
       1. But, medical counseling was deductible
    6. In-home Care – deductible as long as properly licensed
    7. Meals and Lodging – deductible if it is a “substitute institution” (or on the way to one)

***UNIT XI – Who is the Taxpayer?***

1. General Rules
   1. Rule #1: Everyone enjoys the lowest rates for pre-determined amounts of their income
   2. Rule #2: Each individual is typically a separate taxpayer
      1. Generally applies to children (no age limit to filing a return)
      2. Not the case w/ corporations (where resources are amalgamated)
   3. Rule #3: Generally take into account need to take care of yourself and anyone else you support
   4. Rule #4: Gifts and Support typically non-deductible to the donor, and excludible to the donee
      1. Tax once to the earner
      2. Support is too indistinguishable from Gift, so they need to be treated the same
2. § 1
   1. § 1(a): MFJ and Surviving Spouses are taxed at the same levels
      1. Up to $36,900 – 15%
      2. $36,900 to $89,150 – 28%
      3. $89,150 to $140,000 – 31%
      4. $140,000 to $250,000 – 36%
      5. More than $250,000 – 39.6%
      6. CHANGED WITH TAX CUTS
         1. Not Over $17,000 – 10%
         2. $17,000 to $69,000 – 15%
         3. $69,000 to $139,350 – 25%
         4. $139,350 to $212,300 – 28%
         5. $212,300 to $379,150 – 33%
         6. Over $379,150 – 35%
   2. § 1(b): Heads of Households
      1. Same idea: < 29.6k (15%); 76.4k (28%); 127.5k (31%); 250k (36%); 250k+(39.6%)
         1. CHANGE w/ TAX CUTS
            1. 12,150 (10%); 46,250(15%); 119,400(25%); 193,350(28%); 379,150(33%); 379,150+(35%)
   3. § 1(c): Unmarried individuals
      1. $22.1k (15%), $53.5k (28%), $115k (31%), $250k (36%), $250k+ (39.6%)
         1. WITH TAX CUTS:
            1. $8.5k (10%), $34.5k (15%), $83.6k (25%), $174.4k (28%)

$379.15k (33%), $379.15k+ (35%)

* 1. § 1(d): MFS
  2. § 1(e): Estates
  3. § 1(f): Gov’t must adjust tables for inflation
     1. Cost of living adjustment to be made every year beginning 1993 (except 1994)
     2. § 1(f)(8):
        1. ***Elimination of marriage penalty*** for 15% bracket (bracket must be double that of unmarried individuals)
  4. § 1(g): ***Kiddie Tax***
     1. Unearned income of the child shall be taxed at the higher rate of either:
        1. Their own rate

or

* + - 1. Their parent’s rate 🡪 means ***stacking*** of income
    1. Only applies to *dependent children* (w/ all the required parameters met incl. that earned income cannot provide half of their own support), and only applies to *unearned income*.
       1. Also only applies to that which is *in excess of $1000*.
    2. Underlying concern: the shift of ***unearned income*** to a lower tax bracket. The actual earned income will be taxed at the rate of the earner regardless, but we don’t want the interest to become exempt by shifting.
       1. Why even give the $1000 exemption, then?
          1. Administrative convenience (can get little gifts)
          2. Encourage savings (but probably not the case, better savings plans exist)
  1. § 1(h): Capital Gains
     1. More on this later
  2. § 1(i): Rate reductions for *after 2000*.
     1. Creates 10% bracket
     2. Reductions begin in 2001 and end up at the current rates in 2003

1. § 2
   1. § 2(a): Definition of Surviving Spouse
      1. Taxpayer whose spouse died in either of the 2 preceding years & maintains the principal place of abode for a ***child*** (stepson/daughter OK) for whom the taxpayer may take a deduction under § 151.
      2. However, does not qualify if **remarried**.
   2. § 2(b): Definition of Head of Household
      1. Must be unmarried at the close of the taxable year and maintain as home a household which provides the principal place of abode for a ***dependent*** (child or other qualifying person OK).
      2. § 2(b)(2)(B): you **do not count as married** if spouse is a **nonresident alien**.
2. § 7703
   1. § 7703(b)
      1. An individual is ***not considered married*** if they were not living with their spouse for the final six months of the calendar year and provided at least one half the support for a **child** who maintained his principal place of abode with the taxpayer.
3. Marital Status
   1. Pre-1948: individuals taxed individually, regardless of marital status
      1. Status determined by State Law. If married by state law, then married for tax purposes. Gets interesting with DoMA; 9th Cir. in *Lee v. Comm’r*, p. 479.
      2. *Poe v. Seaborn* – says that community property states means things should be divided in half as it is earned. State law shenanigans ensue.
         1. Result: huge benefit for one-earner households (income split)
   2. Concern for **Horizontal Equity** and **Geographical Uniformity**
      1. Want each ***economic unit*** to bear the same tax
      2. Tried to extend the income-splitting regime across the board
         1. Huge marriage bonus resulted; deemed ***unfair*** to unmarried individuals
      3. Congress responds in 1969
         1. Goes in *favor taxing couples the same*; results in marriage penalty for some, and marriage bonus for others
      4. **Unresolvable Conflict**:
         1. Taxing Couples of Equal Aggregate Income the Same, OR
         2. Leaving Tax Liability *Unaffected* by Changes in Marital Status
   3. Why does Marriage matter, and why should it be treated differently?
      1. Income Pooling
         1. Shared costs, one economic unit
      2. Imputed Income
         1. More imputed income (by having another person in the economic unit) means that there is a higher ability to pay tax.
         2. ***The result***, ***however***, is that the labor market is skewed by disincentive. Possible reinforcement of gender bias.
4. The ***Marriage Penalty***
   1. *Druker* as an example of this, when two wage-earners are married, they are subject to a higher tax rate, since the brackets are not double.
      1. Concern: issue of “sham divorces” arise based on marital status being determined at the end of the taxable year.
      2. Revenue Ruling 76-255 (p. 474) addresses this
         1. Says that all the circumstances will determine status, and if it is clear that their only purpose was tax avoidance, they will be considered married.
         2. Must amend joint returns if there is an annulment
   2. Biggest issue: EITC can disappear with marriage
   3. Marriage *bonus* never a big concern for Congress
      1. Happens with single earner, gets increased brackets just by marrying
      2. Should there be concern: *incentive to seek poorer spouses*!
5. § 71
   1. § 71(a) – General Rule
      1. Gross income includes amounts received as alimony
   2. § 71(b) – Definitions
      1. Alimony means any payment **in cash**, *if*:
         1. Received pursuant to divorce or separation agreement,
         2. No election for transferred tax liability (per agreement),
         3. Payee and payor **do not live together** at the time of payment,
         4. No liability for payments after death of payee spouse
      2. Must be a ***written*** *agreement* or judicial decree
   3. § 71(c) – Payments to support children
      1. (a) does not apply to amounts designated for the children
   4. § 71(f) – Recomputation if front-loading
      1. Excess payments will be taxable to the payor in the 3rd year after divorce
      2. Determined excessive if greater than average of other years (in first 3), plus $15,000
      3. Exception in cases of death, remarriage, or when payments are tied to income (and the resulting fluctuation is due to income fluctuation)
6. § 215
   1. § 215(a) –
      1. Payor can ***deduct***alimony payment
         1. Deductible **above the line** per § 62(a)(10). See p. 482 for confirmation.
   2. § 215(b) – Deductible to payor as long as the ***payee includes it in income***.
7. Alimony
   1. Since *Gould v. Gould*, has generally been held taxable to the payee, deductible to the payor
   2. Termination
      1. Upon remarriage or death
   3. Compare Child Support
      1. Held nontaxable to the Payee, ***nondeductible*** to the Payor
      2. Termination, based on state law, but usually:
         1. General: life change for the child
         2. Examples:
            1. Marriage
            2. Turning 18 (varies by state)
            3. Death
      3. Also, must be ***used for the child***.
   4. Option to Opt-Out
      1. Can choose in agreement to make the payments taxable to the Payor and excludible for the payee. Would do this if payor is in a smaller tax bracket.
   5. Creation of alimony trust
      1. If alimony, includible to the recipient; although creation is nondeductible to the Grantor
      2. If child support, includible to the Grantor

***UNIT XII – Acquisition and Disposition of Property***

1. § 1001
   1. § 1001(a)
      1. Gain computed by subtracting the adjusted basis from the amount realized
      2. § 1.1001-2(a)(1): Amount realized ***includes the liabilities discharged*** as a result of the sale
      3. § 1.1001-2(a)(2): Selling property which *secures a recourse liability* **does not** result in COD income
      4. § 1.1001-2(a)(3): No need to include liabilities if they are not included in basis
      5. § 1.1001-2(a)(4)(i): Sale of property which secures a ***nonrecourse*** liability is considered income.
      6. § 1.1001-2(a)(4)(ii): Sale of property which secures a ***recourse*** liability is considered income if another person agree to pay the liability.
      7. § 1.1001-2(a)(4)(iii): Disposition of property includes a gift or a transfer to satisfy the liabilities
   2. § 1001(b)
      1. Amount Realized from the sale of property shall be the amount of money received plus the fair market value of any additional property received.
      2. § 1.1001-2(b): ***Fair market value is irrelevant*** for purposes of determining the amount realized upon a transfer of a property securing a recourse of nonrecourse liability.
   3. § 1001(c):
      1. *Unless otherwise noted*, the gain or loss realized will be recognized
      2. § 1.1001-2(c)(Ex. 1): Adjusted basis will be full purchase price (incl. any liabilities assumed) minus any depreciation taken. Amount realized will be any cash paid combined with any liabilities assumed (even if the first debtor maintains secondary liability).
      3. § 1.1001-2(c)(Ex. 2): The above still applies with a nonrecourse liability as it does with a recourse liability.
      4. § 1.1001-2(c)(Ex. 7): Amount realized includes the debt discharged, regardless of fair market value of the property transferred.
         1. Makes sense because this way the economic unit which bears the loss is the one entitled to take it for tax purposes.
      5. § 1.1001-2(c)(Ex. 8): If transfer property worth less than the face value of a debt to pay off a debt, then you will have an amount realized equal to the FMV of the property, plus any additional income from discharge of indebtedness.
2. § 1011
   1. § 1011(a): Adjusted basis shall be the ***basis from 1012***, with any ***adjustments from*** ***1016***
3. § 1012
   1. § 1012(a): Basis shall be cost
   2. What to do with stock acquired over time?
4. § 1014
   1. § 1014(a)(1): Property acquired from decedent shall be given a basis of the FMV at the date of the decedent’s death.
5. § 1015
   1. § 1015(a): For a gift, ***carryover basis*** will apply, ***except*** for determining loss when the property is transferred with an FMV below basis, in which case the FMV at the time of transfer will be used as basis for determining the loss.
6. § 1016
   1. § 1016(a)(1): Adjust basis for any capital expenditures
      1. As long as they were not deducted by the taxpayer in previous years (e.g., via 179)
   2. § 1016(a)(2): Adjust basis for any depreciation, amortization, depletion, etc.
      1. Adjust by the amount allowable, not the amount taken
   3. § 1016(b): Substituted basis
      1. Must account for adjustments made prior to transfer and after transfer separately
7. § 1041
   1. § 1041(a): ***No gain or loss recognized*** upon transfer between spouses or on a transfer incident to divorce.
   2. § 1041(b): Property shall given a carryover basis
      1. Spouse gets to keep the loss
   3. § 1041(c): Transfer must occur within one year of divorce, or be related to the cessation of marriage.
8. § 1.61-2(d)(i)
   1. When property transferred to an employee below FMV as compensation for services, transferee should include the difference between the amount paid and the FMV in income. The amount included plus the amount paid will become the adjusted basis in the property.
9. Change in Wealth
   1. Half of the Income equation (Income = Consumption + Change in Wealth, from *Collins*)
   2. Based on the Concept of Amount Realized – Adjusted Basis
   3. ***PROCESS FOR DETERMINING TAX UPON DISPOSITION OF PROPERTY***:
      1. Is there a realization event?
      2. What is the amount of the gain or loss realized?
      3. Is the Gain or Loss recognized?
         1. Not all gains *need* be recognized, and not all losses *can* be reocgnized
      4. Is the Gain or Loss considered Capital or Ordinary?
10. Antenuptial Agreements
    1. *Farid-es-Sultaneh*: woman marries Kresge, accepts ~$200k worth of stock in exchange for a release of marital rights to his estate, which amounted to roughly $375m.
       1. Result: presume that they bargained and reached a price where the exchange was equivalent. As such, she ***can take a basis of the FMV at the time of transfer***, and he ***should pay tax on his gain up to that amount*** at the time of signing.
          1. Nontaxable nature of her “income” supported by 67-221
          2. Seems to be a necessary conclusion that he should be taxed on the gain if the court is to treat it like this.
       2. Note: Not a Property Settlement because not married and not incident to divorce; not a gift because getting something in return
       3. Simply treated as a *bona fide* purchaser
    2. **Conundrum**: How can she have a basis in something she does not have?
       1. Marital rights do not exist before marriage
11. What is basis? (Need to know b/c adj. basis = basis +CapEx – Depr.)
    1. Basis is Cost, more specifically:
       1. Cash paid
       2. FMV of property
          1. *Philadelphia Park* says that, upon exchange of property, basis in new property will be the FMV at the time of transfer
             1. Realize any gains based on old basis at that time as well, with AR being the FMV of the property received, and AB being the Adj. Basis in the property transferred.
       3. For gifts – carryover basis per § 1015
          1. Accrued gain will be recognized by the donee
       4. For inheritance – basis will be FMV at time of death
          1. Accrued gain or loss will never be recognized
       5. Received per Transfer from Spouse or Property Settlement Incident to Divorce
          1. Result: carryover basis per § 1041
       6. Includes liabilities assumed ***upon acquisition***.
          1. Per *Crane*: recourse and nonrecourse debt treated alike, and sale of property encumbered by a loan should include the outstanding loan in the amount realized.
             1. *Tufts v. Commissioner* - says that this applies even when a nonrecourse debt is involved and the FMV is below the amount of the debt.

**Must** be the case if we want to treat nonrecourse debt as a “true loan” with the appropriate presumption of repayment

Otherwise, there was untaxed income at the beginning, since it was not a loan (which gets the preferential treatment due to the presumption of payback)

If you *include it in the basis and depreciate off the full amount*, then there must be the presumption of repayment of the full amount. ***Otherwise deductions for capital never paid for***.

O’Connor says could have also treated this as AR in the amount of the FMV at the time of transfer, plus COD income since it was simply surrendering property with an FMV less than the face value of the debt in exchange for cancellation of that debt.

You get to the same result, just possibly with different capital/ordinary allocation.

Taxpayer still comes out ahead

Increasing the amount of tax deferred via leverage means that nonrecourse debt becomes highly attractive.

* + - 1. No basis if no genuine acquisition of property
         1. *Estate of Franklin* – “buying” Thunderbird motel for a large sum of money, never making any transfers due to structuring, but still being able to take deductions on the full amount, and then defaulting at the end.

This tax shelter attempted post-*Tufts* to defer taxes; balloon payment would be due at the time the shelter burns out, then default.

**FAIL**: not a bona fide obligation in this case either.

Here, the whole structure looks more like an option rather than a true interest in the property. As such, deductions are inappropriate since there is no basis in this property.

* + - 1. No adjustment to basis for obligation assumed later
         1. Second Mortgage still good because you get to realize the appreciation in property without paying taxes
         2. Not included because not a “cost” of acquiring the property
    1. § 1091
       1. Stock repurchase within 30 days of sale, loss will not be recognized, and the basis will remain the same, plus the cost of the option to reacquire
          1. This is a recognition issued (addressed in Unit XIII), but it affects basis
       2. Taxpayer wants to trigger realization without disposing of an asset, IRS does not want to let this happen (see, e.g., *Cottage Savings* for ways around this)
    2. § 1031
       1. With Like-Kind exchange, basis is carried over.
          1. Any boot paid can be added to the basis
          2. Any boot received must be recognized as income, with no impact to basis, since the receipt of cash is a form of recognizing part of the gain
       2. A recognition exception with an impact on basis (like § 1091), so more on this in Unit XIII.

***UNIT XIII – Realization to Recognization***

1. § 165 - Losses
   1. § 165(a): May deduct any loss sustained during the taxable year *not otherwise compensated for*.
   2. § 165(c): Losses will be limited to those incurred in a ***trade or business***, incurred in a ***transaction entered into for profit***, or incurred by ***fire, storm, shipwreck, or other casualty, or from theft***.
      1. § 1.165-7(a)(1): Casualty loss deductible whether incident to a trade or business or not
      2. § 1.165-7(a)(2): Valuing loss to be done by FMV before and after, and this can be evidenced by the ***cost of repairs***, as long as it does not put the property in substantially better shape than before the casualty.
      3. § 1.165-7(a)(3): Can deduct car accident casualty costs not reimbursed by insurance, as long as it was not due to gross negligence or intent of the taxpayer
      4. § 1.165-7(b)(1): Amount deductible is ***either*** the FMV difference (noted above), or the adjusted basis in the property
      5. § 1.165-7(b)(3)(Ex.1): To calculate loss:
         1. Value of Property Before
         2. ***Less***: Value of Property After
         3. ***Take the lesser of***: Result from above and Adjusted Basis
         4. ***Less***: Reimbursement from insurance or other source
         5. ***Result***: Deduction allowable (to the extent it exceeds 10% of income)
      6. § 1.165-8(a):
         1. Theft Losses taken into account in the ***year of discovery***.
   3. § 165(h)(2)(A): Casualty losses limited to that which ***exceeds 10% of income***. [10% floor]
      1. Can offset *causalty gains* fully, though
2. § 267
   1. § 267(a)(1): No losses shall be deductible on transfer to a related party
   2. § 267(b): Qualifying related parties –
      1. Family members from (c)(4)
      2. Corporation/partnerships/individuals/etc. and other corps./partnerships/individuals if they are controlled by the same person (50%+ share ownership)
   3. § 267(c): Ownership can be considered existing if done so by or for his family
      1. (c)(4) – qualifying family relationships are brothers, sisters, spouse, ancestors, and any lineal relationship.
         1. Notice: brother-in-law doesn’t count
   4. § 267(d): Loss will not be recognized on transfer, but if there is later gain, then the disallowed loss can be added to the basis again. (Essentially a carryover basis for gain)
3. § 166
   1. § 166(a): wholly or partially worthless debts are deductible
   2. § 166(b): Basis for determining the deduction shall be the face value of the debt, or otherwise should be determined via 1011.
   3. § 166(c): ***Nonbusiness*** debt deductible only as a capital loss
      1. § 1.166-1(c): Requires ***bona fide debt***, regardless of business or personal
         1. Unenforceable gambling debts would be considered eligible for deduction
      2. § 1.166-1(d)(1): Basis for determining deduction would be the same adjusted basis as used for purposes of determining gain/loss from sale
      3. § 1.166-1(e): Prior inclusion in income required
         1. Easy for obvious loans (previously included), but more difficult for things like receivables (need to show that they were previously included)
4. § 1091
   1. § 1091(a): No loss for stock sold and then reacquired (or a contract to reacquire is purchased) within 30 days.
   2. § 1091(d): Basis in the stock after acquisition will be the old basis, plus any incremental costs associated with the reacquisition of the stock.
5. § 121
   1. Gain excluded on the sale of principal residence up to $250,000 per person, up to $500,000 for joint returns if both spouses meet the use requirement
   2. Need to use as principal residence for 2 years out of the 5 preceding the sale
      1. Some exceptions if move b/c of work or health (then take proportion stayed in the residence compared to two years, and multiply that fraction by the appropriate exclusion)
6. § 1031
   1. § 1031(a): No gain or loss recognized on transfer of **like-kind** property, when both the property transferred and the property received are used in the taxpayer’s trade or business.
      1. Does not apply to stock, bonds, etc.
      2. 180-day time limit
      3. § 1.1031(a)-1(a)(1): No gain or loss when pure like-kind transfer
      4. § 1.1031(a)-1(a)(2): Non-recognition does not apply to additional property or money transferred in an otherwise like-kind exchange
      5. § 1.1031(a)-1(b): Definition of like-kind
         1. Must be held for ***productive use***, not just investment
         2. Refers to kind or class, not grade or quality
      6. § 1.1031(a)-1(c): 30-year lease in exchange for property is like-kind
         1. As is truck for truck, even if there is a boot
   2. § 1031(b): Gain from exchanges not solely in kind ***will be recognized*** to the extent of its fair market value – ***limited to the extent of gain***.
      1. Will use FMV because presume that this was the “boot”
      2. § 1.1031(b)-1(b): Pay tax on only the non-like-kind property, to the extent it exceeds the old basis in the property when combined with the property received
   3. § 1031(c): Loss from exchanges not solely in kind ***will not be recognized*** for the receiver of the additional items.
   4. § 1031(d): Basis adjustments
      1. Basis = Old Basis – Recognized Loss + Recognized Gain – Money Received
      2. § 1.1031(d)-1(a): Use old basis, if additional consideration was *given*, then *increase* the basis by that amount
      3. § 1.1031(d)-1(b): Use old basis, if additional consideration was *received*, then *decrease* the basis by that amount, but also *increase* the basis by any gain recognized
         1. Example: if basis would be $2,500, receive $2,400 worth of property and $200 boot, then you decrease the basis by $200, but then add $100 to basis for the gain recognized.
7. In General
   1. Losses deductible if attributable to a trade or business
      1. Also deductible if attributable to a profit-seeking activity, although it may be subject to restrictions.
      2. Personal losses are typically ***not*** deductible, except casualty and theft losses
   2. When deductions are limited, split into three categories:
      1. Considered personal
         1. Ex. limiting gambling losses and hobby losses to the gains in those areas
      2. Related to unrealized gains (no **market risk** assumed)
         1. Ex. wash sales in § 1091 and sales to related parties in § 267
      3. Tax shelter losses
   3. Concepts
      1. **When** does a loss occur?
         1. Example of sales to related parties, then there is no actual economic loss under the concept of single economic unit
         2. Loss only when ***there is no possibility of recoupment***.
         3. Can occur even without traditional “realization event”
            1. 165(g) for a deduction when certain securities become worthless
            2. A casualty is treated as a realization event
         4. Never a deduction for the loss of anticipated income
      2. **Amount** of loss deduction?
         1. Adjusted basis in the property, not its fair market value
         2. Must account for any insurance or other compensation received
      3. **What kind** of loss?
         1. Trade or business losses typically deductible above the line.
         2. Profit-seeking activity losses typically deductible below the line
            1. Means they will only be taken if they exceed the standard deduction
            2. Exception: if they result from the sale or exchange of property, or are attributable to property that produces rent or royalties
8. Profit-Seeking v. Personal
   1. In General
      1. Personal losses will be nondeductible unless from casualty or theft
         1. Corresponds to § 262 disallowing personal expense deduction
   2. Residential Property
      1. If primarily for residence, any loss will be nondeductible
         1. If converted to rental use, should be deductible to the extent of the remaining basis, which should be based on the FMV, calculated at the time of conversion
      2. If divided use, then proper allocation of basis between personal and business use property should be made, and loss deductions will be based off of that
         1. Division will be made, and any depreciation taken will only subtract from the business portion of the basis.
   3. Gambling Losses
      1. Presumption of some degree of consumption involved
      2. Allow offsetting of gambling winnings
         1. But no carrying forward of losses
         2. Winnings can include anything *arising out of* a gambling transaction (meaning comps, free drinks, etc. provided)
      3. Issue: proving loss
         1. Typically would need better evidence than just losing racetrack tickets
      4. While a professional gambler may deduct expenses, still cannot deduct gambling losses
9. Casualty Losses – p. 384
   1. Based on ***ability to pay*** considerations
      1. High floor indicates that the loss will be *beyond the taxpayer’s control*.
      2. 10% floor ensures only large and uninsured losses will be accounted for
      3. Comparable to medical expense deduction, which has a 7.5% floor
   2. Applies to sudden, unexpected losses not due to deliberate or willful actions
      1. ***Sudden*** requirement:
         1. Termite damage typically nondeductible
         2. If advance warning, no deduction (squirrels are destructive)
         3. Compare diamond falls due to car door slamming (deductible) as compared to diamond being flushed down the toilet accidentally (nondeductible)
      2. ***Physical Damage*** requirement
         1. Means **market** **fluctuations** will be insufficient
      3. Why such a high bar?
         1. Allowing for anything else would be ***equivalent to allowing depreciation*** for personal goods.
   3. Amount of Loss
      1. Limited to the ***lesser of***:
         1. Fair market value before *minus* Fair market value after

or

* + - 1. Adjusted basis in the property
    1. Logic behind #1 (use if prop. decl. in value): Any decline in FMV would be attributable to consumption, so use #1 to get at what the remaining value was
    2. Logic behind #2 (use if prop. incr. in value): Any increase in FMV would have been untaxed appreciation, so limit the deduction to adj. basis (likely to be original cost)
  1. **Theft** Losses
     1. Deductible in year of discovery
     2. Must prove illegality
        1. Ex. forged signature on painting, must proved there was a knowing and intentional act by the seller
  2. Other forms of casualty exceptions
     1. Allowed to exclude reimbursements for living expenses from insurance when home is destroyed by fire or other casualty
     2. Allowed to deduct if casualty ***results from negligence***, but **no deduction** will be allowed for casualty resulting from ***gross negligence or intentionality***.
        1. *Blackman v. Comm’r*
  3. Insurance concern
     1. A disincentive for insurance?
        1. Since insurance reimbursements offset any casualty loss, may make people less inclined to buy insurance.
     2. However, 10% floor and the idea that it is *deductible*, and not a reimbursement makes this argument weak; would rather have the full amount rather than some fraction

1. § 1031 & 1091
   1. General Concept: no loss permitted unless there is a bona fide sale
   2. § 1031
      1. Prohibits sale b/w family members or corporations and their majority SHs
   3. § 1091
      1. Notice that the wash sale will only apply ***to stock or “substantially identical”*** properties. For example, *Cottage Savings* says that bonds will not be considered substantially identical if they are from different issuers.
2. Non-recognition Provisions
   1. Tax deferral
      1. Through like-kind exchanges and other non-recognition provisions, there is a huge incentive to defer taxes by undertaking these transactions rather than through sale
      2. Defer until taxpayer dies, then basis gets stepped up and everyone wins
   2. Like-kind Exchange
      1. Basis of property given up becomes basis of the property received
         1. If there is a ***boot***, then taxes will be paid on that. Any gain recognized will be added to the basis, but any money received will be subtracted from that basis.
      2. “Like-kind” refers to the nature, not the grade or quality
         1. Can trade real property for real property (even if one is improved & other isn’t)
         2. Can trade copyright to a book for a copyright to a book
            1. But cannot trade copyright to a book for copyright to a song
         3. Can trade printer for a computer
            1. Cannot trade heavy-duty truck for a passenger car (maybe)
         4. Personal property with more restricted idea of like-kind than real property
            1. Livestock of different sexes not like kind because of the typical intended use of each
      3. Incentive to structure deals as like-kind exchanges
         1. Ex. have purchaser with cash buy a property you want and then swap
         2. BUT, IRS typically will look to see if there was the ***requisite intent to enter into a like-kind exchange***, but it has been more liberal recently in allowing three-party exchanges
            1. See p. 638, Rev. Rul. 77-297 (saying an agreement to buy with the caveat that there be an exchange if a suitable property may be found was sufficient for 1031 purposes).
         3. Property for 30-year lease typically considered to be like-kind
            1. Exception: sale-leasebacks with boot
      4. General Requirements
         1. Must be **in kind**, cannot simply assign contract rights and exchange cash to be used in purchasing the property
            1. Intent does not matter in this scenario
         2. Must be made **within 180 days**
            1. This is to prevent long-term options being used to defer taxes on a sale
         3. Upon receipt of like-kind property, must have the **intent** to continue to use in a trade or business. Ex: receive ranch and then gift later vs. receive houses and intended as gift
      5. Rationale
         1. Can’t be concerned over no cash being transferred, because non like-kind property exchanges are taxed
         2. Can’t be concerned about valuation, because in any case where there is a boot, there must be some valuation going on
         3. Claim: change in form, not in substance of the investment
            1. Makes sense w/ restrictions on some personal property, but doesn’t make sense when you think about a farm being exchanged for an apartment building.
            2. Also flawed in that inequity with the person who sells for cash and shortly thereafter reinvests.
   3. § 121 and the Principal Residence exclusion
      1. Can exclude $250k, or $500k for MFJ, of gain in sale of primary residence if you have lived there for 2 of the previous 5 years
         1. If health, employment, or other unforeseen circumstances necessitate a move in less than 2 years, then can exclude a proportionate amount.
      2. Can only have one principal residence
      3. Gains attributable to periods of nonqualified use are not eligible for exclusion, unless it happens *after* the taxpayer has used the property as a principal residence.

***UNIT XIV – Characterizing Gains***

1. General Capital Gains Rates
   1. 0% - for Assets held for more than one year, if the taxpayer is in the 10% or 15% bracket
   2. 10% -
      1. Will only ever apply if in the 10% bracket, and will apply in the following circumstances:
         1. Assets held for one year or less
         2. Gain to the extent of depreciation on real estate if held for more than 1 year (1250 property)
         3. Gain on collectibles
         4. Gain on small business stock after 50% exclusion
   3. 15% -
      1. Generally, this is the rate applicable to capital assets held for a period of 25 years or more, as long as the taxpayer is taxed at a 25% or higher rate
      2. May also be applicable if the taxpayer is in the 15% tax bracket, and the following circumstances arise:
         1. Assets held for one year or less
         2. Gain to the extent of depreciation on real estate if held for more than 1 year (1250 property)
         3. Gain on collectibles
         4. Gain on small business stock after 50% exclusion
   4. 25% -
      1. Will apply for:
         1. To the extent of depreciation on real estate held for more than one year
         2. If otherwise taxed at a 25% rate, will apply to:
            1. Gain on small business stock after 50% exclusion
            2. Gain on collectibles
   5. 28% -
      1. Applies in instances where the taxpayer is in a 28% or higher bracket
         1. To collectibles
         2. To small business stock after the 50% exclusion
   6. $3000
      1. For individuals only: up to $3000 worth of capital losses may be used to offset ordinary income. Any disallowed losses may be carried forward.
2. § 1(h)
   1. § 1(h)(1)(A): Tax rate will not exceed your ordinary tax rate
   2. Rest of § 1(h) essentially lays out the above rate schedule
3. § 1221
   1. § 1221(a): Capital asset means everything *except*:
      1. 1221(a)(1) – inventory, must be primarily for sale to consumers in the ordinary course of business
      2. 1221(a)(2) – property used in a trade or business which is subject to depreciation
      3. 1221(a)(3) – copyright, literary or artistic works, letter or memoranda, etc. that was prepared by or for the taxpayer
         1. Excludes any of these things if purchased by the taxpayer
      4. 1221(a)(4) – accounts or notes receivable acquired in the ordinary course of business
      5. 1221(a)(5) – publication of government received other than by purchase
         1. Prevent Congressmen from getting huge tax benefit w/ donation
      6. 1221(a)(6) – any commodities derivative financial instrument held by a commodities dealer
      7. 1221(a)(7) – any hedging transaction; must involve 1221(a)(1) or 1221(a)(8) property
         1. § 1.1221-2(a)(1): Term capital asset does not include property that is part of a hedging transaction as described in (b), below
         2. § 1.1221-2(b): Hedging transactions means a transaction entered into to manage price fluctuations with regard to inventory and costs
         3. § 1.1221-2(c)(2): Ordinary property to a taxpayer only if its sale could not produce capital gain under any circumstances
         4. § 1.1221-2(c)(3)(i): Aggregate risk against which a hedge is placed must be in regard to the risk with regard to the particular inventory or cost.
            1. Ex. would have capital gain if you hedged against interest rate increases, even if that in turn allowed you to ensure ability to purchase something (?)
         5. § 1.1221-2(d)(1)(i): Transaction entered into to reduce the taxpayer’s risk must actually reduce that risk.
         6. § 1.1221-2(d)(1)(ii)(A): Can hedge a small part of the enterprise; need not hedge everything, as long as it can be shown that a certain hedge protect against risk to a certain asset.
         7. § 1.1221-2(f)(1): Taxpayer must identify a hedge as such on the same day it enters into it.
            1. This way it doesn’t know if it’s a winner or a loser yet.
         8. § 1.1221-2(g)(1)(i): If you say it is a hedge, then that is binding and any gains will definitely be taxed as ordinary income. However, if there is a loss, you may still be subject to scrutiny and still must comply with the requirements set forth above.
         9. § 1.1221-2(g)(2)(iii): **Anti-abuse rule** – even if you don’t elect to call this a hedging transaction, the IRS reserves the right to label it as such and tax it as ordinary income if there was no reasonable grounds for not labeling it a hedge
      8. 1221(a)(8) – supplies used by the taxpayer in the ordinary course of business
         1. E.g., reselling jet fuel, etc.
   2. § 1221(b):
      1. § 1221(b)(3) – no ordinary income re: musical works from 1221(a)(3)
   3. *Malat* – rental business selling off land when it doesn’t work out
      1. First determine **primary purpose of the business**, then you can figure out what will qualify as ordinary or capital (e.g., inventory or not)
   4. *Arkansas Best* – stocks will never count as ordinary income
      1. Intent of the taxpayer will not matter in this regard
4. § 1222
   1. Defines capital gains; each involve a “Sale” or “Exchange”
   2. Short term capital gains: held for not more than 1 year
   3. Long term capital gains: held for more than 1 year
   4. Net short terms capital gains, then net long term capital gains, then net them against each other for net capital gains.
5. § 1223
   1. Holding Period provisions
      1. Holding period includes the time before a 1091 wash sale took place
      2. If you get property from a dead person, no matter how short of a time you wait before you sell, it will be regarded as being for more than one year.
6. § 1211
   1. § 1211(a): Capital losses limited to gains for corporations
   2. § 1211(b): Capital losses limited to gains, plus $3000 of ordinary income for individuals
7. § 1212
   1. § 1212(b): Allows for carryover of disallowed capital gains losses
8. § 1231
   1. § 1231(a): General rule – when 1231 property gains exceed losses, ***capital gains applies***, but when losses exceed gains, then it is considered an ***ordinary loss***.
9. § 1245
   1. § 1245(a)(1): Must treat as ordinary income the amount by which either the sale price or the recomputed basis exceeds the adjusted basis
   2. § 1245(a)(2): Recomputed basis means the adjusted basis plus any depreciation or other deductions taken
   3. § 1245(a)(3): 1245 Property
      1. Must be personal property
      2. Cannot be real property
      3. Must be depreciable
10. § 170(e)
    1. § 170(e)(1): amount of any charitable deduction shall be reduced by any unrealized non-long term capital gains
       1. 170(e)(1)(B): And in the case of tangible personal property, if the property donated is not related to the function of the charity or if it is sold within one year, then it will also be reduced by the unrealized long term capital gains as well.
          1. If sold within 3 years, the taxpayer must recognize income in the year of sale amounting to the additional deduction allowed for the unrealized long term capital gains.
11. Policy Notes
    1. 24% of taxable capital gains accrued by those with an AGI of $10 million and up
    2. One thing people claim it ameliorates is ***bunching***, because by taxing outside of ordinary income, it prevents the sudden realization of large amounts of income from being subject to higher progressive rates, and pushing her normal income into a higher bracket.
       1. Bad claims:
          1. Just inflation adjustment – bad arg. b/c we still tax the extra salary give as a raise, even if it is just a COLA adjustment
          2. Just interest rate changing – bad arg. b/c while it is true that has an impact, then this would mean that there was income in the form of interest. Clear benefit.
          3. Lock-in concerns – the only solution would be to never tax the gains (which would be inappropriate for an income tax), or to tax them as they accrue (can’t do this)
12. Capital Gains, Generally
    1. Two Benefits
       1. Defer taxes on gains
          1. Because, using stocks as an example, “interest” will accrue to the stock value, rather than pay out in the form of coupons or dividends
       2. Taxed at a favorable rate
    2. In General
       1. Requires three things:
          1. “Property” that is a “capital asset”
          2. Must be transferred in a “sale or exchange”
          3. The minimum holding period must be met
    3. Capital Asset
       1. **Everything**, except:
          1. Inventory held primarily for sale to consumers
             1. *Malat* says primarily must mean that the top priority w/ regard to the goods is to sell to consumers

Means: sale of rental property will be subject to taxation at ordinary income levels where that is in the ordinary course of business. Dual purpose not a problem for lower courts.

* + - 1. Depreciable property used in a trade or business
      2. Copyright, letters, etc. held by its creator (except musical works creators)
      3. Accounts or notes receivable acquired in the ordinary course of business
      4. Gov’t publications received at a below market price
      5. Commodities derivative financial instruments
      6. Identified hedging transactions
      7. Supplies regularly consumed by the taxpayer in the ordinary course of business
  1. Inherent complication
     1. Market adjustments to account for favorable treatment will end up favoring those in higher tax brackets (presuming more investors are needed beyond those), same as gov’t bonds.

1. Mechanics of Capital Gains
   1. Realization event? Yes. G/L of some amount? Yes. Recognized? Yes. Character?
   2. First ask: was this a sale or exchange?
      1. If not, no capital gains per § 1222.
      2. If yes, go on.
   3. ***Start w/ § 1245***
      1. Applies only to tangible, personal property used in a trade or business
         1. If there is a ***gain on the sale or exchange***, then it will be considered ordinary to the extent of depreciation taken/allowed.
      2. Rationale: depreciation allowed was greater than economic loss occurring, so the taxpayer must account for the costs already claimed as deductions.
         1. Otherwise there would be a CONVERSION of some income from ordinary to capital
   4. ***If § 1245 does not apply***, or if there is a *residual gain* beyond the depreciation amount, the next question to ask is:
      1. Is this a capital asset?
         1. Stock is *always* a capital asset (unless securities dealer)
            1. *Arkansas Best* essentially lays this out definitively; *Corn Products* to be read as essentially an OK to the hedging provision that comes later
         2. Look to § 1221; it will be a capital asset unless it falls under one of the eight categories
            1. If it does not fit in any of the exceptions 🡪 capital asset which can be netted as laid out in § 1222.
            2. If it falls under any of the exceptions aside from 1221(a)(2), then it will be subject to taxation at ordinary income levels.

1221(a)(3) subject of litigation, but then they added the “letter or memoranda” and kept the “similar property” aspect, which would likely be broadly interpreted.

Again, a reminder that musicians are special…

* + - * 1. If it falls under 1221(a)(2), then you need to look to § 1231

§ 1231 and the Hotchpots

***Hotchpot #1 / Firepot***, two categories go in here:

Gain/loss on casualty from 1221(a)(2) property held for more than one year

Gain from casualty if you get more from insurance than you had as adjusted basis.

Gain/loss on casualty from any other capital asset used in a trade or business, held for more than one year.

Physical bearer bond that burns up may qualify for this.

**NET** these two:

If loss, take an ordinary loss for this amount

If gain, take the amount and put it in Hotchpot #2

***Hotchpot #2***, three categories go in here

Any gain from Hotchpot #1

Do not bring over losses

Gain/loss from the sale or exchange of 1221(a)(2) [trade or business] property held for a year or more

Gain/loss from the condemnation of 1221(a)(2) property or any capital asset held for use in a trade or business or held for investment

Must be held for one year or more prior

This would normally ***not*** be a capital asset because a condemnation is not a “sale or exchange”

**NET** these out:

If loss, you get an ordinary loss in that amount

If gain, you get to take capital gains

BUT NOTE: Keep the gains and losses separate, need to do ***1250 stuff***.

* + - * 1. Finally, check for § 1250 Property

If there is a gain from the hotchpot, must offset the gain attributable to the property by up to the amount of depreciation taken.

1. Capital Gains, Other
   1. “***Substitute for Ordinary Income***” Doctrine
      1. Arises in cases like *Hort* and another called *P.G. Lake*, where there is a concern that pre-paid expenses will be treated like capital assets when they clearly should **not** be, based on their nature.
         1. As such, *will treat such expenses as ordinary*, even w/o express statutory lang.
      2. Tension: all capital assets are the present value of a future cash flow stream
         1. Dealt with in *Lattera*
      3. How to determine?
         1. Some courts look for “underlying investment” (*Maginnis*), but this is a test of limited applicability, so might be better to go with…
         2. **Family resemblance test** (*Lattera*)
         3. Says it is a three-step process:
            1. **Step One**: does this look like a trad. capital asset (stock, bonds, land)?

If yes, then treat as capital.

Or does it look like a traditional income item (rent, interest)?

If yes, then tread as ordinary.

* + - * 1. If unclear/no to both, then move onto **Step Two**

What is the *nature of the sale*?

Was it a horizontal carve-out (selling a portion of time or right to an asset for a limited time)?

If yes, then typically ordinary income.

Was it a vertical carve-out (permanent disposition of interest in the property)?

If yes, then go on to…

* + - * 1. **Step Three**: what is the character of the asset?

Right to earned income?

Ordinary. If pre-existing right, then any money received is just essentially interest.

Right to *earn* income

Capital. If not a pre-existing right, than risk will mean market fluctuations which should be subj. to capital gains treatment.

* 1. Holding Period – p. 635
     1. Must be ***more than one year***. *Caspe* says exactly one year does not count.
     2. Day of purchase is **excluded**, but the day of sale is **included**.
        1. Example: July 1st sale, will be deemed to have held for more than 6 months if acquired the property on Dec. 31st.
     3. No holding period for inherited property (§ 1223(11))

1. The Charity Bombshell
   1. Gifts of Appreciated Property
      1. If real property or stock, then any ***unrecognized long term capital gain will not be subject to tax***, and a deduction for the full amount of the FMV will be allowed - § 170(e)(1)(A)
      2. If personal tangible property, the same rule applies as long as:
         1. It is related to the purpose or function of the charity - § 170(e)(1)(B)(i)(I)
         2. It is not sold within three years. - § 170(e)(1)(B)(i)(II)
            1. If it is sold within the first year, the taxpayer must ***reduce the charitable deduction*** by the sum of the unrealized long term capital gains as well, effectively making the ***deductible amount equal to the donor’s basis***.
            2. If sold in years 2 or 3, then the donor must report as income an amount equal to the deduction taken minus the adjusted basis at the time.
         3. Notice: 1245 property will need to reduce the FMV by the amount of depreciation taken
      3. Abuse
         1. Problem 1: Turning hobbies into charitable deductions
            1. Result – IRS says game trophy donations limited to the lower of basis or FMV, with basis being only the taxidermy costs
         2. Problem 2: Clothes donations
            1. Result – Congress said clothes must be in good condition, low-value items exempt from being deductible. ***Problem***: unenforceable.

***UNIT XV – Tax Timing***

1. § 446
   1. § 446(a): Taxable income to be computed based on the way the taxpayer keeps his books
   2. § 446(b): If no accounting method regularly used, or another method is used which does not clearly reflect income, the Commissioner may adjust to go with the one that ***clearly reflects income***.
      1. Commissioner will get high level of deference (per *Thor Power Tool*)
   3. § 446(c): Permissible methods of accounting
      1. § 446(c)(1): Cash receipts & disbursement method
      2. § 446(c)(2): Accrual method
      3. § 446(c)(3): Any other method permitted by this chapter
      4. § 446(c)(4): Any combination of methods
2. § 451
   1. § 451(a): Income to be treated as part of gross income in the year received unless accounted for otherwise by an allowable accounting method
   2. § 1.451-1(a):
      1. Gains to be included when actually or constructively received (under cash method)
      2. For accrual method, gains and deductions are to be taken in the year in which they are fixed (with reasonable certainty)
   3. § 1.451-2: Constructive Receipt of Income
      1. “credit to his account, set apart for him, or otherwise made available such that he may draw upon it at any time”
      2. Key feature: look to whether or not it was within the volition of the taxpayer to remove
   4. § 1.461-1(a)(1): Cash basis
   5. § 1.461-1(a)(1): Accrual method
      1. Interesting note: when ***uncertainty as to liability***. When liability or amount owed is contested, accrual method taxpayer should still include the amount that is *not* contested.
   6. § 1.461-4: Economic Performance
      1. Economic performance required for deductions
3. § 461
   1. § 461(a): Any deduction or credit shall be taken in the year proper based on accounting method
   2. § 461(h):
      1. § 461(h)(1): **All events** test is not met until **economic performance** occurs
      2. § 461(h)(2): Time when economic performance occurs -
         1. § 461(h)(2)(A): When services/property is provided to the taxpayer
         2. § 461(h)(2)(B): When services/property is provided by the taxpayer
         3. § 461(h)(2)(C): When payments arising from workers compensation or tort liability are actually made.
         4. § 461(h)(2)(D): Secretary can add more regs on economic performance
      3. § 461(h)(3): Exception for certain recurring items
         1. If the ***all events test is met***, the ***payment is made within 8.5 months*** of the close of the taxable year, the ***payment is recurring***, and it is ***best matched with the income*** from the prior year, then it may be deducted without “economic performance” *per se*.
      4. § 461(h)(4): All events test
         1. Satisfied when all events have occurred such that there is definitely a liability and the amount can be determined with reasonable accuracy.
   3. § 461(i)(1):
      1. No exception for recurring items in the case of a tax shelter
         1. Need economic performance in such a situation
         2. Tax shelter: any partnership or other plan or arrangement with the significant purpose of tax avoidance
4. Cash Method
   1. Income upon receipt, deduction upon payment
   2. Constructive Receipt Doctrine
      1. Generally: a means to limit flexibility of cash method; the “Treasury may subject income to taxation when the only thing preventing its reduction to possession is the volition of the taxpayer” – p. 675, see *Ross v. Comm’r*.
      2. Rule is whether there is “***free and unrestricted control***,” or at least no “***substantial limitations or restrictions***”
         1. See *Carter v. Comm’r* saying that man’s salary, despite being owed, was not constructively received because he had clearly tried to get it, but was denied. Obvious lack of control means no receipt.
         2. Other cases: *Hornung* wins a car, but the people giving the prize don’t hand it over until the next year, and they actually did not even have it purchased or set aside at the time they awarded it to him. No constructive receipt.
            1. But see *Fetzer* where Controlling SH can establish constructive receipt if there was money in the corporation and he had the authority to write checks.
      3. Note: in *Comm’r v. Mott*, established that you are not taxable on income you could have received (trustee did not take the 3% he was entitled to, so even though it was there the whole time, there was no constructive receipt).
   3. Receipt of Cash Equivalent or Economic Benefit
      1. Courts are uniform in saying that cash equivalent is taxable upon receipt, but they are ***not uniform*** in saying what constitutes a cash equivalent.
         1. E.g., most say yes to checks, but receiving other rights is unclear, such as an instrument that is only negotiable at a substantial discount.
      2. Note: requires **actual receipt** of a property or a right to receive property
         1. ***General test***: Does the property received convey a present – and often marketable – benefit? **NEGOTIABILITY TEST** (*Cowden* – p. 683/4)
      3. *Keep in mind*: General idea behind cash basis taxpayer is that they only recognize gain or loss upon receipt or payment, respectively. So cash equivalent ***gets close to the line****.*
   4. Checks
      1. *Lavery* – obvious case: if you can deposit it in Yr. 1, you cannot claim that just because you actually deposited it in Yr. 2, you only had income then
      2. *Bright* – funds did not clear until the New Year, but the Court says he could have had the funds sooner if he had opened a new account with the drawee bank
         1. Compare *Baxter*, where the court said that option to get the check on a Saturday (Dec. 30th), when the banks wouldn’t be open until the 2nd does not constitute constructive receipt.
      3. **General test**: could the taxpayer have “actually” received the cash?
         1. **BUT SEE**: *Kahler* says even receiving check after-hours on Dec. 31st counts as income in that year because it automatically had an FMV.
         2. **Compare**: IRS says that even if you get a check for the wrong amount, you must *report it as income*, regardless of your intentions on cashing.
            1. Makes an exception for times when cashing the check would prejudice a further claim against the payor; or if you were not entitled. – p. 682

Amounts to a kind of “**actually received**” test.

* + 1. Oddity:
       1. IRS says that if Post Office cannot deliver the mail due to no one available to sign, then the check is still taxable in that year because there was no limitation or restriction on the receipt of payment.
          1. *Davis* holds to the contrary – p. 683
  1. Deductions
     1. Capital Expenditures
        1. Not deductible just because paid in cash (per *Boylston* and CapEx, generally)
        2. *Zaninovich* and the one-year guidepost; Tax Court tries to say no, 7th Cir. shoots them down and says even an accrual basis taxpayer may deduct expenses
           1. Covered in deductions, above
     2. Interest
        1. Prepaid interest is now required to be deducted over the loan period, rather than upon payment in the beginning (essentially everyone is accrual method for interest)

1. Accrual Method
   1. Generally: Income included in the year earned, not the year received. Expenses are to be deducted in the year incurred, not paid. [Most corporate taxpayers, some others]
      1. Three problems arising in the use of this method:
         1. Where there is uncertainty about whether or not an item will be paid/received
         2. Where an amount is received before it is earned
         3. Where an obligation to pay is fixed long before payment is due
   2. The “All Events” Test
      1. Statutory definition says that the all events test is met when all events have occurred that establish the **fact of liability**, **as well as the amount** (with reasonable certainty).
      2. Originated in *United States v. Anderson* in 1926, then put in the regulations, and now codified. Essentially when the taxpayer knows the tax it will owe, and it has the same “footing” on “appellee’s books” as other line items, then the tax is due.
         1. See *Spring City Foundry*: you sold the goods and knew how much was due, so at that point there was income. BK petition filed later in the year had no impact, and would be accounted for through other means (e.g., 166)
   3. Amounts Received Before Being Earned
      1. At first: included in income based on the “claim of right” doctrine per *North American Oil* – p. 700
         1. BUT, then some success pushing out the recognition w/ *Beacon Publishing* which allowed a publisher to report the advance subscription fees paid on an annual basis, rather than reporting them all when received.
         2. HOWEVER: 1957/61/63 decisions by SCOTUS say **include** *even if accounting principles suggest deferral*.
            1. This **gives the Commissioner the discretion** to overstate income.
      2. *Westpac*: ***advance trade discounts do not constitute ordinary income***.
         1. Bases the decision on other cases:
            1. *Indianapolis Power & Light* (1991) – security deposits are not income b/c of obligation to repay

Even if conditions req’d in order to get refund, still not income, per *Oak Industries*.

* + - * 1. *Automobile Club of Michigan* (1957) – dues paid to AAA were taxable in the year paid, even if it had benefits into the next year

Because of complete dominion, were not going to be obliged to pay back any of it; and no clear/definite expenditures were going to happen to which the funds were earmarked.

* + - * 1. *Schlude* (1963) – amounts paid to dance studio are income when received, not when the lessons are provided

Again, complete dominion; not refundable and they would keep it even if the student did not show up.

* + - 1. Says that **cash advance trade discounts** are like the security deposits in *Indianapolis*, and since they are subject to restrictions and may be paid back, then there is no single “accession to wealth”
         1. Therefore, the *pro rata* approach of Westpac is correct
         2. Compare *Prime & Fancy Food*, where loan with forgiven payments was not able to be (or they did not) distribute it out pro rata
    1. *Milenbach*: may be a bit more of a stretch, but a cash loan only to be paid from luxury box proceeds from non-existent stadium in L.A. was not income ***because it was a genuine obligation***.
       1. In the same vein: *Tampa Bay Devil Rays* said that no need to report income received in exchange for season tickets, even though it was unclear whether or not they would ever get a team.
       2. *Artnell*: can delay income and report in a future year, even when there is no possibility of giving the money back, if the distribution of income can be accurately predicted (White Sox case, saying each game is set, they know the value)
  1. Expenses
     1. Generally: incentive to incur sooner, and then push actual payment far into the future
     2. *Ford Motor Co.* – Trying to claim full tort settlement in year of settlement, even though paid over a period of time through an annuity costing about 1/6th the amount.
        1. Tax Court adopts a “modified cash basis” allowing the cost of the annuity to be deducted, and then its returns exempted from tax
           1. Cash basis would have been to allow not deduction for the annuity, tax the returns appropriately, and then give a deduction in the years paid.
        2. A victory on ***time value of money grounds***
           1. Rather extreme case required (compare *Hughes* where they allowed a deduction for the progressive jackpot amount)
     3. Result: ***§461(h) disallows deductions until “economic performance” occurs***.
        1. Exception for recurring items: means to resolve the issue of sales made in one year and then costs associated with the sale being in another year. These recurring items are then more appropriately considered in connection with the income producing activity which incurred the costs.
        2. Only applies to the provision of services or property, or liability arising from tort.

1. § 163
   1. § 163(a): Generally, all interest payments are deductible
   2. § 163(d)(1): Investment interest deductions is limited to investment income
   3. § 163(d)(2): Investment interest deductions may be carried forward
   4. § 163(d)(3): Investment interest means interest paid by reason of loan for investment purposes
      1. Does not include qualified residence income or passive gain income
   5. § 163(d)(4): Net investment income means investment income over investment expenses
   6. § 163(e): Original Issue Discount Bonds
      1. Deduction for interest available in the amount of the original issue discount, to be divided into amounts accrued per day, and then can take deduction for the aggregate of those daily portions which occurred in the taxable year.
      2. § 163(e)(2)(C): Short term obligations (less than one year are deductible only upon payment)
   7. § 163(h):
2. Interest
   1. Business interest
      1. Generally deductible without limit (unless needs to be capitalized)
   2. Investment interest
      1. Deductions limited to net investment income
      2. But, allowed to be carried over without limit
         1. ***Note***: interest not usually subject to being carried over, so this could be a benefit to those with interest expenses that would have otherwise been lost.
   3. When does the distinction matter?
      1. Securities – if you can classify a debt used to purchase a security as business interest, then you will be able to deduct that interest, and then pay capital gains rates on the gain
         1. Would be inequitable with the person who financed with cash (no benefits for the deduction)
   4. Personal Interest
      1. Nondeductible
         1. Example: In case of divorce, interest paid on a mortgage owed to the other spouse will not qualify for 1041 because it is separate
            1. But if the amount of later payment was not fixed, then the whole amount would have been not taxed as a 1041 transfer
      2. Exception: “qualified residence interest”
         1. § 163(h) – up to $1 million worth of debt, reduced over time as principal is repaid to avoid double dipping/continuously keeping a deduction
         2. Also, treats mortgage insurance premiums **as deductible interest**, as long as the AGI does not exceed $110
         3. Why is this ***a big deal***?
            1. Can turn personal indebtedness into qualified residence indebtedness via second mortgage or refinancing
3. Sham Transactions
   1. Three Doctrines
      1. Sham Transaction Doctrine
         1. *Knetsch* analysis: when the result does “not appreciably affect his beneficial interest except to reduce his tax,” this is a sham transaction.
            1. I.e., if there is only a tax reason behind a decision, it will not be deductible. Also important was that the ***underlying transaction never happened***, and it never would have meant anything if it did.
         2. *Goldstein*: says that this logic extends to any transaction without economic purpose other than tax benefits.
            1. Lottery winner uses proceeds to prepay interest; disallowed.
      2. “Economic Substance” Doctrine
         1. *Lifschultz* – No need to evaluate whether or not the transactions were “genuine” in any sense. Because there was **no opportunity** for economic profit from the transactions entered into, then the deductions would be disallowed.
      3. Invalidity of Loan
         1. *Estate of Franklin* – Loan determined to be not a loan, so then interest payments would be nondeductible
4. Loan Interest and Income
   1. Original Issue Discount, General Rules
      1. Account for interest income over time, typically every six months
      2. Use the imputed interest (as though it were accruing), and tax on that
      3. Interest is claimed in the year accrued, and can be expensed if allowed that year as well
   2. OID Rules and Property
      1. If selling appreciated property, will create an OID bond
         1. How?
            1. Calculate PV with adequately stated interest (Applicable Federal Rate)
            2. If Issue Price is equal to or Less than that amount, it’s OK!

In other words, if PV is ≥ issue price, then all good

* + - * 1. Then, accrue interest on the bond as per other OID rules

Gains up to the issue price will be realized upon OID issue

* + - 1. Does not apply to principal resident, debt instruments of publicly traded properties, sale of patent, or sale of a farm ≤$1m
  1. Low-Interest Loans
     1. 7872 precludes the use of interest-free/low-interest loans ***between employees and employers to avoid employment taxes***, between ***family members to shift income***, between ***SHs and Corporations to disguise dividends***.
     2. **Demand Loan**
        1. Payable on demand
        2. Will treat as if AFR had accrued *semi-annually*, and the amount will be taxable to the **lender** as interest. Employee will have ***additional compensation income*** in that amount, which may be deductible if under §163.
           1. Employer will then be able to **deduct the additional compensation**, so there will be no income tax consequences, although there will be employment tax consequences.
     3. **Gift Loan**
        1. Will treat as if AFR had accrued *semi-annually*, and the amount will be taxable to the **lender** as interest. Recipient will **not have additional income**, since it will be treated as a gift, but gift taxes may apply to the lender. §163 deductions would still be allowed if applicable.
           1. Lender will also not be able to deduct, because it is a gift.
     4. **Term Loan**
        1. Occurs when PV of payments to be received is less than the amount loaned.
           1. Calculate correct amount based on AFR, anything more than that which is loaned is treated as income to the recipient, interest to the lender.
        2. Same results as above, except that it should be noted that all income would be recognized by the recipient in year one, and any deductions would not be recognized until each payment date.
           1. Benefit to the lender, because they get to recognize a payment in the beginning and then only recognize gains in interest over time.

Charitable Contributions

- Only people being incentivized are the rich

- So this means they get to choose distribution of otherwise government fund

Itemized Deductions

- § 62 affect AGI, below do not

- Miscellaneous: unreimbursed employee, tax preparation, income producing expenses (not T/B)

- 2% AGI floor; 3% haircut up to 80% of deductions [3% AGI - $100k], not in effect (§ 68)

- Medical Expenses: 7.5% floor, unreimbursed

- Employee ***compensation***. § 104-106

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NSCL

NLCG

15 – For LCG

Ordinary – For SCG

NSCG

NLCL

15 % if gain

Ordinary if loss (up to $3,000)

Ordinary if gain

Ordinary if loss (up to $3,000)

Ordinary loss up to $3,000