1. **Policy**
   1. **Efficiency**: Avoid changing behavior, or at least change behavior the way intended
   2. **Equity**
      1. Vertical: Those with more pay more
      2. Horizontal: Those with same pay same
   3. Administrative ease, reduce admin costs
2. **Income**, §61
   1. “Accessions to wealth”, *Glenshaw Glass*
   2. **Inclusions** in income
      1. **Compensation for services**, §61(a)(1)
         1. Property or services, FMV, §1.61-2(d)(1)
            1. If property sold for <FMV as comp, comp is FMV minus price
            2. Services valued by the price paid
      2. Business income; sale of property; interest; rent; royalties; dividends; alimony; annuities; life insurance; pensions; discharge of indebtedness
      3. Special rules for **restricted property**, §83
         1. At vesting (not subject to forfeiture), pay taxes on FMV minus amount paid, §83(a)
         2. But may elect to pay taxes at transfer, §83(b), market going up and plan to stay
            1. Get no loss if subsequently forfeit
         3. Employer deducts when included, §83(h)
      4. **Paid obligations**, *Old Colony Trust*
      5. **Illegal gains**, §1.61-14, *James*, *Collins*
         1. But deduct when forfeit, *Stephens*, *Ianiello*
   3. **Exclusions** from income
      1. **Imputed income**
         1. Inequity btwn person who works and pays and who performs service for self
         2. Incentive not to work if after-tax income lower than cost but pre-tax income higher
      2. **Employer contributions to life insurance** up to (but not beyond) $50k, §79(a)
      3. **Life insurance** payouts at death,§101
      4. **Gifts**, §102
         1. Disinterested generosity, *Duberstein*
         2. Employer gifts not excluded, §102(c)
      5. Interest on **state and local bonds**, §103
         1. Greater advantage for higher tax brackets
         2. Lower interest rate for public bonds v. pvt
      6. **Health-related payouts**, §104
         1. Including health insurance, workman’s compensation, and tort recovery
         2. Must be for “personal physical injuries”
      7. **Payouts from employer health ins**., §105
         1. Excluded only for medical care
         2. Otherwise incl. (baffling what would be)
      8. **Employer contributions to health ins**., §106
      9. **Improvements to rented land** constructed by lessee, unless a rent substitute, §109
      10. **Scholarships**, §117
          1. Tuition, fees and books, not housing
          2. Not provided in return for services
      11. **Meals/lodging** furnished by employer, §119
          1. Must be for the convenience of employer
          2. If meals, on the business premises
             1. If majority of employee meals qualify, all meals are excluded, §119(b)(4)
          3. If lodging, on the business premises *and* accepting is a condition of employment
      12. **Fringe benefits**, §132
          1. No-additional-cost fringes, §132(a)(1)
             1. Must be in employer’s and employee’s line of business
          2. Employee discounts, §132(a)(2)
             1. May not exceed gross profit margin for property or 20% of price for services
          3. Working condition fringes, §132(a)(3)
             1. If the employee could have deducted
          4. *De minimis* fringes, §132(a)(4)
             1. So small that accounting impractical
             2. Eating facilities are *de minimis* if on-site and no net cost, §132(e)(2)
          5. Transportationfringes, §132(a)(5)
             1. Transit pass, <$100; parking <$175
3. **Realization and recovery of basis**
   1. **Realization rule**, §1001
      1. No tax on gains in property until disposition
         1. Gain includes lessee improvements, §1019
         2. Sale of a part is a realization event for that part, equitably apportioned, §1.61-6(a)
         3. Sell easement, - basis, no tax, *Inaja Land*
         4. “Material difference” test for realization, easy to find realization, *Cottage Savings*
      2. Income at disposition is the difference between amount received and adjusted basis
         1. AR is cash plus FMV of property received
         2. AB is basis (or purchase price, §1012) plus investments, minus depreciation, §1016
      3. Expected income does not change basis, *Hort*
      4. Cash treasure trove reported if not part of purchase price, expectation test, *Cesarini*
      5. If never realized, cannot deduct later, *Haverly*
      6. Policy in favor of realization rule
         1. Liquidity problems (not true for stocks, large corporations, wealthy individuals)
         2. Appraisal costs
         3. Fluctuation in revenues due to markets
         4. Politically, eliminating it would be difficult
   2. **Annuities,** §72
      1. Treated better than investments w/ interest
      2. Exclude ROC pro rata (life expectancy)
         1. Proper accounting would have total minus interest as return of capital (spreadsheet)
         2. Better than economic income due to time value of money, return of capital earlier
      3. Deduct the unrecovered investment (not expected return) at death (mortality loss)
      4. If outlive life expectancy, all income from the annuity is taxable thereafter (mortality gain)
   3. **Loans and indebtedness**
      1. No taxation on receipt of a loan, *Collins*
         1. Receive cash, but have obligation to repay
         2. Thus, loans income-neutral, but can have income if obligation to repay discharged
      2. **Discharge of indebtedness** taxed, §61(a)(12)
         1. But no income from discharge of non-enforceable debt, *Zarin* (*Rood* disagrees)
         2. Exclusion from income for bankruptcy or insolvency, §108(a)(1)(A-B)
            1. Insolvent if total liabilities > assets
            2. Not more than total insolvency may be excluded even if more discharged
         3. Purchase price adjustments, §108(e)(5)
            1. If debt of property purchaser to seller reduced, price adjustment, not income

Neither chips nor “opportunity to gamble” count as property, *Zarin*

Only functions when seller and creditor are same, Rev. Rul. 92-99

* + - 1. Other exclusions, §108(a)(1)(C-E)
         1. “Qualified farm indebtedness”
         2. “Qualified real property business indebtedness” (pre-1993 only)
         3. Principal residence indebtedness, foreclosures do not create income

1. **Deductible business expenses**, §162
   1. Above-the-line deduction if paid by employer or paid by employee and reimbursed, §62, but a MID if not reimbursed to employee, §67(b)
   2. Must have legitimate business purpose, *Gotcher*
   3. Must be “ordinary and necessary expenses”
      1. “Normal, usual or customary”, *du Pont*
      2. Not ordinary to pay another’s debt for reputation w/o obligation to do so, *Welch*
      3. Litigation not deductible for accidents not arising from business, *Gilliam*
   4. Explicitly mentioned business expenses
      1. Salaries and other compensation
         1. Must be payment purely for services, test is if comp reasonable, §1.162-7
         2. Any salary is presumed reasonable unless shown that success unrelated to management, *Exacto Spring*
      2. Travel expenses, including meals and lodging while “away from home”
         1. Must be away overnight, *Correll*
         2. And cannot be away for over a year
         3. “Home” means entire metro area containing your place of business
         4. Must have a prior place of business to be away from home, *Hantzis*
      3. Rent and “other payments” for property
      4. Litigation for criminal defense, *Tellier*
      5. Clothing required for work if objectively useless for general/personal uses, *Pevsner*
      6. Business meals, not extravagant, §274(k)
         1. Must be w/ an outsider, *Moss*
         2. Meal/entertain. capped at 50%, §274(n)
   5. Explicitly nondeductible business expenses
      1. Bribes, kickbacks, etc., §162(c)
      2. Lobbying of federal officials, §162(e)
      3. Fines and penalties, §162(f)
      4. 2/3 of treble antitrust damages, §162(g)
      5. Remuneration over $1M of an officer of a publicly held corporation, §162(m)
         1. But not if performance-based comp
         2. Lawyers employment act
      6. No deduction for drug dealers, §280E
   6. Presumption against entertainment, §274(a)
      1. Must affirmatively show business-related
      2. Except meals, compensation, reimbursed expenses, recreation, etc. §274(e)
   7. Substantiation for travel/entertainment, §274(d)
2. **Accounting for costs of producing income**
   1. Only income-producing property, §263A(c)(1)
   2. Three ways to account for costs
      1. Expensing: account for costs immediately
      2. Capitalizing and depreciating: account for costs over a certain, fixed period of time
      3. Capitalizing and not depreciating: account for costs only at disposition; if does not lose value
   3. **Capitalization v. expensing**
      1. Generally, capitalize if lasts more than a year
      2. Capitalize real property acquired, §263
         1. Not incl. salary, §1.263(a)-2(d)(3)(ii)(D), also for intangibles, §1.263(a)-4(e)(4)
         2. If self-constructed, include all, determine portions of salary capitalized, §263A
         3. Includes transaction costs, §1.263(a)-2(d)
         4. *Idaho Power*: Capitalize machinery depreciations into building basis
      3. Improvements v. repairs
         1. Expense repairs/maintenance that do not increase value, §1.162-4, §1.263(a)-3(e)
         2. Capitalize improvements that do increase value (“betterments”), §1.263(a)-3(f)
         3. Maintenance includes substantial extension of lifetime, Rev. Rul. 2001-4
      4. Capitalize intangible assets, §1.263(a)-4
         1. Unless <1 year (e.g., rent), §1.263(a)-4(f)
      5. Capitalize costs of exploring and investigating transactions, §1.263(a)-5, *INDOPCO*
         1. Includes appraisal litigation, *Woodward*
         2. <$5k trans. costs deductible as *de minimis*
      6. Can expense up to $500k worth of real prop. or computer software upon acquisition, §179
         1. Huge subsidy, used to stimulate economy
         2. Phases down to $125k next year
         3. Phases out if>$2M, no expensing if >$2.5M
   4. **Depreciation**
      1. In order for an asset to be depreciable, it must produce income, degrade over time, and have a non-zero §1011 adjusted basis, §167
      2. Salvage value presumed zero, §168(b)(4)
      3. Methods of depreciation, §168(b)
         1. Straight-line depreciation method
            1. Used for nonresidential real property and residential rental property
            2. Depreciate pro rata portion each year
            3. Can elect straight-line depreciation
         2. Double-declining balance method
            1. Used for all other property
            2. Depreciate double proportion each year (40% if 5 yrs, 20% if 10 yrs, etc.)
            3. Switch to straight-line depreciation when straight-line depreciation better
      4. Tangible asset depreciation rules, §168(c)
         1. Residential rental property
            1. 27.5-year recovery period
            2. Mid-month convention
         2. Nonresidential property
            1. 39-year recovery period
            2. Mid-month convention
         3. Other tangible assets
            1. Recovery period varies
            2. Half-year convention
      5. Intangible asset depreciation rules, §197
         1. 15-year recovery period
         2. Whole-month convention
         3. Straight-line depreciation
      6. Note that §1016(a)(2) reduces AB by amount that could be depreciated, even if not taken
3. **Deductible personal expenses**
   1. **Personal expenses** not typically deductible, §262
   2. **Personal exemption**, §151
      1. $2k per spouse, adjusted upward for inflation
      2. Additional $2k exemption per dependent (child or relative, defined in §152)
         1. Child: <19 (or <24 & student); descendant, sibling or descendant of sibling
         2. Relative: Any relative but a cousin, gross income less than exemption and taxpayer provides more than half of support
      3. Reduced for wealthy, though not eliminated
   3. **Standard deduction**, 75-80% use, §63(b)
      1. $3k per spouse, adjusted upward for inflation
      2. $4.4k for head of household
      3. +$600 if blind or >65, $750 if also unmarried
      4. Mutually exclusive w/ itemized deds., §63(e)
   4. **Itemized deductions**, §63(d)
      1. Medical expenses, §213
         1. Any medical expenses of taxpayer, spouse or §152 dependent, incl. care, ambulances and lodging, but not cosmetic surgery
         2. Taken in year of expenses, §1.213-1(a)
         3. Deductible only to the extent >7.5% of AGI, therefore almost never taken
      2. Charitable donations, §170
         1. Donations to any §501(c)(3) nonprofit
         2. Deductible up to 50% of taxable base
         3. Not a charitable contribution if you get something in return, *Hernandez*
         4. Appreciated property, §170(e)(1)
            1. Deduct basis & LTCG, §170(e)(1)(A)
            2. Tangible personal property donations, special treatment, §170(e)(1)(B)

If used for charitable purpose for >3 years, deduct FMV at donation

If sold immediately, deduct AB

If charity sells w/in 3 years, deduct FMV at donation, then taxed on AR minus AB at sale

* + - 1. Depreciated property, only FMV deducted
    1. Alimony payments, §215 (see below)
    2. State and local taxes
    3. Interest payments
    4. Miscellaneous itemized deductions (MIDs)
       1. Note: everything not a MID listed in §67
       2. MIDs ignored if below 2% of AGI
       3. Unreimbursed bus. expenses (see above)
       4. Non-business income production (e.g., costs of acquiring stock), §212(1)
       5. Costs of tax preparation, §212(3)
    5. IDs reduced by 3% of AGI >$100k, §68 (eliminated by Bush tax cuts, chaotic)
  1. **Child care credit**, §21
     1. Nonrefundable credit
     2. Credit for 35% of cost of care at $15k, reduced by 1% per $2k until $43k (or 20%), then flat
     3. Capped at $3k per spouse, §21(c)
     4. Also capped at income of lower-earning spouse, except students w/o income, for whom it is capped at $250 per spouse, §21(d)
  2. **Child tax credit**, §24
     1. Addt’l credit of $1k for any §152 child <17
     2. Partially refundable if income above $10k
     3. Begins to phase out above $75k income
  3. **Earned income tax credit**, §32
     1. Refundable credit
     2. Available to low-income earners, phases out
     3. Increases for taxpayers w/ children

1. **Family Units**
   1. Four **different filing statuses**, §1
      1. **Single**
      2. **Married filing jointly**
         1. Also “surviving spouse” for 2 yrs, §2(a)
      3. **Married filing separately** (worst)
      4. **Head of household**
         1. Unmarried and supporting kids, §2(b)
   2. Marriage penalty and marriage bonus
      1. Advantage for spouses w/ different incomes
      2. Disadvantage for spouses w/ similar incomes
      3. No constitutional issues w/ this, *Druker*
      4. Cannot divorce and remarry, Rev. Rul. 76-255
   3. **Kiddie tax**, unearned income of §152 child taxed as if it was in parent’s top marginal bracket, §1(g)
   4. **Alimony** and **child support**, §71
      1. Alimony must be cash, divorce/separation agreement and not in same household
         1. Deduction for payor, §215
         2. But can elect to exclude and provide no deduction to payor, §71(b)(1)(B)
      2. Child support always excluded, §71(c)
      3. Noncash payments always excluded, §1041
2. **Property transactions cont’d.**
   1. Special basis rules
      1. Gift, donor’s basis, unless experience a loss, in which case basis is FMV at gifting, §1015(a)
         1. If would have gain using FMV at gifting but loss using donor’s basis, no gain or loss
         2. Unless gift from spouse, incl. property settlements, always donor basis, §1041(b)
      2. Inherited property, FMV at receipt, §1014
      3. Marital rts presumptively valued at property for which exchanged, *Farid-es-Sultaneh*
      4. Property swap, basis is FMV of prop. acquired, not property transferred, *Philadelphia Park*
         1. Have to pay taxes on bargain property swaps, get included in your basis
   2. Treatment of **mortgages**
      1. Basic mortgage rules (recourse mortgages)
         1. Mortgage value included in basis as cost
         2. Becomes part of amount realized at disposition if purchaser assumes liability
         3. Transferee of mortgage includes in basis
      2. Nonrecourse mortgages
         1. Foreclosure, entire value of mortgage realized even if FMV < mortgage, *Tufts*
         2. When clearly no intent to pay mortgage, as when mortgage > FMV at acquisition, mortgage not in basis, *Estate of Franklin*
            1. *Pleasant Summit*, nonrecourse debt up to FMV included in basis (3d Cir), reasonable creditor not foreclose if settled for FMV, so FMV genuine
3. **Recognition of gain and loss**
   1. **Gains** generally recognized as a rule
      1. **Property swaps** not recognized, §1031
         1. Must be for production of income
         2. Does not apply to stocks, bonds, etc.
         3. Only swaps of like property, **mandatory**
         4. Basis in new prop, AB in previous property, minus recognized loss, plus recognized gain, minus cash received
            1. If unlike prop received, FMV is that prop’s basis, remainder to like prop
            2. Example!

|  |  |  |  |
| --- | --- | --- | --- |
|  | Given | | Received |
| FMV | $12.5k like prop | | $9k like prop  $2k unlike prop  $1.5k cash |
| Initial AB | | | $10k | |
| Rec’d loss | | | -$0k | |
| Rec’d gain | | | +$2.5k | |
| Cash received | | | -$1.5k | |
| New basis | | | $11k; $2k to unlike (FMV), then $9k to like | |

* 1. **Losses** deductible unless restricted, §165(a)
     1. Only **specified losses**, §165(c)
        1. (1) Trade or business losses
        2. (2) Transactions for profit (stock, e.g.)
        3. (3) Casualty losses (disasters/theft)
           1. Each casualty must be >$100
           2. Only >10% of AGI, §165(h)(2)(A)
           3. Lesser of FMV or AB, but if FMV pre-casualty <AB, then AB, §1.165-7(b)
           4. Car accidents, no-fault, §1.165-7(a)(3)
     2. **Bad debt** loss recognized, §166
        1. Bona fide debt (*Zarin* rule), §1.166-1(c)
        2. Nonbusiness debt treated as STCL, §166(d), scrutinized for gifting, even worse than if ordinary income
     3. **Wash sales** (repurchase in 30 days), §1091
        1. Unrecognized, basis transfers to new stock
        2. Plus additional price paid to reacquire
     4. **Family transactions** unrecognized, §267(a)
        1. Sibling, spouse, linear family, §267(c)(4)
        2. Basis does not carry over

1. **Character of income** (capital or ordinary)
   1. *Lattera*: Ordinary income substitute ordinary, but if entire stream sold can be capital if invest more
   2. Tangible, personal, depreciable prop, §1245
      1. Only when sold at a gain, held >1 year
      2. AR below depreciation, ordinary income
      3. AR above depreciation, capital income
      4. Trumps all other determinations
   3. Other **non-capital assets**, §1221(a)
      1. Inventory, §1221(a)(1)
         1. Must be primarily inventory, *Malat*
      2. Realty or depreciable personalty, §1221(a)(2)
         1. But see §1231 below for hotchpots
      3. Copyrights, art, letters and memoranda created by the taxpayer, §1221(a)(3)
      4. Rights to business income, §1221(a)(4)
      5. FedGov publications, §1221(a)(5)
      6. Inventory stock or other financial instruments held by brokers, §1221(a)(6)
      7. Hedging transactions, §1221(a)(7)
         1. Counts as ordinary loss and gain
         2. Mitigates risk on ordinary property
         3. Normal course of trade or business
         4. Must identify as hedging initially
      8. Supplies for business, §1221(a)(8)
      9. Capital if not explicitly mentioned in §1221(a), intent irrelevant, *Arkansas Best*
   4. **Hotchpots and firepots**, §1231
      1. Hotchpot #1/Firepot
         1. Casualty gain/loss on §1221(a)(2) prop.
         2. Casualty gain/loss on cap. business assets
         3. Losses > gains, ordinary; otherwise #2
      2. Hotchpot #2
         1. Hotchpot #1 if gains > losses
         2. Gain/loss on §1221(a)(2) prop held >1 yr
         3. Condemnation of §1221(a)(2) held >1 yr
         4. Losses > gains, ordinary; otherwise capital
2. **Treatment of capital gains**
   1. Definitions, §1222
      1. Long-term capital gains, held >1 yr
      2. Short-term capital gains, held <1 yr
   2. Determination of net capital gains/losses, §1222
      1. Net long term capital gains with losses
      2. Net short term capital gains with losses
      3. Offset any losses against any gains
      4. Any remaining NLTCGs and NSTCGs taxed
      5. Carry over any remaining losses, §1212, count up to $3k against ordinary income, §1211
   3. Capital gains tax brackets
      1. Long-term capital gains taxed at 15%
         1. Collectibles taxed at 28%
         2. §1250 property taxed at 25% to extent of depreciation (15% beyond depreciation)
      2. Short-term capital gains taxed at 35%
3. **Timing/accounting methods**
   1. **Cash method**
      1. Gain when received, §1.451-1(a)
         1. Active receipt when actually received
         2. Constructive receipt if “credited, set apart, or made available to draw upon”, §1.451-2
            1. Free and unrestricted control, *Carter*
            2. Facts and circumstances test, *Hornung*
            3. Might claim early constructive receipt to reach 5-yr SOL or due to brackets
         3. Checks generally cash, but not if cannot deposit before yr ends, *Baxter*
         4. “Cash equivalence”, account for rts when convertible to cash, Rev. R. 73-173
      2. Loss when paid, §1.461-1(a)(1)
         1. 12-month rule, deduct amounts for which benefit lasts <12 months even if straddles two years, §1.263(a)-4(f)
   2. **Accrual method** (businesses must do this)
      1. Gain when rt to receive fixed, §1.451-1(a)
         1. Prepayments accounted for when received if not refundable but after performance if refundable, *Westpac*
      2. Loss when liability fixed and economic performance has taken place, §461(h)
         1. Special 8.5 month rule for recurring
      3. Must be able to determine amount of gain/loss w/ reasonable accuracy
      4. Take a current deduction for annuities in payment of tort settlements as opposed to accounting for payments over time, *Ford*
   3. Other special rules
      1. Bad debt accounted for at discharge/recovery regardless of accounting method, §1.451-1(a)
      2. Medical deductions taken when “paid”, §213
4. **Interest deductions**
   1. §163(a): Generally, business interest deductible; logic that interest is a cost of producing income
      1. Business interest deductions capped at investment income, §163(d)(1)
      2. Excess carries forward, §163(d)(2)
      3. Choose LTGC rate or interest deduction, §1(h)
      4. No deduction if spent on muni bonds §265
   2. §163(h): Personal interest nondeductible
      1. Home equity deductible to $100k, does not matter what spent on, §163(h)(3)(C)
      2. Loan for education deductible to $2.5k, only for low-income taxpayers, §221

PV = FV / (1+r) ^ t

**Basis rules**

1. **Purchase**: Cost, §1012
2. **Inheritance**: FMV of property acquired, §1014
3. **§1031 swap**: AB – rec’d loss + rec’d gain – cash
4. **Rec’d swap**: FMV of prop acquired, *Philadelphia Park*
   1. For marital rts, still FMV, *Farid-es-Sultaneh*
5. **Incident to divorce**: Transferor’s basis, §1041
6. **Compensation**: FMV of prop acquired, §1.61-2(d)(2)
   1. Discount, comp. included in income plus cost
7. **Gift**: Transferor’s basis, unless loss, then FMV, §1015
8. **Subject to liability**: Cost + liability, *Crane*
   1. Nonrecourse liability > FMV, cost only, *Franklin*

**Amount realized**

1. Cash
2. FMV of property
3. FMV of services
4. Any liability assumed