**Taxation Outline**

Things to hit on EVERY Exam:

* § 61 income for normal jobs, etc. (mention it!)
* Imputed Income
* Constitutionality of Tax
* Charitable Contributions
* Like-kind Exchange
  + Always looks at how preserved gain will be taxed!
* Leveraged Transactions
* Horticultural Reference
  + CGs (when a sale)
    - Don’t forget §§ 1231 (promised land) and 1245/1250 (recapture)
  + Assignment of Income (when a gift)
* Divorce & Alimony
* § 162 vs. § 212
* START-UP EXPENSES § 195

Meaning of Income

None of Congress, through § 61; the Executive, though Reg. § 161-I; or the Constitution, through 16th Amend; tell us what income really means. All we have is the text of § 61 (which defines income with the word income) and judicial interpretation:

**§ 61 – Gross Income Defined:**

1. Gross income means all income from whatever source derived, including (but not limited to):
2. Compensation for services, including fees, commissions, fringe benefits, and similar items; [§ 132]
3. Gross income derived from business; []
4. Gains derived from dealing in property; []
5. Interest; [§ 163]
6. Rents; []
7. Royalties;
8. Dividends;
9. Alimony and separate maintenance payments [§§ 71, 215];
10. Annuities; [§ 72]
11. Income from life insurance and endowment contracts; [§§ 79, 101]
12. Pensions;
13. Income from discharge of indebtedness; [§ 108; see § 1017]
14. Distributive share of partnership gross income;
15. Income in respect of a decedent; and
16. Income from an interest in an estate or trust.
17. Cross Reference: §§ 71-90 give items specifically included in gross income and §§ 101-140 give items specifically excluded from gross income.

**Reg. 161-1 – Gross Income:**

Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whenever in money, property, or services.

* ***NB***: Parrots § 61, noting statutory exclusions and incorporates the *Eisner v. Macomber* realization of gains (though it does not acknowledge it as a limitation 🡪 sufficient, not necessary)

**AW** seems to prefer the **Haag-Simons** definition of income:

“Personal income, may be defined as the algebraic sum of **[1]** the market value of rights exercised in consumption and **[2]** the change in the value of the store of property in rights between the beginning and end of the period in question.”

Clearly this is not how the IRC treats income (which is more focused on *sources* of income, i.e., gain), but it represents the outer limit of income.

**16th Amendment:**

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

If § 61 is occupying the whole constitutional space then when we determine what “income” is, we are answering a statutory and constitutional question. Statutory exclusions (*e.g.*, §§ 119, 132) prevent us from having to answer the constitutional question because they makes clear that the IRC is not occupying the entire space allowed under the 16th Amendment.

The only guidance we have from the cts on the constitutionality of income tax is *Eisner v. Macomber*, creating a realization requirement determined by severability. But the cts have backed away from this. See Realization, *infra*.

“***Tax Expenditures***” is a calculus that determines the revenue that would be gained if there were no deductions or credits (loopholes) and determines how much is “spent” by granting those loopholes (This calculus shows us the “***whole constitutional pie***” so to speak). The result is the ***IRC***, which shows what is actually taxed.

*Turner*: What matter when determining tax on non-cash income?

Turner family wins two cruise tickets but didn’t seek them out, can’t use them, and can’t sell them. They trade them into the cruise line for four lesser cruise tickets that they can use. On taxes, family claims they are income of $520 and the IRS claims they are $2,200. Ct says $1,360 (just splits the difference).

* Valuation: The ***default rule is FMV*** but here the ct said that it wasn’t worth FMV to the family, shouldn’t be taxed at that amount
  + The Valuation method can consider Fairness, Efficiency, Administrability
* **Takeaway**: There is no easy and completely fair way of valuing non-cash income but cts do the best they can, considerations listed above are considered b/c they can’t be avoided

*Old Colony*: Is the payment of tax on behalf of the TP income to her?

Company wanted to pay taxes for employees but doesn’t want to pay taxes on paying taxes. Ct and IRS say that this is income to the employee and thus taxable, must “gross-up” to accomplish goal.

* “Grossing-Up”: Way to determine how much you must pay to include tax in income
  + N = G(1-t) ***or*** G = N/(1-t)
* “Stacking": When grossing up, is the company paying the tax for the salary as if it were the only income or on top of all other income (either whole salary is taxed at the marginal tax rate or at the true rate (if it pushes you into new marginal rate it incorporates that))?
  + This matters because of graduated/progressive income tax (marginal tax will change)
* Average v. Marginal tax rates:
  + Average tax rate
    - Percent of overall income paid in taxes
  + Marginal tax rate
    - The marginal rate is the rate that applies to additional dollars of taxable income
* Gross v. Net tax rates
  + Gross, or tax-inclusive rates
    - Amount includes tax (160,000 salary is pre-tax)
  + Net, or tax-exclusive rates are things like sales taxes
    - Price does not include tax
  + This is important is b/c we compare tax rates. If one is on a tax inclusive basis and one is on a tax exclusive basis then they really aren’t comparable without some translation

**Imputed Income:**

Imputed income is the income that could be gained if property or services were maximized on the market but are not for whatever reason. Such income is not taxed (nor is it clear that it could be in all cases). Examples include the benefits derived from labor on one’s own behalf, the benefits from the ownership of property, or from leisure.

It is considered problematic because it creates inequalities by making similarly situated individuals pay different taxes which in turns causes them to make different economic choices that they would have made in a tax-free world. It also creates inefficiency (deadweight loss producers!).

For services, the largest source of imputed income comes from homemakers (“domestic” services) and for property; it is the imputed rental value of owner-occupied homes.

**Capital** – Houses, Washing Machine (not going to the laundromat)

* Housing: Incentive to own your own home
  + A makes money and rents home, is taxed on income (pays rent in post-tax dollars) but B owns home and pays no rent, is not taxed on rent he “receives” to live in his own house
  + Rationale: Maybe the government wants to encourage owner-occupied living for other reasons?
  + Fix: Possible to change incentives for imputed value not just by raising taxes on imputed value but to decrease them on competing industries or actions: Give renters a special rate or deduction as an indirect means to even out distinction out – (distinction exacerbated b/c renters are generally lower income to begin with).

**Labor** – Stay-at-home Moms/Dads

* Incentive for spouse to stay at home b/c not taxed on income he/she “earns” for work in his/her own home BUT if he/she went to work, she/he would be taxed on salary and would have to pay housekeeper out of post-tax earnings
* Fix: Lower tax rate on 2nd-earners; Tax the money “earned” at home / Tax “leisure”; Tax the “potential” you could earn; Child care deductions to encourage you to work
* **AW**: This is really about market transactions vs. non-market transactions (working v. staying at home) – again, you could lower taxes on women entering the market (deduction for childcare)

**Leisure** – month off from work v. a raise

* You choose $120k + 1 mo. vacation instead of $130k → vacation is a benefit, but it is not taxed.
* Liquidity problem - person doesn’t have the cash to pay the tax (tax isn’t payable by giving leisure to IRS), also, people feel worse losing something than not having it to begin with.
* **KJW**: Should we tax people to the maximum output they could have produced? Seems wrong.

Problems with taxing imputed income:

* Administrability and Valuation
* Liquidity: How are you supposed to pay the tax when you have no cash coming in?
* Fairness: Politically impossible to tax imputed income, people don’t understand the income tax system
* **Limiting Principle**: Taxing imputed income from labor and capital is one thing, but leisure??

**Realization:**

The Constitution reqs that income be realized before it be taxed (*Eisner*). There are several ***rationales*** for this:

* No Actual Income: Unrealized gains are only gains on paper
* Liquidity: Unrealized gains require some external source of cash to pay the tax
* Valuation/Adminstrability: It is difficult to know the true value of an unrealized gain
* Uncertainty/Volatility/Fairness: Many appreciable assets are volatile (e.g. stocks), there no way to know if the paper gain will be captured in reality which could lead to over/under-taxing the “gain”

None of these are perfect explanations; we still tax benefits-in-kind and they have the same liquidity problem (cars in lieu of cash) or the same valuation/fairness concerns (*see Turner*). At the end of the day, ***for appreciable/depreciable assets, we require a realization event before a tax can be assessed***.

* **NB**: Via § 263 depreciable assets may have tax consequences (deductions) w/o a realization event

(1) A gain must be realized before it can be taxed (*Eisner*)

* Question is not whether to tax but ***when***

(2) Severability is required for a realization event (*Cesarini*)

(3) Congress intends to use all of its 16th Amend power in § 61 unless it expressly indicates otherwise (*see Cesarini*; *Haverly*)

(4) Realization events can be used to avoid double tax benefits; deductions can be a realization event (*Haverly*)

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| --- | --- |
| **CHOICE OF COURT** | * Dct   + Generalist judge, jury trial   + Pay tax, sue for refund   + Preferable for weak legal but strong facts   + 🡪 Ct of Appeals 🡪 SCOTUS (and they don’t want to hear it, causing confusion) * US Tax Ct   + Expert judge, no jury   + Don’t pay tax, appeal service decision   + Preferable for strong legal but weak facts   + 🡪 Ct of Appeals 🡪 SCOTUS (and they don’t want to hear it, causing confusion) * US Ct of Claims   + Semi-expert, no jury   + Pay tax, sue for refund   + Somewhere in between, seems like a place where you are seeking Fed. Cir. review   + 🡪 Fed Cir. 🡪 SCOTUS (and they don’t want to hear it, causing confusion) |
| **BASIS** | **§ 1012**: **Basis** in property or assets is the ***COST*** of such property or asset (***not*** FMV)   * **AW**: Or the amount on which you have paid taxes (this isn’t in IRC)   Basis of Gifts:  There is a “***Carryover Basis***” in the case of gifts, recipient receives basis of the giver   * ***Unless*** basis < FMV, in which case basis = FMV at time of transfer **(§ 1015**)   Basis for Exchange of Property/Assets:  When no money changes hands, the basis is the new asset is the FMV of the old asset   * If property #1 is exchanged for property #2 and #1’s value is unknown, but #2’s value is known and we think it is a fair exchange, impute the FMV of #2 to #1 * *But see* Like Kind Exchange *infra* (form of ***Carryover*** Basis) * Basis in Old = basis in New w/ **§ 1031(d)** adjustments for any boot   Basis in Cash:  Cash always has a basis equal to its face value  Basis of Property Acquired from a Decedent 🡪 ***Achieving Tax Nirvana***  There is a “**Step-up Basis**” when the property is acquired from a decedent, the basis is the FMV at the time of death. **(§ 1014**)  **AW**: Reduces incentive for elderly to not liquidate assets, produces “***borrow, spend, & die***” mentality  Allocation of Basis: **Must be Reasonable 🡪 Make arguments!**  **AW**: Basis is all about ***logic***. Was it allocated in a reasonable way? Arguments for why you should allocate basis the way you do matters (think ***Nixon*** and his friends going to jail).  ***Early recovery*** defers the realization of income  ***Late recovery*** accelerates GI for tax purposes  ***Pro Rata recovery*** sees the most fair  **~Example: Sale of Portion~**  **Reg. Sec. 1.61-6(a):** When a portion of property is sold, the basis must be divided among the parts: The gain or loss on each component part must be determined at the time of sale of each part and cannot be deferred until the entire property has been sold.  ***Master Flow Chart for Computation of Gains and Losses***   1. § 1012(a) – Determine **Cost** of Property; **Basis of Property** (“BoP”) 2. § 1011 – Use § 1016 to adjust BoP; get **Adjusted Basis** (“AB”) 3. § 1001(b) – Determine how much money ($) and property (worth determined by its Fair Market Value) that you got for the thing you sold; add them together **($ + Stuff FMV**); get **Amount Realized** (“AR”)    1. **NB**: When determining **AR** there are other tax implications for Real Property (§ 1001(b)  * (1) Do **not** take into account reimbursements for **real property** taxes (paid by the seller??) imposed on the purchaser under § 164(d), ***and*** * (2) **Do** take into account amounts representing **real property** taxes imposed on the TP (seller) under § 164(d), if such taxes are to be paid by the purchaser  1. § 1001(a) – Determine if you are calculating Gain or Loss    1. **Gain**: Subtract AB from AR (**AR – AB = Gain**)    2. **Loss**: Subtract AR from AB (**AB – AR = Loss**) 2. **NB**: § 1001(c) – Entire amount of Gain or Loss will likely be recognized.  * First in first out (***FIFO***) governs the cost basis of (indistinguishable) assets acquired at different times * **AW**: If the value of property #1 exchanged for property #2 is unknown, but we know the value of property #2 and we think it is a fair exchange, we can impute the FMV of #2 to #1   **~Constitutional Questions~**  Does Congress have the constitutional power to tax me on the total amount realized?   * 16th Amendment seems say no, it can only tax income and income is gain, which is inherently a net concept (taxed as income under § 61(3)).   + *But see* **§ 280E** (no deduction or credit for expenditures in connection with illegal sale of drugs): Cts have said **§ 280E** is constitutional so maybe Congress does have the Const. power (maybe income means gross income?). * Income must be defined for the statute **AND** for the Const. |
| **BURDEN OF PROOF** | **§ 7491(a)**: Burden of Proof – (1) ***Burden is on the TP*** but ***shifts*** if TP comes up with ***credible evidence***, and (2) complies with record-keeping, produces witnesses/info/docs.  **AW**: Would have been a historic shift if not for the reqs on the TP and the fact that it doesn’t apply to ***BIG businesses*** (entities worth over $7 million). Doesn’t mean much in practice; was a political “throw away” |
| **FOOD & BEVERAGES** | Individual:  **§ 119(a)(1)**: Meals ***excluded*** from GI if:   1. Provided by the employer to the employee (+ spouse/dependents); 2. Provided for the convenience of the employer; ***and***    1. ***Don’t consider*** choice of employee/req to pay (**119(b)(2)**) 3. Provided on the business premises of the employer   **§ 119(b)(3)**: Fixed Charges for Meals — Meals ***excluded*** from GI if:   1. An employee must periodically pay a fixed charge for meals; 2. The meals are provided for the convenience for the employer; ***and*** 3. The employee must pay whether or not she accepts the meals 4. **NB**: Irrelevant whether employee pays charge out of own funds or from stated compensation   **§ 162(a)(2):** Ordinary and Necessary ***Travel*** Expenses 🡪 May deduct amounts spent on meals “while **away from home** in pursuit of a T/B” ***UNLESS*** “lavish or extravagant **under the circumstances**” (*see* “Ordinary and Necessary” *infra*)   * If **[1]** employee and **[2]** pays, ***excludible*** under **§ 132(d)**.   **§ 274(k)**: Business Meals (taking (prospective clients out to eat) – ***No*** deduction (under **§§ 162**, **212**) for food or beverages ***UNLESS***:   1. ***Not*** lavish or extravagant under the circumstances; ***and*** 2. The TP is present at the furnishing of such food/beverages  * Includes amounts spent for the employee taking the client out ***UNLESS*** there is ***abuse*** (*Moss* – frequency counts, fact intensive)   **RR 63-77**: Interview Costs 🡪 Meals included; ***excludible*** from GI, to the extent of expenses incurred (*see* Job-seeking Expenses *infra*), but would be no deduct (***Asymmetry***)  **§ 217(b):** Amount deductible for ***moving*** expenses does ***NOT*** include meals  *See also* De Minimis Fringe *infra* (**Reg § 1.132-6(d)(2)**; overtime meals ***excludible***)   * Infrequent (occasional) * Overtime * Enable to work overtime * (Meal or meal money, reimbursement allowed?)   Business:  **§ 162(a)(2):** Ordinary and Necessary ***Travel*** Expenses 🡪 May deduct amounts spent on meals “while **away from home** in pursuit of a T/B” ***UNLESS*** “lavish or extravagant **under the circumstances**” (*see* “Ordinary and Necessary” *infra*)   * **§ 274(n)(1)**: Deduction capped at 50% of cost of meals connected w/ entertainment (*see* Entertainment *infra*); ***BUT*** * **§ 274(n)(2)(B)**: Full deduction if excludible under **§ 132(e)** (*see* de minimis *infra*) * Look for “**Eating Facilities**” *infra* 🡪 ESCAPE 50% CAP!! * *See* Reg § 1.132-6(d)(2); overtime meals ***deductible*** (de minimis)   **§ 274(k)**: Business Meals (taking (prospective clients out to eat) – ***No*** deduction (under **§ 162**) for food or beverages ***UNLESS***:   1. ***Not*** lavish or extravagant under the circumstances; ***and*** 2. The TP (or employee of TP) is present at the furnishing of such food/beverages  * Includes amounts spent for the employee taking the client out ***UNLESS*** there is ***abuse*** (*Moss* – frequency counts, fact intensive)   **RR 63-77**: Interview Costs 🡪 Meals ***included***; reimbursements or direct payments are deductible as O/N business expense (*see* Job-seeking Expenses *infra*) |
| **WORKING CONDITION FRINGE** | Individual Only:  **§ 132(d)**: Any property or service provided to employee by her employer that would be deductible under **§§ 162 and 167** if paid by the employee are ***excludible*** from GI.  Same test as always for **§ 162** 🡪 “***Dominant Business Purpose***” (*Gotcher* – Husband’s trip is excludible via **§ 132(d)** but wife’s (non-employee) was not; no dominant business purpose) |
| **DE MINIMIS FRINGE** | Individual Only:  **§ 132(e)**: Any property or service (provided to employee by her employer) whose value is so small as to make accounting for it ***unreasonable*** or ***administratively impracticable*** is ***excludible*** from GI.   * Frequency matters (*See* Reg § 1.132-6(a)-(d)(2), (e)(1); overtime meals/transport) * Same Reg: gifts from an employer can be de minimis (despite **(§ 102(c)**)   **§ 132(e)(2)**: Eating Facilities – Provision of eating facilities by employer to employees is a de minimis fringe if:   1. Facilities is located on or near business premises; ***and*** 2. Revenue derived from such facilities normally equals or exceeds the direct operating cost of such facility (i.e., normally isn’t operated at a loss)   ***NB***: If eating facility satisfies **§ 119**, for purposes of this provision the employee will be treated as having paid the direct operating cost for their meal (***creates fictional revenue***) |
| **MOVING & TRAVEL** | Individual:  ~Moving~  **§ 217**: Moving Expenses – Deduction ***allowed*** for “reasonable moving expenses” incurred when starting a new job.  “Reasonable moving expenses” include travelling, moving household effects/furniture from old home to new, etc. Does ***not*** include meals.  Deductible if:   1. 50 miles from old principle place of work or (if no old PPW) from old residence; ***and*** 2. Works as a full-time employee for at least 39 weeks in the 12 months immediately following the move; ***or*** 3. If ***self-employed***, works in the area of the residence for 78 weeks in the 24 months immediately following the move (with 39 coming in the first 12 months)   **If *fired***: Probably **Substance over Form**, make arguments**!**  **§ 132(g)**: Qualified Moving Expense Reimbursements – reimbursements that would be deductible under **§ 217** if paid directly/incurred by the individual, are ***excludible*** from GI.  **§ 82**: Reimbursements for Moving Expenses – Other than provided in **§ 132(g)**, reimbursements for moving expenses are ***included*** in GI.  **§ 274(m)**: Limits on Luxury Water Transportation, Travel as a Form of Education, Other Travel Expenses – Look if there is something weird  ~Travel~  **§ 162(a)(2):** Ordinary and Necessary ***Travel*** Expenses 🡪 May deduct amounts spent on travel (including lodging and meals) “while **away from home** in pursuit of a T/B” ***UNLESS*** “lavish or extravagant **under the circumstances**” (*see* “Ordinary and Necessary” *infra*)  **Commuting** expenses are ***non***-deductible, personal expense (*Flowers*; **Reg. § 1.162-2(e)**)   * Personal choice where you live, treated similar to having children (– the credit)   **§ 132(f)**: Qualified Transportation Fringe – These transport benefits = excludible from GI:   * **Commuter highway vehicle** – transportation in connection w/ travel btwn residence and place of employment ($100/month limit – creates ***asymmetry*** w/ **Reg. § 1.162-2(e)** (commuting expenses)) * **Any transit pass** ($100/month limit) * **Qualified parking** (($175/month limit) * **Qualified bike commuting reimbursement** ($20/mo limit if qualified under (F)   **§ 274(h)**: Attendance at a Convention – ***No*** deduction for conventions outside of North America ***unless***   * Directly related to active conduct of TP’s T/B; ***and*** * Other enumerated factors   *See* **§ 274(m)(3)** for travel for spouse, dependent or other individual  **§ 274(m)**: Limits on Luxury Water Transportation, Travel as a Form of Education, Other Travel Expenses – Look if there is something weird  *See* De Minimis Fringe *supra* (Reg § 1.132-6(d)(2); overtime transport ***excludible***)  Business:  ~Moving~  Likely all moving expenses are deductible under **§ 162**, especially those amounts reimbursed to employees for moves that are excludible from their income (as to **§ 82**, make arguments).  ~Travel~  **§ 162(a)(2):** Ordinary and Necessary ***Travel*** Expenses 🡪 May deduct amounts spent on travel (including lodging and meals) “while **away from home** in pursuit of a T/B” ***UNLESS*** “lavish or extravagant **under the circumstances**” (*see* “Ordinary and Necessary” *infra*)  **§ 132(f)**: Qualified Transportation Fringe – Can use ***asymmetry*** between this provision and **Reg. § 1.162-2(e)** (commuting expenses) to lower employee salaries |
| **ENTERTAINEMENT** | Individual & Business:  **§274**: General prohibitions on deductions but:  **§ 274(a)(1)(A)** – Deduction ***allowed*** for entertainment, amusement, or recreation ***if***:   1. ***Directly*** related to; ***or*** 2. Such activity **[1]** ***directly*** preceded or followed a **[2]** bona fide business discussion ***and*** was **[3]** “***associated with***” the TP’s trade or business.  * **AW**: “Associated with” looses [1] to mean sometime in the same day.   Facilities:  **§274(a)(1)(B):** Costs of ***Facility*** associated w/ **(a)(1)(A)** entertainment is ***not*** deductible   * Clubs: **§ 274(a)(2)(A)** – club membership fees treated as facilities; ***no deduction***. * **AW**: Rationale: Club membership is inherently personal (entanglement).   **§ 274(k)**: Business Meals (taking (prospective clients out to eat) – ***No*** deduction (under **§ 162**) for food or beverages ***UNLESS***:   1. ***Not*** lavish or extravagant under the circumstances; ***and*** 2. The TP (or employee of TP) is present at the furnishing of such food/beverages  * Includes amounts spent for the employee taking the client out ***UNLESS*** there is ***abuse*** (*Moss* – frequency counts, fact intensive)   **§ 132(j)(4)**: Work-premise Gyms – *See* Other Fringes *infra*  ~Other Approaches~  Both Carter and Reagan want to removed all of extra-bus deductions (entertainment, etc.) |
| **LODGING** | Individual:  **§ 119(a)(2)**: Lodging ***excluded*** from GI if:   1. Provided by the employer to the employee (+ spouse/dependents); 2. Provided for the convenience of the employer; 3. ***Don’t consider*** choice of employee/req to pay (**119(b)(2)**) 4. Is the employee is working in lodging (*Adams v. U.S.* – house in Tokyo) 5. Lodging is on the business premises; ***and*** 6. The employee is required to accept such lodging as a condition of employment   **§ 119(d)**: Lodging Furnished Education Institutions – Lodging ***excluded*** from GI if:   1. Qualified Campus Lodging; ***and***  * [1] Not lodging under **(a)(2)**; * [2] Located on/in proximity of a campus of the educational institution; * [3] Furnished to the employee (or spouse/dependents); * [4] By or on behalf of such institution; ***and*** * [5] For use as a residence.  1. Rent does not exceed the lesser of:  * 5% of the appraised value of the qualified campus lodging, ***or*** * **[1]** The average of the rentals paid by individuals (other than employees and students of the EI) **[2]** during the calendar year **[3]** for lodging provided by the EI **[4]** which is comparable to the lodging provided to the employee (NYU/Columbia Rent Control provision) * **MINUS** * The rent paid by the employee for the qualified campus lodging during such calendar year   **I.e.,** 5% ***or*** Average Comparable Lodging – Rent Paid = amount included in GI under **(d)**   * But not less than 0 (“zero”), no negative GI   **AW**: Note the different approaches to fringe benefits. Sometimes, ***if there are constraints***, Congress acts like benefits are worthless (**§ 119**), other times it limits the value **(§119(d)**)  **§ 162(a)(2):** Ordinary and Necessary ***Travel*** Expenses 🡪 May deduct amounts spent on lodging “while **away from home** in pursuit of a T/B” ***UNLESS*** “lavish or extravagant **under the circumstances**” (*see* “Ordinary and Necessary” *infra*)   * If **[1]** employee and **[2]** pays, ***excludible*** under **§ 132(d)**.   **RR 63-77**: Interview Costs 🡪 Lodging included; ***excludible*** from GI, to the extent of expenses incurred (*see* Job-seeking Expenses *infra*), but would be no deduct (***Asymmetry***)  Business:  **§ 162(a)(2):** Ordinary and Necessary ***Travel*** Expenses 🡪 May deduct amounts spent on lodging “while **away from home** in pursuit of a T/B” ***UNLESS*** “lavish or extravagant **under the circumstances**” (*see* “Ordinary and Necessary” *infra*)  **RR 63-77**: Interview Costs 🡪 Lodging ***included***; reimbursements or direct payments are deductible as O/N business expense (*see* Job-seeking Expenses *infra*) |
| **OTHER FRINGES** | **§ 132**: Certain Fringe Benefits –  (a) Fringe benefits are ***EXCLUDED*** from GI if one of the following:   1. No-additional-cost service; 2. Qualified employee discount; 3. Working condition fringe; 4. De minimis fringe; 5. Qualified transportation fringe; 6. Qualified moving expense reimbursement, 7. Qualified retirement planning services   (b) **No-additional-cost Service** is defined as **[1]** any service provided by an employer to an employee (see **§ 132(h)**) **[2]** for use of such employee if:   1. **[3]** The service is offered for sale to customers in the ordinary course of the line of business, ***and*** 2. **[4]** Employer incurs no substantial additional costs (including forgone revenue) to provide such service to employee (not counting any amount employee pays for service)  * **Airline Example**: Trump can give empty seats on jet to his employees b/c it isn’t his ordinary line of business but Southwest could (FedEx too, *see* (j)(7), and (i))   (c) **Qualified Employee Discount**:   1. Qualified Employee Discount is defined as **[1]** any employee discount re: **[2]** qualified property or services **[3]** to the extent such discount does not exceed: 2. Property: The gross profit percentage of the price employer offers to customers (otherwise known as “cost”) 3. Services: 20% of the price employer offers to customers 4. Gross Profit Percentage 5. Gross Profit percentage means the percent which the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer, is of the aggregate sale price of such property 6. Gross Profit Percentage is determined on the basis of all property offered to customers in the ordinary line of business and the employer’s experience during a representative period. 7. Employee Discount is defined as the amount by which 8. Price at which the employer provides the property or services to an employee for use by such employee, is less than 9. Price at which the employer provides such property or services are to customers 10. **Qualified Property and Services** is defined as **[1]** any property or services **[2]** which are offered for sale to customers in the ordinary course of the line of business   (h) **Individuals Treated as Employees** for (1) No-additional-cost Service and (2) Employee Discount   1. Employee includes those individuals 2. Who were **[1]** previously employed by the employer and who **[2]** separated from that service by reason of retirement or disability, ***and*** 3. **[3]** Any widow or widower of any individual who died while employed by the employer is such line of business or while otherwise qualifying under (A) 4. Spouse and Dependent Child 5. Any use by the spouse or dependent child of an employee counts as use as an employee 6. Dependent child means **[1]** any child who is **[2]** dependent on the employee, ***or*** **[2]** both parents are deceased and who **[3]** has not attained age 25.  * For Divorcees see the flush language and § 152(e)  1. Special Rules for Parents – Any use of air transportation by parents of an employee (excluding employees under (1)(B)) shall be treated as use by the employee  * **Airline Example**: Mom of employee can fly (3), dad of living spouse can (maybe) fly (3), dad of dead spouse can’t fly (3)+(1)(B); **AW**: unclear if mom of dead employee can fly (looks like the fact that Congress didn’t flush it out may hint that they can fly).   (i) **Reciprocal Agreements** – For the purpose of (a)(1) **[1]** any service provided by **[2]** an employer to an employee of another employer shall be treated as proved by the employer of the employee if   1. **[3]** Such service is provided pursuant to a written agreement between such employers, ***and*** 2. **[4]** Neither of such employers incurs any substantial additional costs (including foregoing revenue) in providing such service ***or*** **[4]** pursuant to such agreement   **(j)(4)**: On Premise **Gyms** and Other Athletic Facilities –   * On-premise gyms provided to employees by employer ***excludible*** from GI * On-premise Athletic Facility means it **[1]** is located on the premises of the employer, **[2]** is operated by the employer, and **[3]** substantially all of the use of it is by employees, spouse, and their dependent children (according to (h)) * Another way of taxing fringe benefits is to tax the employer (***Surrogate Taxation*** – we don’t know how much the employee is using the gym but we can tax the expenses on a gym). **§ 274(a) *but see* § 274(e)(4)—**(the cost of operating a gym NOT deductible to employer as a business expense—**(a)(1)(b)** ***BUT*** if the gym is used primarily by non-highly compensated employees, then can deduct it (**(e)(4)** – a kind of anti-discrimination clause).   **(j)(7)**: Air Cargo – For (b), transportation of cargo by air and transportation of passengers by air shall be treated as the same service  (k) **Customers not to Include Employees** (especially for (c)(2))  (m) **Qualified Retirement Planning Services**   1. QRPS means any retirement planning advice or information provided by employer (who is maintaining a qualified employer plan) to employee and her spouse 2. Nondiscrimination Rule for (a)(7) 3. Qualified Employer Plan means a plan, contract, pension, or account described in ***§ 219(g)(5)*** |
| **DAMAGE PAYMENTS, INSURANCE & Medical Expenses** | ~Damage Payments~  Individual and Business:  Damage payments are taxable subject to the *Raytheon* **Substitution Principle**: “*[I]n lieu of what were damages awarded*?” If underlying gain would have been taxable, the damage payment is taxable. (*Raytheon*)  ~Physical Personal Injury~  **§ 104(a)(2)**: GI does ***not*** include damages received for ***personal*** sickness or injury.   * Congress creates carve out from *Raytheon* for personal physical injuries * **AW**: Different approach: could set a limit, tax everything above $1m * Whether by **suit, agreement, lump sums, or periodic payments**, all the same * Punitive Damages ***are*** taxed * ***Hypo***: 100k for getting hit by a taxicab, tort suit (medical costs, pain and suffering, lost wages). All excludible under **§ 104(a)(2)**, even the lost wages * **NB**: If payments included TP’s car, the portion payment allocable to the car would be taxable under *Raytheon* (not ***personal*** injury)   ~Non-Physical Personal Injury~  ***Hypo***: Dean is libeled both professionally and personally, gets 100k for each.   * Professional harm taxed under *Raytheon* (substitute for profitable opportunity) * Payment for personal reputation would ***not*** * Taxes non-physical harm, is this gain? * **AW**: Is such a tax constitutional? Is it consistent w/ view of Human Cap?   ~Human Capital~  There should be no tax on recovery of human capital.   * Basis of pre-injury body is amount of damages received (as restitution). *See* **PL107-16 § 803**   Business:  Deductions are generally allowed for ***damages paid***, *e.g.*, Florida Gulf Oil Spill. DOJ can insist on no deduction for same reason that civil fines are not (weakens penalty)  **§ 162(f)**: ***No*** deduction allowed under **(a)** for any fine/similar penalty to a gov’t for the violation of the law (*see* *Tank Truck* for policy rationales)  **§ 162(g)**: Deductions for (Treble) Antitrust Damages limited to 1/3 (makes sense, 2/3 is punitive)  ~Medical & Accident (Casualty) Insurance~  **§ 162(l)(1)**: Trade or Business Expenses – Deduction ***allowed*** for self-employed individuals for amts paid for medical ***insurance*** for themselves, spouse, and dependents  **§ 104(a)**: Compensation for Injuries or Sickness – ***Excludible*** from GI:   * ***Works comp*** for personal injuries or sickness * Health/accident insurance for personal injuries or sickness   Taxes are ***not just ex post***, they have an effect on behavior: *e.g.*, $1 for $100 of insurance and deducting premium under 50% rate comes out the same as $2 and $200 if not taxed.  **§ 105**:Amount Received under Accident and Health Plan  *See* Chart, *infra*  **§ 106**:– Contributions by Employer to Accident and Health Plans  *See* Chart, *infra*  ~Medical Expenses~  **§ 213(a)**: – Medical, Dental, Etc. Expenses – Deduction ***allowed*** for personal medical expenses (not compensated by insurance or otherwise) for TP, spouse, and dependents to the extent they exceed 10% of AGI   * **(b)**: Costs of medicine are included in (a) if such is a “prescribed drug” or insulin * **(d)(9)**: Expenses for medical care does not include expenses for cosmetic surgery * ***Unless*** O/N business expense (entertainment) or disfigurement/injury   **§ 213(d)(1)**: Medical care means amts paid for “diagnosis, cure, mitigation, treatment, or prevention of disease, or for purpose of affecting any structure or function of the body.”   * IRS has further interpreted this definition (Revenue Ruling 87-106 (p. 439) * An expense that is merely beneficial to general health is not an expenditure for medical care * Capital expenditures which are related only to the sick person and not to the permanent improvement or betterment of the property are ***deductible*** * Capital expenditures that are permanent improvements: ***deductible*** up to the amt that the cost exceeds the improvement (increased property value) * For an expense to be deductible under **§ 213** it must be  1. An essential element of the treatment; ***and*** 2. Must ***not*** have been otherwise incurred for nonmed reasons (*Jacobs*).   **§ 223(a)**: Health Savings Account – Deduction ***allowed*** for the aggregate amount paid in cash into the HAS (yearly limit of $4,500 (family plan), $2,250 (individual plan)   * **(c)(1)(A)**: “Eligible Individual”: anyone covered by a high deductible plan and not covered by an overlapping (has to be unique coverage) low deductible plan   ~Life Insurance~  **§ 101(a)(1)**: Life insurance payouts **by reason of death** of insured are ***not*** included in GI.   * “By reason of death” ***includes*** payouts for insured’s who are terminally ill **or** chronically ill (**§ 101(g)(1)** – Accelerated Death Benefits).   **§ 79(a)**: Employer payments for life insurance ***included*** in GI to extent such costs exceed:   * The cost of $50k of such insurance, ***and*** * The amount paid by the employee toward the purchase of such insurance   **NB**: The biggest difference between **term** and **whole** life insurance is the savings aspect. The “inside build-up” isn’t taxed but if the extra amount were personally invested and you purchased term insurance, that investment WOULD be taxed. So, as far as taxes go, this is a great investment for TP. Whole life is a combination of an investment account and insurance protection + tax benefits.  **Term Insurance**: Premiums go up as you get older, Set duration  **“Whole Life” Insurance**: Premiums averaged out over your life – (overpay when younger and underpay when older); get both an insurance return and a return on your capital investment;   * Income never taxed so long as paid upon death OR if paid to a chronically ill person **§ 101(g)** * Income on the savings account not taxed under **§ 101** |
| |  |  |  |  | | --- | --- | --- | --- | | **Medical Insurance** | **Premium** | **Recovery** | **Incentives** | | Employer Provided | Not Taxed – **§ 106** | Not Taxed if for medical care - **§ 105(b)** | **AW**: Huge! | | Individual | Deductible in excess of 10% of AGI - **§ 213** | Not Includible - **§ 104(a)(3)** | **AW**: Tiny! | | **Accident Insurance** |  |  |  | | Employer Provided | Not Taxed – **§ 106** | Not Taxed, if not indexed on amount of work missed ***and*** if paid for permanent loss/loss of use of a member or function of the body - **§ 105(c)** | **AW**: Some Incentive (not huge but not tiny) | | Individual | No deductions | Not Taxed - **§ 104(a)(3)** | **AW**: Small to no incentive (what we would have if not tax system) | | |
| **JOB-SEEKING & START-UP EXPENDITURES** | **RR 75-120**: Job-Seeking – Expenses incurred while looking for a job are ***deductible*** under **§ 162** if ***not*** changing to a **new T/B**.   * Public office: *McDonald*, *Estate of Rockefeller*: p. 307 🡪 state judge can’t deduct party contribution that had to be paid to get political support for election; political office is not itself a trade or business, (possibly) each new office is a new T/B, thus expenses aren’t deductible.   **RR 63-77**: Interview Expenses – Expenses for round-trip transportation costs for **interviews** (including the cost of meals and lodging) are ***not*** includible in GI ***if*** paid for (either initially, or via reimbursement) by the interviewing firm/company.   * **AW**: Didn’t cite any legal authority or apply any law. This is inconsistent b/c if no company pays there would be no deduction (***asymmetry***)   **§ 195**: Start-up Expenditures:  (a) Except as provided, deduction ***not*** allowable for start-up expenditures  (b) May deduct ***the lesser of*** (**max 5k**)   1. The amount of start-up expenditures and 2. 5k (reduced by the excess of 50k)   🡪 Remainder to be ratably amortized over 180-months (from month active T/B begins)  (c) Definitions of start up expenditures and beginning of T/B  (d) Scope and time of election under (b) |
| **GIFTS** | “Gift” is a matter of ***motivation***: What the property given out of “***detached & disinterested generosity***,” “***affection, respect, admiration, charity or like impulses***”? (*Duberstein* ***–*** “gift” given out of business interest)   * Factfinder lefts to apply experience w/ “mainsprings of human conduct to the totality of the facts” to determine if a gift (*i.e.*, It is a fact intensive inquiry)   Individual:  **§ 102(a)**: Value of property acquired by gifts or inheritance is ***excludible*** from GI.   * **AW**: strange that DONOR is taxed when donee is the one consuming gain   **§ 102(b)**: Gifts of Income: GI ***includes***   1. Income from property in (a); ***or*** 2. Gifts, inheritances, etc. that in the first instances are income from property (*Irwin*)  * **Hypo**: I assign, to my daughter, the rents from property I own. B/c they are income from property ***and were not taxed to me***, they will be taxed to her (there must be a tax somewhere!) * Codified *Irwin v. Gavit*: * “Gift” of income interest for 15 years 🡪 Taxed to son   + SOMEONE has to be taxed for current income   + Temporal division w/ realization req might allow for tax deferral * Gift of remainder of trust paid over 5 yrs 🡪 Not taxed to daughter: GIFT   **§ 1015**: Basis for Gifts/Trusts   1. If ***gain***, basis carries over from donor (***Carryover Basis***), 2. If ***loss***, basis is FMV at time of gift.  * **AW**: Allows you to pass gains to lower tax-rate members of the family but not to pass losses to higher tax-rate person. ***Asymmetry!***   ~IRC System of Business Gifts~  **§ 102(c)**: Employee Gifts – GI ***includes*** gifts from employers to/for benefit of employee   * Unless de minimis (**§ 132(e)**)   ~Judicial System of Business Gifts~  *Duberstein*: “Gifts” given to business associates ***included*** in GI   * Definition of gift depends on motivation: ***detached [&] disinterested generosity***,   **§ 274(b)(1)**: ***No*** deduction **(§§ 162** or **212**) for gifts to the extent that they exceed $25   * “Gift” defined as that which is deductible under **§ 102**   Business:  **§ 102(c)**: Employee Gifts – GI ***includes*** gifts from employers to/for benefit of employee   * Unless de minimis (**§ 132(e)**)   **§ 274(b)(1)**: ***No*** deduction **(§§ 162** or **212**) for gifts to the extent that they exceed $25   * “Gift” defined as that which is deductible under **§ 102**   *Duberstein* + **§ 274(b)(1)**: Together they create a negative inference that the kind of “gifts” given out of business interest (*Duberstein*) ***are*** deductible under **§§ 162** & **212** (a kind of compensation?).   * ***But see*** *Welch* (not O&N to give “gift” of paying debt that is not legally req’d)   Part Gift, Part Sale:  **§ 1011(b)**:Bargain Sale to a Charitable Organization – Part sale, part gift to charitable org 🡪 basis is determined by the ratio of the sale price to the FMV, applied to the § 1012 basis (Vertical Division)  **§ 1012(a)**: Basis of Property –Basis is what you paid for it (cost), even when you paid less than FMV (Horizontal division)   * ***Trigger***: Difference between Horizontal (sale at loss to liquidate) and Vertical (part gift, part sale) is, usually, whether sale was to charity or family member   **Reg. 1.1001-1**:Determination and Recognition of Gain or Loss – Gain is the excess of the adjusted basis, ***no possible loss*** (for deduction purposes)  Testamentary Transfers:  **§ 1014(a)(1)**: Basis of Property Acquired from a Decedent –Basis of property acquired from a decedent is ***FMV at the time of the decedents death*** 🡪 “***Step-up Basis!***”   * If income, *see* Assignment of Income and § 691 *infra*   *President’s Proposal*: Creation of realization events when property is transferred or at death (even when not actually realized).  **KJW**: § 1015 carryover basis better (than President’s Proposal), there are administrability problems but Congress can put onus on the TP to demonstrate that basis or it gets the § 1015 uncertainty treatment |
| **PRIZES & AWARDS** | **§ 74(a)**: Prizes and Awards are ***included*** in GI   * ***Reg. 1-102-1(a)***: Prizes are still included even if gratuitous * **AW**: Historically, we have not taxed prizes for competitions in which you did not enter (distinguishing Nobel prizes from, say Olympic Medals).   **§ 74(b)**: Excluded from GI if   1. Received for religious, charitable, scientific, educational achievement; 2. Chosen w/o entering contest; 3. Recipient not required to render substantial future services; ***and*** 4. Prize ***given away*** to gov’t or charity   Examples:   * Nobel Prize Money taxed if you keep it (but not if you give to gov’t or charity) * Child’s trophy is taxed ($2.50) 🡪 no limits (but probably de minimis) * Oscar goodie bags taxed as prize   **§§ 74(c) & 274(j)**: Employee Achievement Award = **[1]** Item of tangible personal property, **[2]** awarded as part of a meaningful presentation, **[3]** for length of service ***or*** safety, **[4]** that doesn’t look like disguised compensation; excluded from GI if:   * Cost of award does not exceed the allowable deduction: * $400 for all non-qualified plan awards * $1,600 for all qualified and non-qualified plan awards * Established, written, non-discriminatory plan |
| **EDUCATION** | ~Exclusions~  **§ 117(a)**:Qualified Scholarships – ***Excludible*** from GI   * **(b)** Qualified Scholarship means used for tuition and related expenses * **AW**: No need to trace money, amount is what matters * **(c)** Money for teaching/research as condition of scholarship = ***included*** in GI   **§ 127(a)**:– Employer Educational Assistance Programs – ***Excluded*** from employee GI amounts paid/expenses incurred by the employer for ed. assistance via such a ***program***   * Maximum of $5,250 per taxable year * **(c)(1)** Limited to tuition, fees, and supplies (supplies limited to those not retained by employee); doesn’t include education involving “***sports, games, or hobbies***” * **AW**: Historically, included room and board but no longer does so   **AW** on Policy: When we start subsidizing things through the tax system we need to look at what is really going on and who is really going to benefit.  ~Deductions~  **§ 162(a)** + **Reg 1.162-5(a)**: ***Individual*** expenditures for education are ***deductible*** if edu:   * Maintains or improves skills req’d for individual in his employment/other T/B, ***or*** * Meets the express reqs of employee/applicable law as a condition of ***retention*** of an established * Employment relationship; * Employment status; ***or*** * Rate of compensation * **(b)(2)**: Expenses to meet minimum educational reqs for job are ***not*** deductible * **(b)(3)**: Expenses to qualify for a new trade or business are ***not*** deductible * *Wassenaar*: Law student wants to deduct expenses of LLM degree, saying he qualifies under Reg. 1.162-5(a), improvement of skills relating to his T/B. The ct say ***no*** deduction b/c law is a new T/B for him under Reg. 1.162-5(b)(3) (he hadn’t yet worked as a lawyer). * **AW**: Almost impossible for law student to win under this test, not for an MBA student, it is about improving skills but “not qualifying” for a new field (undergraduate just gives you the basic recs so not included either)   **§ 221(a)–(b)**: Interest on Education Loans (*see* Interest *infra*) – Deduction ***allowed*** on education loan interest but ***capped*** at $2,500 and ***reduced*** according to (b)(2)(B) (adjusted for inflation and rounded down to nearest 5k)   * **(c)** A dependent can’t take this deduction! * **(d)** Only for higher education and for TP’s spouse or dependents   **§ 222(a)**: – Qualified Tuition and Related Expenses – Deduction ***allowable*** up to amount equal to qualified tuition and related expenses (*but see* (b))   * **(b)** Dollar Limitation (***watch the cliff***): * GI 0–65k, limit deduction to 4k * GI 65.1k–80k, limit deduction to 2k * GI 80.1k+, no deduction * **AW**: Mom wants to pay for your tuition, can she deduct it? If you are under 24, yes (start at **§ 222(d)(1)** and follow it through the code)   ~Credits~  **§ 25A – Hope and Lifetime Learning Credits:**   * Hope/AO Credit:   + 4 Years   + 100% of first 2k; 25% of next 2k (qualified tuition, related expenses)   + Can’t be used for graduate degree   + Credit starts to decrease at 80k and is completely gone at 90k   + Per ***student*** credit * Lifetime Learning Credit:   + Non-refundable   + 20% of a maximum of 10k qualified tuition, related expenses (limit = 2k)   + Per ***TP*** credit |
| **LOAN FORGIVENESS (DISCHARGE OF INDEBTEDNESS)** | Borrowing: Not income b/c there is offsetting liability and ***expectation to repay*** (no gain)   * **AW**: There’s not always offsetting liability: ***Nonrecourse & Recourse borrowing*** * That being said, we treat borrowing ***AS IF*** there is an offsetting liability   *Kirby Lumber*: Basis (Cost) of debt = Amount Received, therefore 🡪 when debt is forgiven, the cost (basis) of the debt has been reduced but the AR remains the same, therefore taxed on the difference as Ordinary Income (*Zarin* – difference between 500k settlement for 3.5m debt is taxable income, only not applicable in 3d Cir)   * Liability Basis: There is an idea of “anti-basis” that is a reduction in value that acts as a **negative basis** (but **NB**: we ***cannot*** have negative basis). This resolves the Dead Beat Dad hypo: As judgments accrued his value went down so when the debt was forgiven he didn’t have a gain, just a return to zero net value. So, ***no amounts received, no tax***.   Disputed Debt Doctrine (ignored in *Zarin*):  Where there is dispute about what the debt was, the settlement agreed on is considered to be the amount of indebtedness (therefore payment of settlement is a symmetrical offset of the debt itself and thus no taxable gain via discharge)  **§ 108(a)**: Discharge of Indebtedness – ***Included*** in GI, **EXCEPT**:   * Insolvency: * Exclusion of ***excess*** of debt forgiven in insolvency. Any assets retained will be taxed. * (50k debt forgiven, 40k assets left; 10k excluded, 40k taxed) * **(b)(2)(E)** - basis is decreased by the amt excluded b/c of insolvency * Qualified Principle Residence (**discharged before 2015**): * Preserve tax by reducing basis (**§ 108(b)**) 🡪 just a deferral * Capped at $2m for mortgages (w/ purpose of buying home) * Specific Industries 🡪 Real Estate **§ 108(c)**; Farms **§ 108(g)** * (**§ 108(f)(2)(D)(ii)**) Student loans if: * Forgiveness done in part to meet “unmet needs or [to work] in areas with unmet needs” * This causes LIPP to have two programs, gross-up for private sector |
| **DEBT INSTRUMENTS**  **(ORIGINAL ISSUE DISCOUNT)** | Three Steps:   1. Identify that taxation will happen over the maturity period (on amortization, ***not*** ratable portion) 2. Recognize that this raises constitutional issues (no realization event until the end) 3. Resolve Const. Issues by noting that unlike stock dividends, this is a “sure thing”   Original Issue Discount (OID) exists where the original issue price of a debt instrument is less than the amount to be paid at maturity; ***OID increase in value is taxed***.  **§ 1272(a)(1)**: Current Inclusion in Income of OID – GI **includes** gain over accrual period   * The accrual period is ***every six months***; adjusted issue price will be different for the first and second half of the year   **§ 1273(a)(1)**: Amt of OID determined by subtracting the issue price from the redemption price at maturity  OIDs are an unrealized gain, how is that constitutional? **AW** thinks there are two reasons:   * Distinguishing *Eisner*: Unlike stock dividends, the gain from OID debt instruments are a “sure thing”   + If this really is the reason then *Eisner* isn’t about severability, liquidity or “on paper” gains, **it must be about certainty/fairness** * Practical Implications: If Congress doesn’t tax OID gain then non-taxable entities will take advantage of this “loophole” and have a market advantage   + Unconvincing argument b/c it doesn’t address the constitutional question and Congress could always revoke non-tax status |
| **ANNUITIES** | Allocation of basis for annuities occurs via the “exclusion ratio” **(§ 72(b)**).  **§ 72(a)**: Annuities – GI ***includes*** any amount received from an annuity   * (b) Basis is allocated via Exclusion Ratio: take the “investment in the contract” and divide it by the expected return on the contract; times that by payout amt * (c) “Investment in the Contract” =cost of annuityminus any money that was withdrawn before the start of the annuity period (this is the basis)   **Example of Exclusion Ratio Calculation**: I pay $80 for an annuity (investment in K) and expected payout, over 4 yrs is $100; 80/100 is a 4/5 ratio. Yearly payout is $25, applying the ratio, 20 of $25 counts against basis (***not taxable***); remaining $5 is ***included*** in GI.  **Term Annuity**: An annuity with a set number of years (as seen in the example, *supra*)  **Life Annuity**: An annuity through the end of one’s life (*see* Mortality Gains)   * Both: if expected term ends early (you die early) you are over taxed along the way, any basis still unrecovered is deducted in final tax return (**§ 72(b)(3)**). * Life: If you live longer than expected, undertaxed by taking deduct’s early but taxed on whole amount after expected term ends: ***mortality gain*** (**§ 72(b)(2)**). |
|  |  |
| |  |  | | --- | --- | | **§ 162 – “O&N” Business Expense** (deductible NOW) **AW**: This is a subset of business expenses; it leaves out extraordinary/unnecessary business expenses despite the fact that company doesn’t have that gain (this creates ***double taxing*** where that expense is going to be taxed by the employee who receives it as income (if salary)). But with §§ 262, 263, is there anything in the “extraordinary/unnecessary” box? If there is, are we just disincentivizing innovation? | **§ 262 – Personal Expenses** (NEVER deductible) *but see* § 212. | | **§ 263 – Capital Expenditures** (deductible over time if it is an assets that depreciates in value, e.g., a computer) | | |
| **PERSONAL & FAMILY (CHILD) EXPENSES** | **§ 262**: Personal, Living and Family Expenses – Deduction ***not*** allowed (*but see* **§ 212**)  \*\*Every example in this section is about defining the line between personal & business\*\*  ~Clothing~  *Pevsner*: Woman wants to deduct cost of expensive work clothes. **Test**: Cost of clothing is deductible if:   1. The clothing is of a type specifically required as a condition of employment; 2. It is no adaptable to general usage as ordinary clothing; and 3. Its not so worn.   She fails (2) because it is adaptable. Test is ***objective*** for both fairness and practical (administrability) reasons (McDonald’s uniform would meet test)  ~Child/Dependent Care~  Per **§ 262**, child and dependent care (a family expense) are not deductible but see the following:  ~Credits~  **§ 21**:Household/Dependent Care Service Expenses Necessary for Gainful Employment –  Credit capped at 3k (1 Qualifying individual) and 6k (2 or more QI); for ***amts paid for household services and for care of a QI*** 🡪 Non-refund; helps wealthy more than poor   * QI = child/dependent (spouse or otherwise) incapable of caring for herself * Limited to earned income of lowest earning spouse (if single, just earned income) * **Reg. 1.21-1(d)(3)**: Read the § 21 to req that household services have some connection to dependent being cared for   **§ 22**: Credit for Elderly/Permanently and Totally Disabled – %15 credit against **(c)** amts  **§ 24**: Child Tax Credit –1k credit for each qualifying child**;** decreases by $50 for each additional 1k above threshold amt (110k for joint return) of AGI (*see* **(b)(2)**)   * Apparently, a portion of the credit is refundable   **§ 32**: Earned Income **–** Credit calculated with the following formula:  (credit percentage of earned income amt) – (((AGI) – (the phaseout amt)) x the phaseout percentage) = total credit  Example:   * AGI 80k with 2 qualifying children (40% is credit percentage) * Earned income amount is 9k * 9k x 40% = 3.6k (Credit percentage of earned income amt) * Phaseout amount is 11k * Excess of earned income over the phaseout amount is 69k * Phaseout percentage is 21.06 * 21.06% x 69k = 14.5k - 3.6k = -10.9k (can’t exceed this??)   ~Exemption~  **§ 129**:Dependent Care Assistance Programs –GI does ***not*** include amounts paid by an employer for assistance w/ dependent care of employee but ***capped at $5,000***   * (b) Further limited; cannot exceed the earned income of the employee or (if married and spouse makes less) the earned income of employee’s spouse   ~Deduction~  **§ 151**: Allowance of Deductions of Personal Exemptions – 4k deduction for each of the TP, spouse, and any dependents   * Reduce the personal exemption 2 percentage points per 2.5k (or portion thereof) over 300k (but **adjust for inflation**), which increases your taxes by that reduction x the applicable tax rate (**AW**: this is an attempt to hide the tax rate). Complete phaseout at $422,501 (portion; whole is 425,000).   \*\***§ 152** defines dependent |
| **CAPITALIZATION** | Legal Requirement of Capitalization:   * ***Exam Triggers for Capitalization*** (when you see these think “CAPITALIZE!”):   + 2 characteristics     - (1) Don’t immediately decrease net worth     - (2) Provide future benefits   + 1-yr guidepost (*INDOPCO*)     - When expenditure is expected to produce income over time rather than only in current year, expenditure should be capitalized   + Non-recurring expenditure standard     - Nonrecurring expenses more likely to be req’d to be capitalized   **§ 263**: Capital Expenditures –Deduction ***not*** allowed for:   1. Amts for a new building, permanent improvements, or betterments made to increase “value of any property or estate” 2. Amts expended to ***restore*** property or make good its exhaustion   **§ 263A**: Capitalization and Inclusion in Inventory Costs of Certain Expenses – Any property not included in inventory costs (*see* **§ 472**) ***must*** be capitalized   * **(c)(5)** Exception for Timber and Certain Ornamental Trees but then *see* (e)(4) * **(h)** Capitalization is ***not*** required for any “qualified creative expense” * **AW**: High bar of capitalization: Does it stay on the balance sheet? Green Beans? Yes, until sold (then cost of goods sold – Inventories, **§ 472**). Salary? No, it is just a simple cost. Super simple idea, depreciation (and options to expense) is the interesting part 🡪 In other words, if in doubt, capitalize   *Woodward*: “***Origin of the claim***” 🡪 Costs associated with a capital expenditure must be capitalized. ***Test:*** Look to the origin of the legal and other fees, not the consequences of the transaction. ***Here it was to get stocks***, thus non-deductible under **§ 263**, CAPITALIZE!  ~Salaries and Overhead, *Woodward* & **§ 263A**~  Clinton Admin Regs said that you don’t have to capitalize ANY in house salary (even if ***for acquisition*** of assets – overrides *Woodward*). ***Huge incentive to bring cost in house***.   * Bush said no capitalization of costs associated with purchases of intangibles (highly criticized) * Obama said no capitalization for costs associated with purchases of tangibles   **§ 263A(b)**: Have to capitalize everything(including salary) ***if you Produce/Manufacture***   * Bush and Obama administrations seem to think that they had authority to interpret vague **§ 263** to the benefit of non-producers but **§ 263A** precluded that for producers * Options ***to make it fair***: * Repeal **§ 263A** (and pass a similar Reg *supra*); ***or*** * Apply **§ 263A** to non-producers (via Reg) * **AW**: By and large, it is EXTEMELY difficult to get judicial review of the administrations reg that reduced someone else’s taxes (usually don’t have standing etc.).   *INDOPCO*:  (Blackmun) A friendly take over and the expenses associated with it “produced significant benefits . . . that extended ***beyond the tax year in question***.”   * ***Test***: “lifespan of the benefit”, does it accrue this year or in the future? * **AW**: But doesn’t this mean that a CEO’s salary should be capitalized?? It surely creates future benefits. What about advertising? ***Viable test?***   ~Repair vs. Improvement~  Generally, keeping assets in efficient operating condition are deductible as repairs under **§§ 162** or **212**. Are we just continuing the life of the asset or extending its life? But is this line consistent with *INDOPCO*?  **AW**: The service is already being much more practical than SCOTUS (see RR 2001-4)  ***RR 2001-4***:   * Situation 1   + Routine maintenance – even though technically extends life such maintenance is expected from the begnning   + All may be deducted * Situation 2   + Some routine repairs; some new stuff   + Some is deducted; some is capitalized * Situation 3   + A very old plane; if not for maintenance work, it would have gone out of service immediately     - Life was extended past its expected lifetime   + Capitalization of some of exact same work that done in Situation 1; just different circumstances   + No deductions; all capitalized   + The principle is that if it produces income in future years, it has to be capitalized (*INDOPCO*)     - But this is way too broad to actually work in the real world   + ***Everything is tremendously fact-oriented***     - This ruling is an example of a dialogue between the IRS and the industry.   ~Contracts~  Asset need not be a physical object to be capitalized, it can be a contract right  Example: $3000 Fire Insurance Premium for small business; ***capitalize*** over life of policy  ~Self-constructed Assets~  Applies *Woodward* 🡪 Things used (like a machine or human capital (salaries)) to create an asset are considered part of the cost and thus depreciate at same rate as asset created   * **AW**: Even associated salaries are capitalized, otherwise there would be an incentive to do the work yourself   ~**Advertising**~   * Advertising is deductible despite producing a future benefit * Yet, product development must be capitalized – (*INDOPCO*) * ***Incentive to characterize as advertising*** (find a way to make it look like advertising, get the deduction)   **AW**: Congress has suggested capitalization of advertising. You could just tie it to the cost of the product the ad is promoting and that way it would still have a basis (could be done like *Woodward*).  Expensing:  ~Financial Advantage of “Expensing”~  Expensing is just accelerating a deduction and therefore is the same thing as deferring a tax (we saw this earlier) and can actually be used like an exemption.  ~Authorized “Expensing”~  In a number of situations, Congress has given the taxpayer the option of deducting items otherwise required to be capitalized or capitalizing items otherwise deductible:   * Circulation expenses (for newspapers). § 173 * **Research and experimental** expenditures. § 174 * Soil and water conservation expenditures. § 175 * Certain Depreciable Business Assets § 179 * Qualified clean fuel vehicles. § 179A * Expenditures for farmers for fertilizer. § 180 * Cost of removing architectural/transport barriers to handicapped/elderly § 190 * Environmental remediation costs. § 198 * Development of Mines § 263(a) * § 263A(e)(4) – Farming Business   + Can deduct Christmas Trees raising costs * § 263A(h) – Creative Expenses   + Don’t have to capitalize any qualified creative expense     - Literary manuscript, musical composition, etc. (other exceptions) * ***NB***: Only a TP who is likely to have ***no income*** against which to take a deduction would prefer to capitalize rather than expense |
| **“ORDINARY AND NECESSARY” BUSINESS EXPENSES** | **§ 162(a)**: Trade or Business Expenses –Deduction ***allowed*** for “ordinary and necessary expenses” incurred in “carrying on any trade or business” including:   1. Reasonable allowance for ***salaries*** 2. ***Traveling Expenses*** (including lodging and meals **if not lavish/extravagant** under the circumstances) while **away from home** in pursuit of trade or business 3. ***Rentals*** or other payments to be made as condition of continued use or possession   “**Ordinary**”: Expenses which common in the industry; limited to the nature and scope of the specific industry in question; foreseeability, ***not*** frequency is what counts (*Gilliam*)   * Legal fees for crim breakdown on plane are ***not*** “ordinary” for artists (*Gilliam*)   Ordinary determined via our “norms of conduct;” “life in all its fullness” is test (*Welch*)   * Paying off others debt is not ordinary when applied to our experience (*Welch*)   “**Necessary**”: As in Con Law, ***appropriate and helpful***, not absolutely necessary (*Welch*)   * Paying debts of his former bankrupt company to build report and reputation may be necessary (low bar!) *Welch*   “**Carrying on**”: Something like the costs being incurred while doing business stuff   * Plane flight to give an art lecture was “carrying on” for artist (*Gilliam*)   “**Trade or Business**”:   1. Activity entered into w/ dominant intent of realizing profit (*Olive*) 2. Dominant Business Purpose (*Gotcher*)   “**Home**”:   1. Principle place of business (*Flowers*) 2. Two Homes/Residences: Reqs some business connection, T/B must necessitate the maintenance of two homes (*Hantzis*)   “**Away From**”: Temporal, not a spatial term (*Correll* – trip must require sleep or rest)   * **AW**: Easier to tell if the sun has gone down than to set arbitrary distance limit   ~Salary~  *Exacto*: Executive pay is O&N under **§ 162(a)(1)** if passes: ***“Independent Investor” test***:   1. Would an independent investor approve of this bonus? Is it reasonable?  * Higher the rate of return (adjusted for risk) a manager generates, the greater the salary he can command * When, notwithstanding the CEO’s “exorbitant” salary, the investors are obtaining a far higher return than they had any reason to expect, his salary is presumptively reasonable.   + Only “presumptively” b/c good performance might not be due to CEO - could be windfall, etc.  1. Payment as salary must be bona fide – gov’t can show contrary company intent   **§ 162(m)(1)-(4)(C)**: Publicly held corporations ­– If salary is more than ***$1m*** then ***not*** deductible for covered employees (essentially CEO and other 4 highest paid officers)   * Exception does not apply if the compensation is commission or performance-based ***and*** * Goals set by compensation committed (composed of 2+ outside directors) * Terms of performance goals disclosed to SHs * Compensation committee certifies that performance goals were satisfied   **AW**: Creates a large incentive to compensate w/ stocks/link pay to corporate performance  Public Policy: There are no judicial public policy exceptions to **§ 162** (*Tellier*)   * So, Congress created several policy carve outs from **§ 162**   ~Bribes~  Government Officials:   * Deduction ***not*** allowed for “O&N” expenses paid as illegal bribes or kickbacks   + Even if payment is totally legal in the country where it’s made, we won’t allow it (might put U.S. companies at disadvantage vs. other nations who allow their companies to deduct). * **162(c)(1)**: refers us to the Foreign Corrupt Practices Act.   + If it’s a foreign payment ***and*** it violates the FCPA, it’s ***not*** deductible.   Non-Gov’t Officials:   * **§ 162(c)(2)**: Deduction ***not*** allowed for bribes/illegal payments (acc. to state/fed law) to **non-governmental** officials ***only if*** such law is  1. (State Only) Generally enforced; ***and*** 2. Subjects payer to criminal penalty or loss of license    * + Deductibility depends on enforcement policy of the state      + Seems incredibly odd, expensive, and complicated to enforce.   ~Other Illegal Expenditures~  **§ 162(c)(2)**: Also, ***NO*** deduction for expenditures that are illegal under either state/fed law   * **§ 280E**: Expenditures in Connection with the Illegal Sale of Drugs – Deduction ***not*** allowed for expenses incurred in trafficking controlled substances prohibited by fed law * *Olive*: ***Marijuana Case*** – Ct held that expenses related to the sale of medical marijuana are not deductible b/c they fall under the § 280E exception.   ~Fines~  ***§ 162(f)***: ***NO*** deduction for any fine/similar penalty paid to gov’t for violation of the law   * Decreases the effectiveness of the fine…but also doubles revenue to gov’t   ~Legal Fees~  *Tellier*: **Origin of Claim Test for Legal Expenses** – If the government’s charges originate from “profit-seeking activities” then they are deductible.   * No deductions are given for civil/criminal fines but where the expense is for legal representation for crime connected to the business (securities), as here, there is no such “proscribed conduct.”   ~Lobbying~  **§ 162(e)**: Denial of Deduction for Certain Lobbying and Political Expenditures – ***NO*** deduction for lobbying (expenses incurred in connection with influencing legislation)   * (2) ***Exception*** for local legislatures * (5) ***Exception*** for TP whose T/B **is** lobbying and for de minimus ($2k) expenses |
| **PROFIT-SEEKING** | Individual Deduction for Work Expenses  **§ 212**:Expenses for Production of Income –Deduction ***allowed*** for ***individuals*** for **O&N** expenses incurred for:   1. For the production of income; 2. For the management, conservation, or maintenance of property held for the production of income; ***or*** 3. In connection w/ the determination, collection, or refund ***of any tax*** (H&R Block)   **AW**: Line between personal/business becomes blurry in **§ 212**.  **NB**: Not limited to income from T/B, inference to read this provision broadly? |
| **HOBBIES** | **§ 183(a)**:Activities not Engaged in for Profit – ***NO*** deduction for not-for-profit activity   * In other words, you ***DO NOT*** want to be within **§ 183(a)** – ***Exam***: Either get the presumption (**§ 183(d)**) or argue on the facts (*Storey*).   **§ 183(c)**: “Activities not for profit” = activities other than those in **§§ 162** and **212(1)-(2)**  Not for Profit:  **§ 183(b)**: Certain deductions ***allowable*** if 🡪 There would be a deduction if engaged in for profit ***BUT*** limited: (gains – other deductions = **183(b)** deductions)   * Like wagering losses, it cannot exceed the gains from the activity   For Profit:  ~Statute~  **§ 183(d)**: Presumption of engaging in activity for profit: If gain derived from activity for:   * 3+ yrs in 5 consecutive years (non-race horse) * 2+ yrs in 7 consecutive years (race horse); ***and*** * Exceeds the deductions attributable to that activity   ***Then 🡪*** presumptively “engaged in for profit,” ***IRS has burden***  ~Cases~  *Storey* Factors (non-exclusive):   1. The manner in which the TP carried on the activity; 2. The expertise of the TP or his/her advisers; 3. The time and effort expended by the TP in carrying on the activity; 4. The expectation that the assets used in the activity may appreciate in value; 5. The success of the TP in carrying on other similar/dissimilar activities; 6. The TP’s history of income or loss with respect to the activity 7. The amount of occasional profits, if any which are earned; 8. The financial status of the TP (if they don’t need this then probably a hobby); ***and*** 9. Whether elements of personal pleasure or recreation are involved.   **AW**: Engaged in for profit depends on “***expectation of gain***” which is determined by business like you are about it, more you treat it like a business, the better off you are. Not a high standard to meet. |
| **LOSS** | Threshold: Realization  *Cottage Savings*: Just as under *Eisner* for gains, there must be realization for losses. For exchanged property, there is a realization event if the properties are “***materially different***” meaning that the “***legal entitlements that are [enjoyed are] different in kind or extent***.”   * Ct says there is a realization where a financial institution exchanges its interest in one group of residential mortgage loans for another lender’s interest in a different group of residential mortgage loans.   Threshold: Bona Fide Losses   1. Statute: Not **§§ 267** and **1091** but **if it still looks fishy** apply *Fender*! 2. Cases: Was the TP exposed to a real risk of not being able to repurchase the asset in a short period of time and thus not being able to recover the apparent loss for the sale? (*Fender*)  * Remember: **SUBSTANCE OVER FORM**   **§ 165(a)**: Losses –Deduction ***allowed*** for any loss not offset by insurance or **otherwise**  **§ 165(b)**: Amount of Deduction ­– May deduct up to ***basis*** of loss (***not FMV***)   * Avoids double benefit (deduction for unrealized gain) * Remember to factor in depreciation **(§ 1011**)   **§ 165(c)**: Personal Losses – Following losses are ***deductible*** (if ***not*** paid by insurance):   1. Losses incurred in a T/B; 2. Business **(§ 162-ish**) 3. Losses incurred in transactions for profit (not connected to T/B;); ***and*** 4. Profit-Seeking (**§ 212-ish**) 5. Losses of property (not connected to (1) or (2)) if caused by  * “Fire, storm, shipwreck, or other casualty; ***or*** * From theft” (*see* **§ 165(e)**)  1. Purely Personal **(§ 262-ish**)   **§ 163(h)**: Limits on (c)(3) Losses – Must be more than $100 (for each casualty or theft) to deduct and then only to the extent that the loss exceed 10% of AGI  **§ 163(e)**: Theft Losses – Deduction ***allowed*** under **(c)(3)** in the year the loss is discovered   * Remember Madoff; ***characterizing losses*** as a capital investment or as theft MATTERS! (ended up being treated as a theft, so they could deduct but if it had been a capital loss it would have been limited (*see* **§** **167(f)**).   **§ 163(d)**: Wagering Losses – Deduction ***limited*** to the amount of ***wagering*** gains  (g)(1) Worthless Securities; When it become worthless, treated as a loss from sale or exchange  (h) know this one!!  ~Related Taxpayers~  **§ 267(a)**:Losses, Expenses, and Interest w/ Respect to Transactions Btwn Related TPs –  Deduction ***not*** allowed for loss from sales or exchanges of property (directly or indirectly) between related TPs   * (b) List of Relationship 🡪 **AW**: Be suspicious of transactions btwn these people * (d) Related buyer’s basis is sale price ***BUT*** if resold at a gain, gain is further decreased by previously disallowed loss (***BONUS*** for the buyer)   ~Wash Losses~  **§ 1091**: Loss from Wash Sales of Stock or Securities – Deduction ***not*** allowed for loss from wash sale (repurchase of substantially identical security w/in 30 days)   * (d) Basis for Wash Sale: Basis of original acquisition + the difference between the original sale and the second purchase = the basis when the second sale occurs (assuming second sale and subsequent (third) purchase didn’t occur w/in 30 days)   **AW**: You can wash gains but not losses (gov’t wants taxes now even if you are going to be able to avoid a higher tax rate later) (**Asymmetry!**)  ~Form vs. Substance~  *Fender*: Fact based finding of a lack of a bona fide loss (when the statute isn’t enough)  If the sole purpose of the transaction was to create a tax loss and the taxpayer had sufficient control (not strict control, a sale to a friend may be enough) to assure a resale of the asset, then there is not a bona fide loss (*see* Sham Transactions, *infra*). Here the ct found that 40.7% of the stock and a previous favor was enough control and that the transaction did not make sense outside of a naked attempt to create a tax loss so 🡪 no bona fide loss. **(§ 1091** doesn’t apply b/c it is outside of 30 days and **§ 267** doesn’t apply b/c there wasn’t a relative transfer but **SUBSTANCE OVER FORM**!)  **§ 1211(b)**: Limitations on Capital Loss ­–Deduction of capital losses ***limited*** to the extent of capital gains for that year + up to an extra $3,000   * Rationale: Control over realization creates concerns that loss will be triggered shrewdly to offset gains |
| **BAD DEBT** | Individual:  **§ 166(d)(1)(B)**: Nonbusiness Debts – Worthless nonbusiness debt incorporates **§ 1211(b)**‘s $3k limit 🡪 Deduction limited to capital gains and maximum addition of $3k   * (2) Nonbusiness Debt = (debt of individual, not T/B) ***NOT***:  1. Debt created or acquired in connection w/ TP’s T/B, ***or*** 2. Debt, the loss from which, incur to the TP’s T/B   Business:  **§ 166(a)**: Bad Debt – Deductions ***allowed*** for bad debt:   * Wholly Worthless 🡪 ***fully deductible*** * Partially Worthless 🡪 limited to amt “charged off”/officially declared un-payable   ~Business vs. Non-Business Debt~ (*Generes*)  Distinction between Business and non-business debt is whether there is ***dominant business motivation*** (*Generes*). There must be a ***bona fide debt***, meaning a valid and enforceable obligation to pay back the money   * The distinction exists to avoid lending to relatives who you know cannot make good on the debt and then deducting the loss when they default * Voluntary cancelation does not make the debt bad but if it was done for business purposes it may be deductible under **§ 162(a)**. * Special 7-year SoL (hard to know ***when*** it became worthless) - **§ 6511(d)** |
| |  |  |  |  | | --- | --- | --- | --- | |  | **Business** | **Profit-Seeking** | **Personal** | | **Expenses** | § 162  Allow deduction for O&N | § 212  Allow deduction for production and collection of income, etc. | §262  No Deduction | | **Losses** | § 165(c)(1)  Deduct for losses incurred in trade or business | § 165(c)(2)  Deduct for losses incurred in profit-seeking activity | § 165(c)(3)  No deduction for personal losses unless casualty | | **Bad Debts** | § 166(a)  Deduct for bad business debts | § 166(d)  No deduction for nonbusiness debts  BUT you can deduct like a capital loss subject to the limits of § 1211(b) | § 166(d)  No deduction for nonbusiness debts  BUT you can deduct like a capital loss subject to the limits of § 1211(b) | | |
| **DEPRECIATION** | There are two kinds of depreciation:   1. Economic (real world) depreciation; ***and*** 2. Tax depreciation   Economic Depreciation is the rate that assets depreciate in the real world, which varies from asset to asset. Tax depreciation is the rate at which we allow deductions for economic depreciation. These two rarely align first, b/c determining the economic depreciation of every asset or even every class of asset is impracticable, and second, b/c the depreciation method under **§ 168** is an accelerated recovery method. This means it is TP friendly, deducting basis up-front can be a form of tax exemption, even if it isn’t, it sharply decreases the cost of taxes to the individual due to the PV of $$.  **§ 167(a)**:Depreciation–Deduction ***allowed*** for deprecation (exhaustion, wear and tear) of property for T/B or for income production   * (c) Basis is AB from **§ 1011** – ***NB***, no salvage value, ***full basis*** is depreciable   ~Tangibles~  **§ 168(a)**:Accelerated Cost Recovery System–Apply the applicable depreciation method, recovery period, and convention  **§ 168(b)**: Depreciation Method – 200% and 150% are based on straight-line method   * Straight-line method just means that basis is depreciated pro rata over the applicable recovery period. 200% is twice as fast, 150% is 1.5 times as fast   **§ 168(i), (e), (c)**: Recovery Period   * ***Class Life***: There is an attempt to start in the real world, secretary looks at actual experience to classify * (e) ***Classifications of Property*** set forward, accelerated deductions. Slope of acceleration determines the EFECTIVE tax rate. * (c) ***Applicable Recovery Period***: Normal recovery period and broad categories   **§ 168(d)**:Convention – generally half-yr, only half-yr of depreciation in first yr of service  **§ 168(g)**: Exempt Property – Congress provided special classes of property, this didn’t make it illegal for Citibank to own the supply ship or for K&E to own an HLS classroom, it just reduced the incentive (Alternative Depreciation Method is straight-line)  **§ 168(k)**: Bonus Depreciation– Due to Recession, Congress allows faster depreciation  ~Intangibles~  **§ 197**: Amortization of Goodwill and Other Intangibles –Any **§ 197** intangible can be ***amortized*** over a 15-year period**;** No Other Depreciation or Amortization Deduction Allowable (no Stacking)   * (d) List of § 197 Intangibles (good will, going concern value, etc.) * **AW**: Creating arbitrary 15-yr period stopped fact intensive intangibles litigation   ~Antiques~  Generally no depreciation unless you begin using them again (value increase with age)  *World Publishing*: Building purchased with a lease creates two assets – the building (for the lessee) and the purchased lease (for owner), Ct says both parties can take depreciation deductions because both assets depreciate   1. ALWAYS look for multiple assets   **§ 1016**: Sale of Depreciable Assets – Basis is adjusted for depreciation (***subtract the deducted amount from the original basis***)   1. **AW**: Depreciation is based on expectation so there could be depreciation on an appreciating asset (e.g. antiques)   ~Transferability of Depreciation via Leases~  Selling tax assets – creating a lease for an airplane allows Citibank to purchase the accelerated depreciation that American Airlines would get (but can’t use b/c it no income)   * After *World Publishing*, always look for multiple assets in a lease (though it will only exist when a lease is purchased) |
| **DEPLETION** | **§ 611**: Cost depletion: Deduction allowed for cost depletion –   * Estimates total amount of natural resource in property and allows a deduction of its cost in proportion to the year’s extractions * **Hypo** 🡪 Historic practice, every $1 of the mineral it costs me $.10 * Water is always determined under Cost Depletion   **§ 613**: Percentage depletion –   * Allows deduction of a specified percentage of the gross income from the property year after year w/o regard to the recovery of cost * Remains deductible even after the basis (capital actually invested) has been recovered * Subsidy which stimulates natural resource exploration and development * Can opt for cost depletion * Must have an economic interest in the thing being extracted to claim * Water gets cost depletion   **§ 263**:Intangible drilling costs –   * Labor, fuel, repairs, hauling, and supplies used to put a hole in the ground   + Doesn’t include tangible things like sheds * **(c)** TP is given an option either to immediately deduct these costs or to capitalize and recover the costs through depletion. ***Deduction is a better deal*** * **§ 617 Deduction of exploration costs for ores, minerals**   + Must recapture deductions when produces by counting the deductions as income * **§ 616 Deduction of expenses of developing a mine** * Special deduction after minerals are found for any mine except oil or gas |
| **STATE BONDS, TAXES, & SOCIAL WELFARE** | **§ 103 – Interest on State an Local Bonds:**  **Summary**: Generally speaking, the interest gained via a state/local bond is not taxed as income (not included in GI). This is a kind of indirect transfer from DC to the states. This is preferred by the state and local gov’ts like this better than a straight vote b/c it is hidden from the political process but is still a massive transfer of funds (not actually transferred, just never paid in). Hidden subsidy goes to both states AND highest bracket people, they get a cut. Resolving this via price discrimination would not only create a possible constitutional issue but also impractical (fluid market, hard to know who’s selling/buying)  **§ 141 – (a)(1)(A), (b), (e)(1)(G):**  Benefits state/local issuers and the Harvards of the world (26.4m/yr, 264m of endowment)  **§ 135 – Income from US Saving Bonds Used to Pay Higher Education Tuition and Fees:**  **§ 141 – Private Activity Bond; Qualified Bond:**  **§ 145 – Qualified 501(c)(3) Bond:**  **§ 148 – Arbitrage:**  **§ 164**: Taxes–The following taxes are deductible in the year they are paid:   * State, local, and foreign real property taxes; * S&L personal property taxes; * S&L&F income, war profits, and excess profits taxes; ***and*** * The GST tax imposed on income distribution (flush lang includes S&L bus. taxes) * **(b)(5)(A)** ***Choice*** 🡪 TP can choose btwn deducting S&L sales or income tax   ~Policy of S&L Tax Deduction~  Taxes paid elsewhere may be deductible (this seems like a bad idea b/c it means that the fed gov’t is subsidizing local activities and local/state taxes tend to be flat taxes which means that the deductions for these taxes disproportionately benefits high income individuals (higher tax rates))  Rationale and Effects   * Subsidy?   + If that is right it subsidizes the highest earners, if we wanted to really do this they should do it through a credit * Cost of earning Income?   + If this is right then the credit is absurd   Once you take into account § 164, a flat rate state tax falls disproportionately on the indigent (they don’t pay fed taxes so they can’t use the deduction.  **Due to § 164, Cutting taxes at the state level means that the fed gov’t saves money**, perverse?  **Homeowner**  The major beneficiaries are homeowners, we tax renters more carefully than homeowners? Even if it is politically infeasible to go after homeowners more, we could always give more to renters. Fuzzy line between tax and fee?  Another tax benefit to homeowners over renters since it effectively reduces your property tax BUT landlord can’t pass this benefit onto tenant because:   1. Because LL can deduct $4k of the $10k tax (assume t=40%), the tax only costs him $6k 2. But to recover that $6k after-tax, he needs to make $10k in additional pre-tax rent – (so he’s implicitly taxing the tenant)   SO the only way to capture this benefit is by owning your home and not renting – (homeowners shift burden to renters)  NY tries to get around this by saying that renter actually paid the tax and should be allowed to deduct   * **RR 79-180** 🡪 disallows this, Tenants cannot deduct payments of property taxes passed along by landlords as provided by state statute.   ~Social Welfare~  **§ 85(a)**: Unemployment Compensation –Generally ***included*** in GI  **Summary**: It has been the longstanding policy of the Service to exclude from income most gov’t benefits and other welfare payments. But then why tax civil servants, which forces us to gross up their salaries? |
| **INTEREST (DEBT)** | Debt:  **§ 163(a)**: Business Interest – Deduction ***allowed*** for all (debt) interest paid/accrued   * Builds on **§ 162** as interest payments are O&N business expense   **§ 163(d)**: Investment Interest – Deduction for investment interest is **limited** to the ***net investment income***  **§ 163(h)**: Personal Interest – ***No*** deduction (not including qualified residences)   * **AW**: All the action is in personal interest. Argument for why should be deductible 🡪 interest is just the time value portion of debt principal (obligation to repay) * Argument for why all interest should ***not*** be deductible 🡪 A tax system that has income tax and taxes capital gains (investment gains) but that gives a deduction for interest ***accelerates consumption*** (Good idea? Bad idea? You decide?)   **§ 163(h)(3)**: Qualified residences Exception – Deduction ***allowed*** for interest on debt for acquiring a qualified residence (principle residence and one other res (4)(A)(1)) if:   1. Debt is incurred for acquiring, constructing or substantially improving a QR; ***and*** 2. Debt is secured by such residence.   **Limitation** **(3)(B)(ii)** 🡪 9th Cir treats the **$1m** limitation as per TP, the rest of US treats it as per mortgage (you can’t get a deduction up to 200k, yes, like a marriage penalty)   * QR deduction benefits the wealthy more than the indigent – both b/c they are more likely to own homes and b/c ***deductions*** favor those with higher tax rates   **§ 221(a)–(b)**: Interest on Education Loans (*see* Interest *infra*) – Deduction ***allowed*** on education loan interest but ***capped*** at $2,500 and ***reduced*** according to (b)(2)(B) (adjusted for inflation and rounded down to nearest 5k)   * **(c)** A dependent can’t take this deduction! * **(d)** Only for higher education and for TP’s spouse or dependents   ~Tax Arbitrage~  Tax Arbitrage: Assets eligible for favored tax treatment are acquired with debt. “A negative [tax rate] can be achieved when a [TP] can obtain both an interest deduction and the equivalent of a zero [tax rate] on the income from the asset purchased with debt.”  The following are ex: of Tax Arbitrage (achieving a negative tax rate) in the tax system:  Tax Exempt Bonds  **§ 265**: Expenses and Interest Relating to Tax-Exempt Income – Where the interest from bonds is exempt and where the interest is deductible, the tax code allows you to make money off of the difference (this is tax arbitrage). But tax-exempt bond interest rates are lower b/c of this. But even then, they have to attract investors and that means there will be some windfall. **§ 265(a)(2)** shows that Congress thinks the first example is the way it works and therefore deals with the issue. Textbook says that we should repeal this b/c if it were repealed the high-bracket people would just borrow more and fulfill the market without getting a windfall  Residential **(§ 163(h)**)  Congress doesn’t like tax arbitrage in bonds but allows it here, in expensing and in accelerated depreciation but not taxing the rents (imputed income) of homeowners  Expensing  Analytically equivalent to a zero tax rate (moves us closer to consumption tax than income tax) but it isn’t explicitly so not in **§** **265(a)(2)**  Accelerated Depreciation  Tax arbitrage b/c effective tax rate is lower than actual tax rate (rate which you take your deductions) 🡪 moves us closer to consumption tax than income tax  Investment Interest (**§ 163(d)**)  Deals with tax arbitrage in this setting by allowing no deductions for investment interest in excess of net income from such investment. That way you can’t deduct the expense now and put off the income until later.  Other Exempt Income (**§ 265(a)(1)**)  If otherwise disallowable/exempt-able/deductible, no deduction for interest (take that!)   |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | |  | **Tax-exempt bonds** | **Home** | **Depreciable Assets** | **Investment Income** | **Construction Period Interest** | | **Income**  **(less than full taxation)** | Interest from bonds is exempt | Imputed rental income excluded | Accelerated depreciation | Deferred Gain | Deferred income from construction | | **Deduction of Interest** | No deduction | Full deduction | Full deduction of interest – (O&N) | Limited Deduction – (only to gains) | Interest capitalized if hasn’t produced income yet | | **Treatment of Tax Arbitrage** | Tough | OK – (you can scam) | Easy | Tough | Tough |   ~Other Forms of Tax Arbitrage~  Sham Transactions:  Is it really about the sham, the façade?  *Knetsch v. U.S.* (SCOTUS – 1960):  (Brennan) TP borrowed $4M at 3.5% interest in order to purchase annuity bonds from Sam Houston Life Insurance that would pay 2.5%. He then borrowed against the annuity bonds and prepaid interest each year.   * (We’re immediately suspicious that he’s earning at 2.5%, but paying 3.5%) * Total LOSS before taxes, but if the interest on the loans is fully deductible, then he has after-tax GAIN   + He’s getting taxed at special cap gains rate (15%) for the 2.5% inflow, whereas the outflows he’s paying out are taxed higher (90%) – (what’s earned is taxed at low rate, what’s loaned out is taxed at high rate)   Court disallows interest deductions stemming from a sham transaction with “no commercial economic substance” and no effect on the taxpayer’s “beneficial interest except to reduce his tax.”   * Ignoring tax, this annuity was never going to be profitable for Knetsch.   **Dissent** (Douglas): Transaction was perfectly legal. Tax avoidance is an acceptable motive for economic transactions.  Pre-tax Profit:  If the fatal flaw in *Knetsch* was the sham, making it look like something it wasn’t (an investment in annuities), *Goldstein* should have been fine. The fatal flaw here is that it looks like it isn’t profitable before taxes (but does that mean if pre-tax gain is a nickel, then the after tax benefit can be millions??   * **AW**: Cts have had a hard time, some saying you just have to have some pre-tax return, others are saying that there must be some relation between the pre-tax and after-tax return)   *Goldstein*:  Irish Sweepstakes winner paying 4% to borrow money to purchase Treasury notes paying 1.5%. Prepays interest and tries to deduct that payment to offset the $140,000 gain from the sweepstakes. Ct held that even if transaction is not a sham, the interest deduction can be disallowed if there is “no purposive reason, other than the securing of a deduction.” Decision avoids transactions with “no economic utility” other than tax benefit. It looks like the Ct wants pre-tax profit or the deduction is disallowable.  **§ 7701(o)**: Clarification of Economic Substance Doctrine (must change in a meaningful way, apart from tax liability, and have a substantial purpose). Moves away from *Goldstein*   * “Relevance” of the doctrine is the threshold inquiry   **Arbitrage Outline**:  Is the transaction an attempt to cover up what is really going on? (something like *Knetsch*)   * Yes? Then **Sham transaction** (*Knetsch*); apply § 7701(o) *infra* * No? Will there be a pre-tax profit? (*Goldstein*)   + Yes? Is there a relationship between the profit and the after tax gain?     - Yes? Allow deduction.     - No? Maybe still okay, depends on the ct   + No? Apply § 7701(o) 🡪 transaction has economic substance only if:     - 1) Changes TP’s economic position in a meaningful way (ignoring tax effects); ***and***     - 2) TP has substantial purpose for entering into the transaction (ignoring tax effects).       * ***Remember*** PV of pre-tax profits is substantial in relation to the PV of tax benefits ((o)(2))     - Does the transaction have economic substance?       * Yes? Allow deductions.       * No? Disallow deductions. |
| **CHARITABLE CONTRIBUTIONS** | Rationales:   * Not part of consumption therefore shouldn’t be taxed * Subsidy (to encourage giving) 🡪 this seems to make more sense here, it aligns incentives with tax rates, high earners have greater incentive to give * Lowering tax rates hurts charitable deductions b/c it makes giving more expensive   Threshold: Quid Pro Quo – If quid pro quo for donation, no deduction (*Hernandez*)   * Direct Quid Pro Quo of “religious” benefits moves the transaction from the realm of **§ 170** into the market (*Hernandez*) * *But see* **§ 170(l)**   **§ 170(a)(1)**: Charitable, Etc. Contributions and Gifts – Deduction ***allowed*** for the amount of a charitable contribution  **§ 170(b)**: Limitation –   1. Individuals: Capped at 50% AGI (**(b)(1)(A)**)  * Churches; * Educational organizations; * Organizations whose principle purpose is to provide med/hospital care; * Organizations that receive a substantial part of its support from US Gov’t; * Governmental Units; or * Certain Private Foundations (NGOs) * Contributions other than those listed above; 30% of AGI * CG Contributions made to above listed but not subject to **(e)(1)(B)** are deductible only to extent they do not exceed 30% of AGI  1. Corporations: Capped at 10% of taxable income   **AW**: But wouldn’t such donations be deductible under **§ 162**? Why the duplication? 🡪 Really just allows Corp to pass on a benefit to an executive, indirect compensation, w/o being taxed on it. Executive may not be able to make same donation and deduct full amt.  **§ 170(b)(1)(C)**: CG property contributions made to under **(a)(1)(A)** but not subject to **(e)(1)(B)** are deductible only to extent they do not exceed 30% of AGI  **§ 170(c)**: Eligible Donees – Certain class of non-profits, donor can’t be too involved or else seen as producing a private benefit (**(2)(C)**), thus a non-charitable donation   * *See* **§ 170(l)**: exception to private benefit prohibition 🡪 80% of “charitable” donation to a university is a deductible despite receiving right to purchase tickets)   ~Double Benefit~  **§ 170(e)(1)**: Contributions of ***property*** shall be reduced by:   * (A): The amount of gain that would have been non-LTCG (if sold by TP); ***or*** * **(b)(1)(C)**: CG property contributions made to under **(a)(1)(A)** but not subject to **(e)(1)(B)** are deductible only to extent they do not exceed 30% of AGI * (B): The amount of gain that would have been LTCG (if sold by TP); ***if*** * **(i)** Such property is tangible ***personal*** property; ***or*** * If donee use of property is unrelated to tax-exempt status * **(iii)** Patent, copyright, trademark, trade name, trade secret, know-how, software, or similar property * **(iv)** Taxidermy property;   **AW**:Tangible in **(B)** does ***not*** include financial instruments, LTCG is not included in **(a)** so a $20m gift in Microsoft stock would grant a double-benefit   * Services: No double benefit b/c haven’t paid taxes on donation (labor)…but that is precisely the case with appreciate property, why the ***Asymmetry***? (no deduction for pro bono work for charity)   Under **§ 1221(a)(3)**:   * Collector gets CG (no carryover basis) and double benefit * Musician gets CG (**1221(b)(3)**) but no double benefit (**170(e)(1)(B)(iii)**) * Artist gets OI and no double benefit. Isn’t this...***bizarre***?   **§ 501(c)(3)**: Exemptions from Tax on Corps, Certain Trusts, Etc. – List of exempted orgs (religion, science, ed., nat’l sports, humane treatment of animals/children, etc.)  ~Quid Pro Quo 🡪 Private Benefit~  *Hernandez*: \*\* Direct Quid Pro Quo of “religious” benefits moves the transaction from the realm of **§ 170** into the market \*\* Church members made donations of a ***fixed*** amt to receive “auditing” and “training” services and sought to deduct these expenses under **§ 170** as charitable donations. The Ct rejected this b/c a contribution by definition must not be received in exchange for something.  **Dissent** (O’Connor): There are other examples of deductible donations for which there is an exchange of benefits (Pews, seats, temple recommends, etc.). Therefore Scientology has been singled out, this violates the establishment clause.   * **KJW**: Here’s the thing, when I over pay for a church thing, it is because I am donating money, not for the “benefit” itself. That is not what is happening with the “auditing” or the “training” Again, ***line between a fee and a donation.***   ~Part Sale, Part Donation~  **§ 1011(b)**:Bargain Sale to a Charitable Organization – Part sale, part gift to charitable org 🡪 basis is determined by the ratio of the sale price to the FMV, applied to the § 1012 basis (Vertical Division) |
| **COMPUTATION OF TAX** | **§ 1**: Tax Rates  Macintosh HD:Users:karlworsham:Desktop:Screen Shot 2016-04-22 at 10.02.46 AM.png  **§ 63(c)**: Standard deduction = 12,600 for married couple filing jointly (6,300 for single)  **§ 63(d)**: Itemized deductions are those other than adjustments and personal exemptions  **§ 67(a)**: 2-Percent Floor on **Miscellaneous** Itemized Deductions – Allowable only to the extent that the misc. itemized deductions, in the aggregate, exceed 2% of AGI (look for gap between itemized deductions for the wealthy and the standard deduction – 2% might be well above $12,600)   * **(b)** Miscellaneous Itemized Deductions does not include deductions under **§§ 163** (Interest), **164** (S&L Taxes), and **213** (medical expenses), etc. * **AW**: Incentive take sabbatical all in same year, won’t have to get over 2% twice   ~Phaseouts: Pease and PEP~  **§ 68**: Overall Limitations on Itemized Deductions – If AGI > 309.9k (look to inflation) there is a reduction in itemized deductions by the LESSER OF:   1. 3% of excess of 309.9k; ***or*** 2. 80% of the itemized deductions themselves   **§ 62(a)**: Adjustments Include –   * T/B deductions, T/B can’t consist of performance of services (§ 162) * Certain T/B deductions of employees * Losses from Sale or Exchange of property * Deductions attributable to rents and royalties (§§ 212 and 611) * Deductions for life tenants and income Beneficiaries or Property (depreciation under §§ 167 and 611) * Deduction allowed by § 404 (Pension etc. for self-employed TPs) * Retirement Savings (§ 219) * Forfeiture stuff (§ 165) * Alimony (§ 215) * Required Payments of Supp Unemployment Compensation * Jury Duty Pay Remitted to Employer * Moving Expenses (§ 217) * Interest on education loans (§ 221) * Higher Education Expenses (§ 222) * Health Savings accounts (§ 223) * Costs involving discrimination suits   **AW**: Adjustments were originally about profit-seeking expenses (*see* **§ 62(a)(1)**); no more  **§ 151**: Allowance of Deductions of Personal Exemptions – 4k deduction for each of the TP, spouse, and any dependents  Reduce the personal exemption 2 percentage points per 2.5k (or portion thereof) over 300k (but **adjust for inflation**), which increases your taxes by that reduction x the applicable tax rate (**AW**: this is an attempt to hide the tax rate). Complete phaseout at $422,501 (portion; whole is 425,000).  **§ 152(a)**: Dependent Defined – Qualifying Child or Qualifying Relative  Alternative Tax System 🡪 Only used when more tax liability under this system than under ordinary system (almost never happens)  **§ 55**: Alternative Minimum Tax Imposed  **§ 56**: – Adjustments in Computing Alternative Minimum Tax – Depreciation = 150% declining balance method; Only for individuals (no corps) the AMT simplifies dramatically (in a complicated way) |
| **ANNUAL REPORTING** | *Sanford & Brooks Co.*: Declares yr-by-yr taxation constitutional   * A transaction is an over all loss but it results in a gain on the last year. The petitioner asked that he not be taxed b/c the transaction not the year should be the measure. Ct says practical system of raising revenue reqs that there be a set time.   ~Exceptions~  **§ 172**: Net Operating Loss Deductions (NOLs) –Net operating losses can be carried over from year to year; back as far as 2 years and forward as far as 20   * **AW**: This is about identifying that loss resulted from operating a business and not something other cause   ~Tax Benefit Doctrine~  **§ 111(a)**: Recovery of Tax Benefit Items – Recovery of a loss in a prior year is not taxable as gain in this year (***not*** include in GI) if it didn’t reduce your taxes in that year.   * Remember, that the logic is that if you get a tax benefit from a loss and recover that loss you must be taxed on that recovery (to reflect the real world zero-sum situation). It is the logical inference from § 111. We don’t look into the tax rate across intervening years.   ~Unrestricted Claim of Right~  **§ 1341(a)**: – If thought you had a right to some income but then lose it (Law Firm Bonus Hypo) and the income is > $3k, then you can take whichever of the following produces the LEAST tax for the previous year:   1. A deduction equal to the amount of income lost for THIS year; ***or*** 2. Credit for THIS yr in an amount equal to the reduction in the previous yr’s tax liability if such income had been excluded from GI in that year   **AW**: Here Congress takes into account different rates, more complicated but but fairer  ~Accounting Methods~  Cash Method 🡪 take deductions when paid (not always, think capitalization), claim gain when cash received (most businesses are required to use Accrual but law firms have out)  Accrual Method 🡪 when things are “fixed”   * Structured settlements “fix” things   + The problem is that they can deduct the full amount, not just the present value so it is possible under this method that they get a profit.     - One way to address this absurdity is to make them deduct only the present value       * That is variable though     - How about § 461? (this puts cab company on “cash basis” for these kind of situations)   **§461(h)**: Certain Liabilities not Incurred Before Economic Performance ­–   1. Economic Performance before “all events test”  * “All events necessary to take an accrual” = All Events Test (which is when you can claim a loss)  1. If liability results from services to TP, economic performance occurs when services are rendered; If property, when property is received; If use of property, when TP uses property; If the services/property are being provided by TP, occurs as TP provides them  * AW: Pushes the accrual method closer to the cash method   ~Accounting Methods for Inventories~  **§ 472(a)**: – General Rule for Inventories – Secretary determines the accounting practice that most clearly reflects income in that T/B 🡪 AW: the two dogs of tax, FIFO and LIFO  Receipts  -Costs of Goods Sold  Taxable Income  &  Opening Inventory  + Purchase  - Closing Inventory  Cost of Goods Sold  \*Huge incentive for ***fraud*** is to ***understate*** closing inventory\* As closing inventory goes down, costs of goods sold goes up, and taxable income goes down.  **FIFO** (First in First Out): Opening Inventory sold first  **LIFO** (Last in First Out): Most recent purchases sold first   * Difference is all about closing inventory (which makes sense looking above). * Assumes inflation (prices always going up) which is generally a safe assumption   Want to give LIFO to Commissioner  Want to give FIFO to investors   * **AW**: Can do LIFO for tax as long as you report LIFO to investors as well. In practice almost no one uses LIFO, don’t think the investment community can handle it. There have been policy proposals to get rid of LIFO but so far still here |
| **MARRIAGE & DIVORCE** | Marriage:  Community Property States v. Common Law States started a mass change to try to make taxes “fair” to both individuals and married couples (avoid marriage penalties/ benefits)   * Benefit: Helps single earners the most * Penalty: Hurts double-earners the most   Impossible to have all three of:   1. Tax all individual (in the same bracket) equally 2. Tax all couples (in the same bracket) equally 3. Graduate (progressive) Tax Rate   Proposal for Credit for Second Earner – 5% tax credit for second earners; 120k to 210k (5% to .5% at increments of 10k)  *Druker*: The marriage penalty (and the inverse, the singles penalty) is constitutional b/c a progressive income tax cannot exist otherwise   * **KJW**: But isn’t that question begging? Could it be that a progressive tax, if it produces these outcomes, is itself unconstitutional?   **§ 7703(a)(1)**: – Determination of Marital Status – Married if legally married (according to state law) at close of taxable year, or in case of death, at time of death  Divorce:  ~Property Settlements~  **§ 1041(a)**: Transfer of Property Between Spouses or Incident to Divorce ­– No gain or loss for transfer to   1. Spouse; ***or*** 2. Ex-spouse (if an incident of divorce)  * **(b)** Transferee has transferor’s basis (***Carryover Basis***, like a gift)   *Farid*: Property transferred in prenuptual agreement PRE-MARRIAGE. B/c it was pre-marriage, doesn’t fall into § 1041 (which say nothing about Fiancés). So, ct treates it as a market transaction where she gave up here dower rights for the property (so she get FMV at time of transfer as here basis).  The peculiar thing is that they treat it as a market transaction here but did not do so for him when transfer occurred…if it would have been a realization event for husband, it should’ve been a realization event for wife when she made the exchange but it wasn’t.  ***Bottom line***:   1. Transferred for before marriage 🡪 *Farid* (FMV at transfer is basis) 2. Transferred after marriage and before divorce is complete 🡪 **§ 1041** (Carryover) 3. If after divorce is final, probably *Farid*?? But really, look at the other provisions of the IRC that we have (gifts, partial gifts, other transfers, etc.) Depends on whether a ct sees it as an arms length transaction or not.   ~Alimony & Child Support~  **§ 71(a)**: Alimony and Separate Maintenance Payments – GI ***includes*** amount received as alimony or SMPs   * **(b)(1)** Parties have total choice, specify in divorce agreement (possible to always avoid the higher tax rate)   **§ 215**: Alimony Payments – If alimony is taxed to recipient, deduction ***allowed*** for payer  **§ 71(c)**: Child Support – Always taxed to husband (or spouse not taking care of kids) |
| **ASSIGNMENT OF INCOME** | **Horticultural Reference**: Ct refers to property or labor as a **tree** and the income as the **fruit**. This distinction dictates whether the assignor (**fruit**) or assignee will be taxed (**tree**)  Three Kinds of Assignment:   1. Gifts of Property: **§ 1(g)**: Kiddie Tax; Assignee Taxed, normal gift giving (**§ 102**) 2. Gifts of Income from Services: *Lucas v. Earl* 🡪 Assignor Taxed 3. **NB**: Can shift tax when labor services produce property (*e.g.* art/software) 4. Gifts of Income from Property: Fuzzy line, two tests for drawing it (*infra*) 5. If determined to be Income from Property 🡪 Assignor Taxed (*Horst*) 6. If determined to be Property 🡪 Assignee Taxed (*Blair*) 7. *Gavit* is special case of two *Blair* (Multiple Assignee)   ~Gift of property~  \*New Owner\*  When property is assigned, no immediate tax but carryover basis, so assignee will be taxed on any appreciation gain.  **§ 1(g)**: Kiddie Tax – Child’s unearned income (gifts from anyone) is taxed at the parents tax rate (unless child tax rate is higher). Income from labor (“earned”) income, is taxed.   * Child’s income is taxed as if stacked on top of parent’s income * Only children younger than 18 ***or*** who provide less than ½ of their own support * Rationale: Congress is worried about assigning income to a low-income relative and thereby reducing taxes   ~Gift of Income from Services~  \*Old Owner\*  *Lucas v. Earl*: Husband enters contract w/ wife when first married that all earnings of either will be joint property of both. Ct says **fruit** from tree 🡪 taxed to husband.   * Seems to be same concern here as for the “kiddie tax” * Despite *Lucas v. Earl*, possible to shift tax to new owner for labor services that produce property (art/software examples)   ~Gift of Income from Property?~  Possible Distinctions between **property** and **income from property**:   1. Carve-out vs. Whole Interest: If just a carve out 🡪 Income (*Horst*)  * Could be a **monetary** (part of money given) or a **temporal** (comes back to giver) **carve-out**  1. Equitable Interest: If EI (could get an injunction) 🡪 Property (*Blair*)  * Remember, this hinges on ***STATE LAW***   **AW**: Is it even coherent to talk about a distinction if the value of property is just the discounted present value of all future income?  *Blair*: ½ of net income from trust assigned to son. Looks like fruit, not tree but ct says that son has an equitable interest therefore a property interest (**Tree** itself 🡪 taxed to son)  *Horst*: Father gives child bond coupons (carve-outs). (**Fruit** from tree 🡪 taxed to father)  *Gavit*: Special Case 🡪 Whole **tree** assigned; ***Multiple Assignees*** split tree  Father gives son the income from trust for 15 years with the remainder (principal) to daughter when she reaches 21.   * “Gift” of income interest for 15 yrs (**Fruit**) 🡪 Taxed to son   + Temporal division w/ realization requirement might allow for tax deferral * Gift of remainder of trust paid over 5 years (**Tree**) 🡪 Not taxed to daughter: GIFT   ~Other Assignments~  **§ 7872(a)**: ***Gift***/***Demand*** Loans with Below-Market Interest Rates (usually go to relatives) – Foregone interest is treated as income to the borrower (forgiveness of indebtedness) and income to the lender (as an interest income).   * Constitutional? Probably not. Congress manufactures a realization event, income   **§ 7872(b)**: Term loans are treated as OID  **§ 691(a)(1)**: Recipients of Income from Decedents – Income of decedent that was not properly includible in GI in taxable year of the death, is taxed to recipient of such income |
| **PENSION PLANS** | Rationale:  We want to incentivize people to overcome their reluctance to save and to invest in their retirement (Romney Ex: but does that makes sense for the super wealthy?)  Qualified Accounts:   1. Defined contribution plans (TP pays into plan and can deduct it; 53,000/yr cap) 2. Defined benefit plans (employers pay in, capped at 210,000/yr)   **AW**: The latter used to be more common but is less common now b/c employer bore the risk 🡪 change shifted risk from employers to employees, Congress thought this would make employees more responsible (**§ 401(k)**)  Roths:  TP pay taxes up front but you don’t pay taxes on the back end no matter how much the investment increases. (just a difference in timing)  Relationship between QA and Roths:  QA’s are a deferral and Roths are an exemption   * In other words you end up in the same place **UNLESS** the tax rate changes. * If rates will go up then use a Roth, * if you think rates are going down you want a QA   Conversion to Roths:  The difference between QA and a Roth is **WHEN** you pay taxes.  To convert all you do is pay taxes on the current amount in QA. If you have assets outside of the account it is advantages to TP to convert b/c it nominally increases the amount in the QA (now Roth) b/c that money is now after-tax rather than pre-tax.   * Congress says, CONVERT to reduce the deficit. This reduces the deficit in the short term but actually creates more problems in the long run.   So, in summary conversion is:   * For gov’t:   + Good in short term   + Bad in long term * For TP:   + Good if you have “outside” assets to pay conversion tax   + Neutral if you do not have “outside” money to pay the tax |
| **CONSTRUCTIVE REALIZATION & Installment Payments** | ~Constructive Realization~  **§ 1259(a)**: – Constructive Sales – Constructive sales will be treated as actual sale, assignment, etc. re: recognition of gain   * **(b)(1)** Includes stocks, debt instruments, or p-ship interest; if gain would be recognized if it had been sold, assigned, etc. * **(c)(1)** Definition of Constructive Sale   When TP has a short sale against the box (leverages an (b)(1) asset to get cash without actually selling it, but creating a debt of that asset), treated like a “realization” event.   * AR is FMV at time of short sale (batch 2); Basis is cost of batch 1 * ***Constitutional*** under *Eisner*?? * **AW**: These transactions go one step further than recourse/nonrecourse debt, they are completely disconnected from what happens to the stocks performance (the debt = 1 stock, etc. at whatever value)   ~Deferred Payments~  **§ 453**: – Installments – Income in installments (over more than a single taxable yr) will be taxed by distributing basis in proportion to the payments relationship to the total amount |
| **LIKE KIND EXCHANGE & OTHER NONRECOGNITION** | This whole section is epitomizes **§ 1001(c)**, which states that the “entire amount of loss or gain is recognized **unless** otherwise specified.” This section is that “**unless**.”  ~Like Kind Exchange~  **§ 1031(a)**: No recognition of loss/gain for “like kind” exchanges – If property is held   * For a productive use in a T/B; ***or*** * For investment; ***and*** * Exchanged ***solely*** for property of ***like kind*** (broad for real property but not so much for other assets), which is held * For productive use in a T/B; ***or*** * For investment   ***Then*** 🡪 no realization of gain or loss   * ***UNLESS*** property is: * Stock in trade or other property held primarily for sale; * Stock, bonds, or notes; * Other securities or evidences of indebtedness or interest; * Interests in a partnership; * Certificates of trusts or beneficial interests; ***or*** * Choses in action   **§ 1031(b)-(c)**: If all other reqs are met but property is not exchanged ***solely*** for like kind property, i.e., there is a “Boot”, then 🡪   * Gain to Recipient of Boot: Recognized only to the extent of the boot * Loss to Recipient of Boot: Not recognized (would only be in L-K Property)   **§ 1031(d)**: New property basis = old property basis (including boot basis) (***carryover***)   * Increase/decrease by amt of any gain/loss recognized in exchange (always boot) * ***THEN***, If increase/decrease is from boot of: * Money: Decrease basis by an amount equal to that received * Property: Allocate increase/decrease basis (FMV ***when received***) to boot * Assumption of liability = Cash boot   ~Other Nonrecognition~  **§ 121(a)**: Sale of Principal Residence – No Gain Recognized for sale/exchange of property used as Principal Residence for 2 (as aggregated periods) of the last 5 yrs   * **(b)**: Limitation 250k (or 500k for joint return) limit; only one sale every 2 yrs   **§ 1033(a)**: Involuntary Conversions – If property involuntarily converted by   1. Destruction (in whole or in part); 2. Theft; 3. Seizure; 4. Requisition, ***or*** 5. Condemnation; ***or*** 6. Threat or Imminence of any of the preceding   ***INTO***:   * (1) Property similar or related in service or use 🡪 ***No*** Gain Recognized * (2) Money or property not similar/related in service/use 🡪 ***Gain Recognized*** * ***BUT*** only to the extent that not converted it (1) (money could be converted into multiple properties) * 2-yr period to complete replacement (4-yr replacement period for **(h)**) * **(h)**: **F**ederally **D**eclared **D**isasters – ***No*** Gain Recognized from insurance paid for unscheduled personal property involuntarily/compulsorily converted (in **FDD**)   **§ 1044(a)**: Publicly Traded Securities Gain into Specialized Small Business Investment Companies – ***No*** Gain Recognized for sale of **[1]** publicly traded securities to the extent that such proceeds are converted into **[2]** common stock or **[3]** p-ship interest in **[4]** a specialized small business investment company, **[5]** w/in 60 days sale. |
| **LEVERAGED TRANSACTIONS** | *Crane*: We ***don’t*** have ***negative basis***, so we don’t just count the depreciations against the TP. Because of that we have to make the basis the debt and then count, as the AR the forgiveness of the debt.  *Tufts*: Unlike *Crane* this is case of non-recourse debt in which the value of the property has dropped below that of the value of the loan itself. Instead of embracing Crane’s FN, the ct applies *Crane* straight across.  **Concurrence** (O’Connor): This opinion is ***now used for recourse loans*** via **Reg 1.1001-2(a)(1)-(2)**. Essentially, she agreed with the outcome but not the method (because her method would get the same numerical outcome). Her beef is just that “forgiveness of indebtedness” is taxed as GI and gains from property are taxed under the more forgiving capital gains tax. While the numbers are the same, the tax consequences are significantly different.  RW Gain/ Loss:  Taxpayer:  AR: Amount of Loan remaining after surrender (if asset depreciated should be 0)  B: Personal investment in asset  Lender:  AR: FMV of property at time of surrender  B: Amount of loan (- any repayments)  Crane FN 37: (just O’Connor’s property analysis)  *See* Chart *Infra*  *Tufts*: Non-recourse  *See* Chart *Infra*  O’Connor: Recourse  *See* Chart *Infra*  ~Tax Shelters~  *Estate of Franklin*:  “Purchase money mortgages”  Pays only 75k up front, promises to pay full amount but then leases the property to the seller. The seller pays annual rents. The rents and the yearly payment (for the purchase of building) are the same; therefore no cash (other than 75k) changes hands. Buyer is doing this for depreciation deductions. **AW**: 75k could be pre-paid interest  Ct says that this is not a sale but an ***option*** b/c it is a non-recourse loan. This is important because once we go down the *Crane* rabbit hole and say that liability is basis, the buyer could promise ANY AMOUNT (I am not convinced). Ct of appeals say that they ***have to at least show*** that the FMV is in the ball park of the promised amount. So lower ct reasoning (that it is an option) is overturned.  ***Tax shelter*** means deductions upfront that can cover other income (can do through debt)  Ways to limit tax shelters:   1. AMT (less accelerate deprecation) 2. **§ 465**: Deduction Limited to Amount of Risk 3. **§ 469**: Passive Activity Loses and Credits Limited   **AW**: The point is that the attractiveness of accelerated depreciation is MAGNIFIED when you don’t have to use your own money |
| |  |  |  |  |  | | --- | --- | --- | --- | --- | |  | ***Crane* fn. 37** | ***Tufts* (Nonrecourse)** | **O’Connor (Recourse)** | | | **AR** | FMV of property at time of surrender | Loan Amount (-any repayment) | **Asset** | **Liability** | | FMV of property at time of surrender | Loan Amount (-any repayment) | | **Basis** | Full Cost (FMV of loan when surrendered + personal investment) – depreciation | Full Cost (FMV of loan when received + personal investment) – depreciation | Full Cost (FMV of loan when received + personal investment) – depreciation | FMV of property at time of surrender | | **= Today G/L** | X | X | (X)+(Y) | | | **– Depreciation** | -D | -D | -D | | | **= Overall G/L** | =OG/L | =OG/L | =OG/L | | | |
| **Capital Gains** | **Summary**:  Capital gains offers a favorable tax rate for gains (**§ 1(h)** + **§ 1221**). TPs want to be classified as CG for gain. Unfortunately, it offers limited deductions for losses, so TPs want to be classified as OI for losses (generally no limit) (**§ 1211** + **§ 1221**). But, if a TP can get into the “Promised Land”, her gains will be recognized as CG and losses as OI **(§ 1231**).  CG and OI: CG used to be indexed on OI, then it was independent, and now it is indexed again but with step-ups and step-downs, less fluid.  Rationale:   1. Bunching: Many transactions occur over different periods of time (many years) but may be sold reported (and are bunched into) the same year creating greater tax liability than if they had been reported as they accrued. A preferential tax rate ameliorates the bunching problem.  * Could solve this by using an averaging mechanism * **Pushback?** If this is the rationale, one-year holding period should be longer * **Pushback**: But the TP controls the realization method, can choose to avoid bunching (response, see Lock-in *infra*) * **Pushback**: TP wants it both ways, no tax until realization (*Eisner*) but a preferential rate if too much is realized at once * **Pushback**: Realization is best indicator of gain (while still administrable), there’s no reason to give preferential treatment b/c one has been particularly successful  1. Inflation: In so far as appreciation is due to inflation, TP is being overtaxed upon realization; no real gain, that is, no real increase in purchasing power. A preferential rate reduces the amount of over-taxation  * Could be solved by indexing basis for inflation * **Pushback**: Preferential rate has no relationship to rate of inflation, flawed fix * **Pushback**: Solution to inflation problem should be tax-code wide; CG shouldn’t be singled out for a benefit (especially b/c disproportionately benefits wealthy)  1. Encourage Investment: A preferential rate overcomes the inherent risk aversion b/c gains in the CGs arena will produce more after-tax income, more likely to make socially desirably risky investments (funding start-ups, innovation, etc.)  * This could be solved by giving “more generous allowances for losses” * **Pushback**: Generally, preferential treatments is not for risky investments and if it were, the “more generous allowances for losses” solution is the better solution  1. Lock-in: Preferential rate incentivizes realization (instead of waiting for tax nirvana) and allows for more fluidity in the market; better economic growth  * Could be solved by taxing appreciation as it accrues or abolishing step-up basis * SCOTUS adopts this rationale for **§ 1221** (*Corn Products*)   The CG Rate:  **§ 1(h)(3)**: Adjusted Net Capital Gains – ANCG determined by subtracting **§ 1250** unrecaptured gain (**(1)(E)** – real estate stuff) and 28-percent rate gain (**(1)(F)**) from NCG  **§ 1(h)(1)**: Capital Gains Rate – CG bracket determined by stacking Net CG on top of OI.   * **(A)** OI is taxed as if this provision didn’t exist * **(B)** Portion of ANCG that would be taxed below 25% if OI is **taxed at 0%** * **(C)** Portion of ANCG that would be taxed below 39.6% if OI is **taxed at 15%** * **(D)** Portion of ANCG that would be taxed at 39.6% if OI is **taxed at 20%** * **(E)** Unrecaptured **§ 1250** gain **taxed at 25%** (some real estate stuff) * **(F)** Anything in excess of the preceding sections **taxed at 28%** (***Collectibles***)   **§ 11(b)**: OI tax rates for Corporations in **§ 11(b)** is 35%  **§ 1201**: CG tax rate Corporations is also 35%   * IRC, in giving no preferential rate to corporations, seems to adopt Rationales #3 and #4 here; they don’t have to be bribed to do business + there is no tax nirvana   ~Summary of Incentives~  Corporations:   * Neutral as to CG v. OI * Prefer OL to CL (due to **§ 1211**) 🡪 Preference for **§ 1231** assets   Other TPs:   * Prefer CG to OI * If CL exceed CG by more than $3k, prefer OL to CL * Taken together, have an incentive to fight tooth and nail to get into **§ 1231**   Calculating CG:  **§ 1222**: Netting – To get the benefit of **§ 1(h)** you have to have a Net CG 🡪   * Net capital gain = Net Long-term CG – net Short-term Capital Loss, so: * Net any LTCG (LTCG – LTCL = NLTCG) * Net any STCG (STCG – STCL = NSTCG) * Subtract NSTCL from NLTCG (if no NSTCLs, subtract 0) * Again NLTCG – NSTCL = NCG (this is the amount taxed under **§ 1(h)**)   ***NB***: You can always use your losses against gains (first to the individual LT and ST gains) but you can’t always use STCG, they are taxed as OI (incentive to create STCL**!**).  **§ 1211**: If overall loss, no benefit under **§ 1(h)**, moreover deductions of losses are limited:   * Corporations: Capital losses limited to capital gains * Other TPs: Capital losses limited to capital gains + $3k * Rationale: Concern about creating losses by selectively realizing them; instead it creates an incentive to realize them at the same time with appreciated assets * **§ 1212(b)**: Carryover – If NSTCL exceeds NLTCG then STCL can be carried forward to next taxable year   Qualifying Assets and Statutory Requirements:  ***Initial Trigger***: Sale or exchange of a capital asset held for more than a year  ~Sale or Exchange (**§ 1222**)~  Narrower than “sale or disposition” in § 1001 (AR); e.g., lose house to fire you have AR but not a CG (*but see* **§ 1231** (involuntary conversion can create CG; bunching rationale?)   * If bunching/inflation rationales then **§§ 1001**, **1222** distinction doesn’t make sense   ~Holding Period (**§ 1223**)~  TP must hold asset from more than a year for LTC Asset, otherwise, STC asset   * Like Kind Exchange (b/c basis does not change) continues tolling * Rational: Bunching/Inflation don’t make sense for a 1-year holding period   ~Capital Asset~  **§ 1221(a)**: Capital Asset means ***property*** held by the TP (whether or not for T/B)   * “Capital Asset” 🡪 broad definition, must fall into exception to avoid CG treatment (*Arkansas Best*) * Read Exceptions broadly (*Corn Products*) * **EXCEPTIONS**: Read propert * **(1)** Stock-in-trade (i.e., **inventory**) primarily for **sale to customers** in ordinary course of business * Rationale: Lock-in – No incentive necessary, must sell to create income * **AW**: Congress is drawing a line between business income & investments * *Corn Products* read Inventory exception broadly (*Arkansas Best*) * **(2)** Depreciable property under **§ 167** used in T/B * **Promised Land**: Fall out of capital assets and INTO **§ 1231** *infra* * **(3)** Eisenhower Amendment – Copyright, literary, musical, or artistic composition, letter or memorandum, or similar property, **held by** * TP who created such property (or, in cases of letters, memos, similar property, for whom they were prepared/produced); ***or*** * TP who has ***carryover*** ***basis*** (received as gift) in such property * **§ 1221(b)(3)**: OPT-OUT for musical works or copyrights thereof S/E by TPs described in exception (3) (this section) * **§ 1235**: Sale of a patent is S/E of capital asset for individual (not corp) * **(7)** Hedging Transactions – Part of solution to *Corn Products*, **Futures** are excluded from Capital Assets (when ***all*** risk is removed, both loss and gain)   **§ 1202(a)**: If **[1]** not a corporation and **[2]** CG from sale of small business stock **[3]** held for more than 5 yrs 🡪 50% excluded from GI  ***NB***: Remember, if whole business is sold, **each asset** is identified and OI/CG is applied to each ***separately***  ~Link between § 170(e) Double Benefit and CG Treatment~  Under **§ 1221(a)(3)**:   * Collector gets cap gains (no carryover basis) and double benefit * Musician gets cap gains (**(1221(b)(3)**) but no double benefit (**170(e)(1)(B)(iii)**) * Artist gets OI and no double benefit. Isn’t this...***bizarre***?   **§ 1231**’s “Promised Land”:  **§ 1231(b)**: Threshold – “Property used in the T/B” mean **[1]** depreciable property under **§ 167**, **[2]** held for more than 1-year; ***or***   * **Real** property held for more than 1-year   **§ 1231(a)**: Property used in the T/B of TP will be treated as CG for gains, OL for losses   * **AW**: This is the Promised Land. If gain, capital gains rate. If loss, ordinary loss * **§ 1245**: Promised Land (**non-real**) property (like machinery) is subject to recapture to the extent of depreciation deduction (otherwise ***Asymmetry***). If Basis is 10 and TP take 5 of depreciation deductions and then sells for 20 🡪 untaxed as basis, 10 taxed as CG, 5 taxed as OI (amount of depreciation taken) * **§ 1250** Promised Land (**real**) property is subject to recapture to the extent of depreciation deduction above and beyond the depreciation that would be have resulted from straight-line depreciation. **NB**: Almost all real property is depreciated at straight-line so it rarely does anything.   CG Tests:  As in Assignment of Income, there is a fundamental question of what is property (and gets the preferential CG treatment) and what is income (and taxed as OI).  ~Recurring Receipts vs. One-time Sale~  IRC 🡪   * Replacement: * Similar to *Raytheon*; is what the payment replacing taxed as CG or OI? * Recurring Receipts: * One time sale: Land, bonds, stock 🡪 CG * Recurring Receipts: Rent, interest, dividends 🡪 OI * **§** **1(h)(11)**: dividends are taxed as CG but **AW**: exception, not the rule   ***Horticultural Reference***: The return to the Tree and the Fruit –   * *Hort* (and *Lake*): If right to receive future payments which would be taxed as OI is substitute for an upfront lump sum 🡪 OI * **AW**: Is the line between the **fruit** and the **tree** coherent? If terminating the lease is just the substitution for all rent payments, *isn’t selling the land (****i.e., the Tree****) just a substitute for all future rents*? * Also, there is no necessary connection between rationales for CG and rationales for who we tax for assignment of income * *Ferrer*: If you can get an injunction (equitable interest) 🡪 CG. Otherwise 🡪 OI * **AW**: Does it make sense to have all of this hinge on state law (civ pro)   + Marriage is also determined by state law   + Property law too (who owns property)   + But is that consistent with the purpose of cap gains? * *Lattera*: Three-Step Test: * Family Resemblance Test (look more like CG (stocks) or OI assets?) * Carve-out Test (**Fruit**/Horizontal = OI; **Tree**/Vertical = CG) * Character of the Asset Test (Right to Earn**ed** Income = OI; Right to Earn Income = CG)   **AW** Studio Rental Hypo:   * CBS leases TV studio for 60 yrs with obligation to restore property to original condition at the end of the term * When CBS renegotiates, the leasor reminds them of the original obligation  CBS buys them out   + How to characterize this payment:     - *Ferrer* would make it capital gain 🡪 equitable interest     - The tax code would make it capital gain 🡪 it’s a replacement for seats/other depreciable stuff in the studio (**§ 1221(a)(2)** 🡪 **§ 1231**)     - *Hort* would say it’s just a substitute for rent (ordinary income)  you could have charged more rent and not had this obligation   Misc.:  Professions that pay no OI:   * Via **§ 1221(a)(1)** – Traders on NYSE (not trading to customers, just open market) * Via **§ 1221(b)(3)** – Musician (can opt-out of the **§ 1221(a)(3)** exception) * Via **§ 1231(b)(4)** – Christmas Tree Producers |
| **HOMEOWNER BENFITS** | ~Nonrecognition~  **§ 121(a)**: Sale of Principal Residence – No Gain Recognized for sale/exchange of property used as Principal Residence for 2 (as aggregated periods) of the last 5 yrs   * **(b)**: Limitation 250k (or 500k for joint return) limit; only one sale every 2 yrs   ~S&L Tax Deduction~  **Homeowner**  The major beneficiaries are homeowners, we tax renters more carefully than homeowners. Even if it is politically infeasible to go after homeowners more, we could always give more to renters. Fuzzy line between tax and fee?  Another tax benefit to homeowners over renters since it effectively reduces your property tax BUT landlord can’t pass this benefit onto tenant because:   1. Because LL can deduct $4k of the $10k tax (assume t=40%), the tax only costs him $6k 2. But to recover that $6k after-tax, he needs to make $10k in additional pre-tax rent – (so he’s implicitly taxing the tenant)   SO the only way to capture this benefit is by owning your home and not renting – (homeowners shift burden to renters)  NY tries to get around this by saying that renter actually paid the tax and should be allowed to deduct   * **RR 79-180** 🡪 disallows this, Tenants cannot deduct payments of property taxes passed along by landlords as provided by state statute.   ~Interest~  **§ 163(h)(3)**: Qualified residences Exception – Deduction ***allowed*** for interest on debt for acquiring a qualified residence (principle residence and one other res (4)(A)(1)) if:   1. Debt is incurred for acquiring, constructing or substantially improving a QR; ***and*** 2. Debt is secured by such residence.   **Limitation** **(3)(B)(ii)** 🡪 9th Cir treats the **$1m** limitation as per TP, the rest of US treats it as per mortgage (you can’t get a deduction up to 200k, yes, like a marriage penalty)   * QR deduction benefits the wealthy more than the indigent – both b/c they are more likely to own homes and b/c ***deductions*** favor those with higher tax rates   ~Debt Forgiveness~  **§ 108(a)**: Discharge of Indebtedness – ***Included*** in GI, **EXCEPT**:   * Insolvency: * Exclusion of ***excess*** of debt forgiven in insolvency. Any assets retained will be taxed. * (50k debt forgiven, 40k assets left; 10k excluded, 40k taxed) * (b)(2)(E) - basis is decreased by the amt excluded b/c of insolvency * Qualified Principle Residence (**discharged before 2015**): * Preserve tax by reducing basis (**§ 108(b)**) 🡪 just a deferral * Capped at $2m for mortgages (w/ purpose of buying home)   ~Home Office Exception~  **§ 280A(a)**: ***No*** deduction for expenses from using ***home*** for business purposes   * **(c)(1)** Home Office: Allowable deduction for principal place of business * *Popov* Test: (*Threshold*: exclusive use (but is that believable?)) * (1) Relative importance of activities performed at each bus location; ***and*** * Where goods/services are delivered is particularly weighty, (cuts against her) but the ct finds this as difficult a fit for music as it would for an advocate and its podium and a professor and its lectern * (2) The time spent at each place * Usually a straight forward calculation of time (more time practicing than recording/performing) but this prong gets ***even more*** weight where “comparison of importance of functions performed at various places yields no definitive answer to the principal place of business.” * **(g)** Rental Use; if less than 15 days/yr, rent is not income/expenses not deductible * *Extreme Makeover*: Uses this provision to make improvements non-taxable, simply made as a rent payment – So much for Substance over Form; Way in excess of market rent, certainly is not normal way rent paid |
| **Indexed on Agi** | Medical expenses, child tax and earned income credits, Casualty Losses, charitable donations, misc. and overall itemized deductions |
| **POLICY QUESTIONS** | Constitutionality:   * *Eisner* and 16th Amendment   Fairness:   * Who does it favor/disfavor?   Economic Efficiency:   * Incentives?   Administrability:   * How complicated? Interaction with other sections of IRC? Easy to investigate? |