FIT Outline

**I. Introduction to Federal Income Tax**

*A. Computation of Tax Liability*

1. To determine FIT liability of an individual, must answer two questions:
   1. What is the applicable tax rate
      1. IRC §1 sets forth the rate for various taxpayers
         1. 1(a) applies to married individuals filing joint returns
         2. 1(b) applies to head of households
         3. 1(c) applies to unmarried individuals
         4. 1(d) applies to married individuals filing separately
   2. What is the tax rate applied to (what is the tax base)?
      1. Appropriate tax rate is applied to the **taxable income** of the taxpayer
      2. Taxable income is defined under IRC §63
         1. 63(b): For people who do not itemize their deductions, taxable income = (AGI –standard deduction –deduction for personal exemptions under §151)
         2. For all other taxpayers, taxable income = (GI – deductions allowed by §63(a)
2. §61: Gross Income
   1. Except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to):
      1. Compensations for services (fees, commission, fringe benefits, similar items)
      2. Gross income derived from business
      3. Gains derived from dealings in property
      4. Interest
      5. Rents
      6. Royalties
      7. Dividends
      8. Alimony and separate maintenance payments
      9. Annuities
      10. Income from life insurance and endowments
      11. Pensions
      12. Income from discharge of indebtedness
      13. Distributive share of partnership gross income
      14. Income in respect of a decedent
      15. Income from an interest in a trust or estate
   2. For compensation they are still owed during the taxable year, inclusion into gross income depends on whether they are “cash method” or “accrual” taxpayers
      1. Most people are cash method, and if this is the case, because they have not yet received that compensation to which they are owed, do not have to include it into GI for the taxable year
         1. §1.446-1(c)(1)(i) : cash method includes income only when it is actually or constructively received
      2. If they are accrual method taxpayers, it is included in GI currently because they earned it during the taxable year
         1. §1.451-1(a): accrual method includes income when all events have occurred that fix his right to the income and the amount can be determined accurately
3. Concept of Adjusted Gross Income
   1. §62 defines AGI as (gross income – ATL deductions)
      1. §62 is not a deduction granting provision, and in general, only those deductions listed in §62 are taken into account in computing AGI
   2. Two categories of deductions
      1. **Above the Line**: Comprised of deductions enumerated in §62
         1. Can be taken regardless if you itemize or not
      2. **Below the Line**: Deductions a TP considers only after the AGI has been determined
         1. Only allowed if you itemize deductions, foregoing standard deduction
   3. Taxpayer may deduct either the below the line deduction or the standard deduction, not both
      1. If the standard deduction exceeds the BTL deduction, there is no tax benefit and is in effect wasted
      2. BTL deduction is effectively deductible only if in the aggregate, they exceed the standard deduction
   4. Standard Deductions
      1. 1(a) married individuals filing joint returns: $11,400
      2. 1(b) head of households: $8,400
      3. 1(c) unmarried individuals: $5,700
      4. 1(d) married individuals filing separately: $5,700
   5. AGI is also important bc it is used to limit the deduction for certain personal expenses and is used as a basis in calculating various other “tax related” amounts
4. Deductions
   1. Deductions provisions of the IRC start at §161
   2. Every deduction must be authorized by a specific IRC sections
      1. §162: Wages paid to an employee are generally currently deductible
         1. *Higgins v. Commissioner* held that carrying on one’s own investment activities does not constitute trade or business
         2. If deductible under 162, it is ATL deduction pursuant to §62(a)(1)
      2. §262: Personal expenses are generally not deductible
      3. §167(a); 168: Deductions of depreciable property
      4. §212: Deduction for expenses paid or incurred during the taxable year for the production of income
         1. If it does not fall under §62(a)(1)/162 as a business expense (ATL deduction), look to §212 as possible BTL investment activity deduction
      5. §170: BTL deduction for charitable contributions
         1. §170(b)(1)(A) limits the TP’s BTL deduction to 50% of their contribution base (which is just AGI)
         2. Ex. If you have charitable contribution of $6,000, need AGI of at least $12,000 to fully deduct the $6,000
5. Taxable Income (Net Income)
   1. Formula for computing taxable income depends on whether the taxpayer itemizes
      1. If the taxpayer does not itemize deduction, TP is entitled only to the standard deduction in lien of any BTL deductions (other than personal exemptions)
      2. Clearly if the BTL deductions exceed the standard deduction, TP should itemize
      3. Taxable Income = (AGI – itemized deductions – personal exemptions)
   2. §67: 2% Floor on Miscellaneous Itemized Deductions
      1. Certain itemized deductions, called miscellaneous itemized deductions, may not be deducted except to the extent that in the aggregate, such deductions exceed 2% of the taxpayers AGI
      2. Itemized deductions **other than** §’s 163, 164, 165, 170, 642, 213, 691, 1341, 171, and 216 are considered miscellaneous itemized deductions
      3. Ex. If AGI is 100,000, and aggregate miscellaneous itemized deductions are 2,000 or less, none of the miscellaneous itemized deductions may be deducted.
         1. If MID’s aggregate is 2,500, then they exceed the 2% of AGI by $500 (100,000 x 2% = 2000; 2500-2000 = 500), and can deduct that amount
   3. Section 68 Overall Limitation on Itemized Deductions
      1. §68(a) provides that otherwise allowable deductions are **reduced by the lesser of**: 3% of the amount by which the TP’s AGI exceeds an inflation-adjusted applicable amount **or** 80% of otherwise allowable itemized deductions (must apply 2% floor first for miscellaneous itemized deductions to determine this amount)
         1. Applicable amount was $100,000 for joint returns, and 50,000 individually
         2. **WHAT IS THE INFLATION ADJUSTED AMOUNT FOR 2010**
      2. If the standard deduction for the Taxpayers is less than the remaining Itemized deduction, they will take the standard deduction in lieu of itemization
   4. §151(a) provides a deduction for **personal exemptions**
      1. §151(d)(3)(A) reduces the exemption amount by 2% for each $2,500 (or $1,250 if filing individually) by which the taxpayer’s AGI exceeds a specified inflation-adjusted threshold amount
         1. Original thresholds (151(d)(3)(C)) that **need to be adjusted for inflation**:
            1. Joint return: 150,000
            2. Head of Household: 125,000
            3. Unmarried individual, not head of household: 100,000
            4. Married individuals filing separately: 75,000
      2. In the case of a joint return, 2 TPs = 2 personal exemptions; there are additional exemptions for each dependent meeting requirements of §152(c), (d) – qualifying child or qualifying relatives
         1. §151(d)(1) sets exemption amount in general, at $2,000 that needs to be **adjusted for inflation** as set forth under 151(d)(4)
         2. **Adjusted for 2010: $3,650** (xi; .19)
      3. Even if TPs did not elect to itemize, §63(b) makes it clear that they are entitled to claim personal exemption in addition to the standard deviation
         1. Personal exemption and standard deduction provide a floor assuring that TPs will not be taxed unless they have income greater than the combined amounts of personal exemptions allowed and the standard deduction
6. Tax Rates
   1. TPs must apply the appropriate tax rate under §1 (which is adjusted for inflation under p. ix)
   2. Ex. If Joint return has taxable income of $93,400, Tax is $9,362 + 6,350 ((93,400 – 68,000) x .25) = $15,712 tax liability
      1. This liability is preliminary because it can be affected by the maximum capital gains rate provision of §1(h)
      2. §1(h) applies when the TP has net capital gain, including qualified dividend income
7. Credits
   1. TP must determine whether there are any credits which may be taken against the tax
      1. §§21 – 53 provide credits generally
   2. Most Common §31: Withholding taxes paid through the year by ER’s on behalf of the EE’s
      1. Self employed TPs are not subject to withholding tax, but would be required to make advance payments on the tax (estimated tax payment)
      2. Otherwise, the taxes withheld by ER’s during the year on behalf of the EE’s would be subtracted from the tax liability dollar for dollar
   3. Credit reduces one’s tax on a dollar for dollar basis, whereas a deduction reduces taxable income, thus providing reduction in tax that Is dependent n the tax bracket of the individual
      1. $1,000 deduction results in $350 saving for 35% bracket, but only a $150 tax savings for a person in a %15 bracket
      2. $1000 tax credit saves a person $1000, regardless of tax bracket

Gross Income

**II. Gross Income Concepts and Limitations**

*A. Search for a Definition of Income*

1. Determining what constituted “Gross Income”
   1. *Eisner v. Macomber*
      1. Income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets
      2. *Hawkins v. Commissioner* noted that this definition was incomplete, as there may be cases in which taxable income will be judicially found although outside the precise scope of the description already given
   2. *U.S. v. Kirby Lumber Co.*
      1. Ruled that discharge of a corporate debt for an amount less than the face of the debt resulted in income to the debtor
      2. Clear benefit economically from the discharge, even though it did not fit the *Eisner* definition of income
   3. *Commissioner v. Glenshaw Glass*
      1. Noted that *Macomber*’s definition was not meant to provide a touchstone to all future gross income questions; congress intended by its definition of GI to tax all gains except those specifically exempted (e.g. §102 gifts and bequests, etc…)
      2. Instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion is GI (widely inclusive and elastic)
   4. §61 and its enumerations of specific times of GI, together w/ other statutory provisions characterizing certain items as TI, describe most of the items constituting income
      1. Items not specifically addressed by the statute should be evaluated by reference to those which are   
         Income generally includes items that increase the taxpayer’s net worth
2. Examples of GI Determination
   1. *Cesarini v. United States*
      1. ¶61 is so broad and sweeping, there must be an expressed exclusion, or else ascension to wealth is generally gonna be regarded as GI
      2. Found treasure trove in a piano they purchased, even though treasure trove is not expressed under §61 as gross income, it is GI nevertheless
         1. 3 year statute of limitations begins to vest after they find it, not when it (unknowingly) first comes into their possession
   2. *Old Colony Trust Co. v. Commissioner* 
      1. Company resolved to pay the taxes of its officers, and this was considered GI
         1. Paid government 69% income tax off the $980,000 he was paid, which was $680,000 (essentially got paid an additional $680,000 to take tax off)
         2. Government gets tax off the 980,000 salary, and also taxes the 680,000 compensation for additional 300,000
      2. Essentially got paid 1.6 million, and was taxed about 1 million

*B. Income Realized in Any Form*

1. §1.61-1(a): GI may be realized in any form, whether money, property, or services
   1. Realization occurs when some event, by explicit rule or common practice, causes the tax system to account for income that previously existed in a form too unclear to tax
2. §1.61-2(d)(1): If services are paid for in property, measure FMV of the property is the measure of compensation; If paid for in form of services, the FMV of the services received is the amount
   1. FMV is generally the price a willing buyer would pay a willing seller, with neither under a compulsion to buy or sell, and both having reasonable knowledge of relevant facts
3. Difficulty of measurement of certain services should not obscure the fact of payment
   1. GI nevertheless does not encompass all accessions to wealth, there are some real limits on GI, even if they are not explicitly expressed in the IRC

*C. Realization, Imputed Income and Bargain Purchases*

1. Realization Requirement
   1. Mere appreciation in value of property is not taxable because the appreciation has not yet been realized, and will not be charged with income until such realization occurs
      1. Sale of property for cash is most obvious realization event
      2. Income is not found in cash alone, realization events are not limited to cash sale
   2. §1.1001-1(a): Gain or loss is realized on the conversion of property into cash or the exchange of property for other property differing materially either in kind or in extent
      1. *Cottage Savings Ass’n v. Commissioner*: Savings and loan ss’n realized losses on the exchange of its interest in one group of home mortgage loans for interest in a different group of home mortgage loans
         1. Realization is founded on administrative convenience(*Helvering v. Horst*)
         2. Exchange of property gives rise to a realization event as long as the exchanged properties are materially different – legally distinct entitlements
   3. Realization is fundamentally a matter of timing
      1. Unrealized total gain may fluctuate from time to time as the property’s value changes, but that total will only be treated as income only on realization
2. Imputed Income
   1. Imputed income is not taxed (IRC has no specific exclusion; matter of admin. practice)
      1. Imputed income deals with technical “income” incurred from self-help activity
      2. Ex. By mowing your lawn, repairing a pipe, or using your property to live in, you technically have an ascension to wealth, but are not taxed for it
   2. Imputed Income from Property: Homeowner vs. home renter example
      1. John buys a house for 250,000 where he lives (has rental value of 25,000), and Mary invests her 250,000 which earns 25,000/yr and rents a home
      2. John has imputed income of 25,000 rental value (he isn’t renting out the house) and is not taxed for it, but Mary is taxed on her 25,000 yr investment ascension to wealth each year
   3. Imputed Income from Services: Self-help
      1. If you mow your own lawn (assume that mowing is valued at $50), you technically have an ascension of $50, but that is untaxed imputed income
      2. If you mow your neighbors lawn, and he mows yours (**key:** but are not doing it as gifts to one another), each of you are taxed $50 for labor performed, where had you just mowed your own lawn, you get off untaxed
      3. Taxpayers may simply waive payment without being charged for income
         1. Whenever we assist other without expecting or seeking compensation, you are not taxed on the value of the free services you provide
   4. Self-Employment or Employment Activities as Imputed Income
      1. Ex. Value of farm products consumed by owner are not income
         1. Comparable to the rental value of a private residence, which has never been regarded as income or as a factor in the determination of tax liability
      2. In cases where commission is paid to salespersons purchasing for their own account has been found as taxable income, not imputed non-taxable income
         1. Life insurance agent receiving commission on buying LI on his own life
         2. Commission is viewed as income, not a reduction in purchase price
      3. Perhaps difference lies in the presence of another party (ER or independent contractor) who is viewed as making payment to the TP through reduction of the purchase price or application of the commission (depending on what TP preferred)
3. Bargain Purchases
   1. When a taxpayer purchases an asset for less than FMV, wealth has increased, however this is not taxable income because it is just a bargain purchase
      1. In the absence of any indication that the sale/purchase was not an arm’s length transaction, no taxable income on the bargain purchase
   2. *Pellar v. Commissioner*: When transaction is **not at arm’s length** and property is transferred as compensation for services in an amount less than its FMV, the difference between the FMV and amount paid is gross income
      1. If you buy a house for 275,000 that is worth $300,000, but the seller owes you $25,000 and satisfies obligation by selling for the lower price, you have $25,000 in taxable income – cannot ignore bargain element when it represents compensation
      2. In *Pellar*, 2 people have commercial relationship, and 3rd party benefits
         1. If the deal was one that no one else would have received, raises an allocation of income aspect, but benefit would be considered as the commercial partner’s that he passed along (he would be taxed), not the third party’s
         2. The gift would be to the third party, and the related party would be recognized as having gross income from the gift to the related 3rd party
   3. § 1.61-2(d)(2)(i): Do not misapply the realization requirement in connection with compensatory bargain purchase triggering GI
      1. Ex. ER transfer to an EE, as compensation, stock worth $500 in return for payment of $100; EE has GI of $400
      2. Incorrect to say that because $400 gain had not been realized, there would not be income until disposing of the stock
      3. $400 difference does constitute appreciation of the stock while under the EE’s control, it was given as compensation, and the FMV of that property must be sued to measure the compensatory value of the transaction

**III. The Effect of an Obligation to Repay**

1. Loans are **not** gross income
   1. Loan does not represent an accession to wealth or increase the taxpayers net worth because the loan proceeds are accompanied by an equal and offsetting liability
      1. Borrower has an obligation to repay the loan, negating treatment of loan as income
      2. Repayment of a loan does not reduce gross income (repayment is not deductible)
      3. Loans and repayments do not enter or reduce the income tax base
   2. Payment of one’s liabilities by another may give rise to GI
      1. If all or part of debt is forgiven by the lender, this is equivalent to the lender making payment on behalf of the debtor to the extent of the amount forgiven
      2. If lender is also an ER, under principle of *Old Colony Trust* this results in discharge of indebtedness income to the EE
      3. The **loan forgiveness** constitutes income
   3. Taxpayer may not avoid taxation by disguising compensation as a loan
      1. In order for a transfer of funds to constitute a loan, at the time the funds are transferred there must be an unconditional obligation on the part of the transferee to repay, and an unconditional intention non the part of the transferor to secure repayment of such funds (*Morrison v. Commissioner*)
      2. Observe totality of circumstances, and absence of a note is not dispositive (facts that lender had enough funds, shareholder had enough income for repayment, and evidence of any repayment would indicate a loan, not constructive dividends)
   4. Creditors have income under interest under §61(a)(4)
2. Claim of Right
   1. Money or other property received subject to a contingent repayment obligation is income
      1. The contingency of the repayment obligation does not transform the receipt of income into a loan
   2. *NA Oil Consolidate v. Burnett*: Claim of Right Doctrine
      1. If a TP receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to report, even though it may still be claimed that he is not entitled to retain the money and even though he may still be adjudged liable to restore its equivalent
   3. TP who properly reports income under the claim of right doctrine is entitled to a deduction if subsequently required to return the money
      1. Taxpayer may never be required to return the money, and under the doctrine, you do not wait the resolution of a contingency to decide where the money is income
      2. Money received under the doctrine, w/o restriction to disposition is income
      3. *Alamitos Land Co.*: claim of right doctrine applies to cases of self-imposed voluntary restraint while awaiting settlement dispute, and failing to identify it as income
   4. Funds where the taxpayer acts only as a conduit are not received under a claim of right
      1. *Ford Dealesr Advertisign Fund*: By receiving funds in trust destined for a specific use, with no gain accruing to the TP, they were not considered in gross income
         1. There was restriction to disposition of income
      2. When someone receives a bribe just to pass it along, he acts as a conduit
3. Illegal Income
   1. Gains from an illegal business and embezzled funds are both included in GI
      1. *James v. US*: When a TP acquire earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, he has received income which he is required to file, even though he may still be adjudged liable to restore its equivalent
   2. Not all illegal receipts are within gross income, there are marginal cases
      1. *Gilbert v. Commissioner*: Unauthorized withdrawals do not realize income under *James* when the taxpayer
         1. Fully intended to repay the withdrawn funds;
         2. Expected with a reasonable certainty to be able to repay;
         3. Believed that the withdrawals would be approved by the corporation; and
         4. Had prompt assignment of assets sufficient to secure the amount owed is more in nature of a loan
   3. Where embezzlement occurs, the embezzler is caught, and promises to make repayment, and there is a confession of judgment in favor of the victim, embezzlement still constitute GI
      1. *Buff*: The consensual recognition of indebtedness with the victim still does not transform it in to a loan
      2. Repayment of illegal income entitle the taxpayer to a deduction
   4. Distinguishing loans from illegal income
      1. Where there is a consistent pattern of fraudulent dealing demonstrating an absence of an intent to repay, merely labeling the funds obtained as loans will not avoid GI
      2. Where a taxpayer fraudulently misrepresented a transaction, nonetheless the proceeds they obtained were loans, not gross income, since the TPs had always regarded and treated the obligations as bona fide debt they intended to repay
4. Deposits
   1. Treatment of deposits as either advanced payment income or a non-GI loan turns on a fact and circumstance analysis
   2. *Indianapolis Power & Light Company v. Commissioner*:
      1. Focus on whether the utility company enjoyed the complete dominion over the deposits; “lack of unfettered domain” = not GI
      2. Key in determining complete dominion is whether the TP has some guarantee that he will be allowed to keep the money or is there an express obligation to repay
   3. Advanced Discount (Upfront Rebate Incentives): *Westpac Pacific Food*
      1. Where cash advances were subject to a subsequent obligation, and failure to do so would have required repayment, was not considered an accession to wealth
      2. Individual did not get any richer when it received its volume discount in the form of cash up front
      3. Had complete dominion over the cash advance, however there was no accession to wealth since it was just an increase in cash assets offset by an equal liability of purchase in response to the advance trade discounts – loan, not advanced payment
   4. Cash Advances as Income on Receipt
      1. Conversely, in situations where receipt of membership dues that obligated the recipient to provide specified services on demand, but were not subject to refund whether or not services were demanded, have been held as income on receipt

**IV. Gains Derived From Dealings in Property**

*A. Computing Gain Derived from Dealings in Property*

1. §61(a)(3) recognize taxation on **gain** derived from dealings in property
   1. Gain = (Amount Realized – Adjusted Basis of the property sold or exchanged)
      1. Amount realized on the sale or disposition of property = (Money received + FMV of any other property received)
   2. §1001(a): Adjusted basis requires a taxpayer to adjust her basis to reflect recovery of investment or any additional investment (reflects the impact events occurring subsequent to one’s acquisition of property may have on the amount of one’s investment in the property)
      1. If there is no additional investment or recovery of any cost, adjusted basis is the same as original basis
         1. Adjusted basis is also referred to as unrecovered cost
      2. Ex. Purchase a home for $350,000, then add a room for $75,000; the adjusted basis of the home would be $425,000 to reflect the additional investment
      3. Ex. Suppose the same home (sans investment) had a greenhouse destroyed in a storm and received $10,000 from the insurance company, instead of rebuilding she takes a trip and because the insurance proceeds represent a partial recovery of the cost of the home, the adjusted basis in the home becomes $415,000
2. Recovery of Capital
   1. TP may recover tax-free her investment (capital) in property before being charged with income from a disposition of the property
      1. Only the excess of the amount realized over her investment constitutes income
   2. Basis and adjusted basis implement the recovery of capital concept by providing a measure of capital (or investment) the taxpayer is entitled to recover tax-free
      1. Basis prevents previously taxed dollars from being taxed a second time
3. Dividends, Property Earnings, Interest
   1. These do not constitute a tax-free return on capital; rather, constitutes profit stemming from the investment and is treated as gross income
      1. These are viewed as earnings on or profit from one’s investment, thus it is not treated as having recovered any of her investment, and the basis in the investment is not adjusted to reflect these profits

*B. Tax Cost Basis*

1. Defining Tax Cost Basis
   1. If a TP receives property in lieu of cash compensation for services rendered, the FMV of that property is taxable to him as income
      1. The TP is then treated as having a **Tax Cost Basis** in the property equal to the FMV upon which he was taxed
      2. Establish a Tax Cost Basis when compensated with property, rather than cash
2. Examples and Applying TCB
   1. TP receives a car from his ER in lieu of cash compensation
      1. Car is worth $25,000 exactly equal to what he is owed, and TP has $25,000 compensation income
      2. The tax cost basis of the car is $25,000, and if he sells the car for $25,500, he only recognized $500 gain
   2. The ER who transferred the car in lieu of cash to satisfy an obligation owed to the TP would have tax implications also
      1. If ER’s adjusted basis in the car were $20,000, the ER would realize a gain of $5,000, difference between the obligation satisfied to EE and the adjusted basis
   3. If the car was worth $35,000, and TP paid for it with $10,000 cash and the obligation owed to him by the ER, bargain element must be characterized as compensation
      1. TP would have to report $25,000 compensation income
      2. Adjusted basis would be $35,000 (10k cash, 25k compensation income)
      3. Subsequent sale of $36,000 would only recognize $1,000 gain

*C. Impact of Liabilities*

1. Impact on Basis
   1. *Commissioner v. Tufts*: Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan under §1012 is part of the TP’s cost of the property
      1. Whether funds used to purchase property are borrowed or from savings, basis in the land would be the same amount
      2. Makes no difference that the lender is also the seller of the property, basis would be the same if the lender were a 3rd party
      3. Even under nonrecourse liability (where lendee is not personally liable for repayment of borrowed funds), the nonrecourse nature of the loan does not change the taxpayer’s basis in the property
   2. By reflecting in the basis of property the debt incurred by a taxpayer in acquiring the property, the tax system gives credit to a taxpayer for an investment the TP has yet to make
      1. Having received advanced credit for making the investment, TP is not permitted to increase her basis when the debt is paid
2. Impact on Amount Realized
   1. §1.001-2(a)(1): Necessary corollary to the inclusion of liabilities in basis, liabilities of the TP assumed by the purchaser is included in the TP’s AR
      1. Where as part of the purchase price, a buyer agrees to assume the seller’s liability, it is just as though the buyer paid the amount of liability directly to the seller and the seller used that amount to pay off liability
      2. Payment by the buyer of the liability amount to the seller would be included in the seller’s amount realized
   2. Two General Rules
      1. Recourse liabilities assumed by a TP in the acquisition of property are included in the TPs basis in the property
      2. Seller must include in her amount realized on a sale of encumbered property the recourse liabilities assumed by the purchaser
   3. Ex. D purchased a home for $400,000, borrowing $300,000 and paying $100,000 from his own savings. D then sold the home to M for $500,000, $225,000 in cash and M assumed the $275,000 that D still owed the lender at the time of the sale to M.
      1. D’s liability assumed by M is included in the amount realized (225,000 + 275,000 – 400,000 AB) for a $100,000 gain
      2. M’s basis in the property is $500,000 (225,000 cash + 275,000 encumberment)

C. Basis of Property Acquired in Taxable Exchange

1. *Philadelphia Park Amusement Co. v. US*
   1. Court held that the cost basis of the property received in a taxable exchange is the cost basis of the property **received in the exchange**
      1. When property is exchanged for property in a taxable exchange, the taxpayer is taxed on the difference between the AB of the property given in exchange, and the FMV of the property received in exchange
      2. For purposes of determining gain or loss on the exchange, the FMV of the property is treated as cash and taxed accordingly
         1. Upon exchange of property, you are taxed for the net gain or loss that is incurred
         2. Afterwards, the basis in the property you received is its FMV
   2. Gain and loss are distorted if the FMV of property given in the exchange becomes the cost basis of property you received in a taxable exchange (cost basis should be FMV of property **received**)
      1. You transfer property worth 10,000 (you have 5,000 basis in it), and receive property worth 9,000 in exchange.
         1. If your cost basis in the 9,000 property is 10,000, there would be a $1,000 loss inherent in the exchange
         2. Where your net gain on the exchange was 4,000 (9,000 AR – 5,000 basis of property given), the loss on the exchange makes the net gain only 3,000
            1. This is a stepped up basis as you would be taxed on less gain then you are supposed
      2. Conversely, if you receive the 10,000 property, and your basis is the FMV of the property you just gave up ($9,000), you recognize a $1,000 gain on the exchange
         1. If your basis in the $9,000 property you gave away was $12,5000, your §1001(a) loss on the exchange is $2,500 (10,000 AR – 12,500 AB)
         2. However, your net loss of $2,500 is affected by the perceived gain of $1,000 on the exchange of properties because you used the FMV of the property you gave away as the basis in the property you received
         3. In that situation, you are subject to a “double tax” of sorts, as the loss he actually sustained on the transaction was understated (less deduction)
   3. Taxable exchanges involving assumed liabilities
      1. Dory gives a truck ($25,000 basis, FMV $30,000) in exchange for a Kevin’s property ($40,000 FMV and $10,000 encumberment attached that Dory assumes)
         1. Dory’s AR is $40,000; AB for the §1001 net gain calculation is $35,000
            1. AB for the net gain calculation is the $25,000 basis in the truck + the $10,000 encumberment on Kevin’s property
            2. Thus, $40,000 - $35,000 = $5,000 net gain
         2. Dory takes a $40,000 tax cost basis in the property moving forward for any future transactions involving the property he received in the exchange
            1. If Dory were to make a future payment on the mortgage principle, basis would not be affected because she was already credited in basis with paying the $10,000 mortgage balance (though she had not paid it yet, only assumed the debt)
         3. Kevin’s AR is 40,000 (30,000 FMV of truck and 10,000 debt off his hands)

**V. Gifts, Bequests, and Inheritance**

*A. Exclusion of Gifts from Income*

1. §102(a): Gifts and Inheritances
   1. Generally, gross income does **not** include the value of property acquired by gift, or acquired from a decedent through bequest, devise or inheritance
      1. Gifts and property which we receive as a result of the generosity of a person during life or at death is excluded from gross income
   2. Exclusion for gifts is **not** limited to intra-family wealth transfers (though these are seen as the most common and typically meet §102(a))
   3. The further a transfer is removed from the family context, the justification for the 102(a) gift exclusion is much weaker, and whether the transfer rises to level of a gift is questionable
2. Nature of the Gift
   1. Threshold Question for §102(a): Whether whatever is received can be **characterized** as a gift, bequest, devise or inheritance?
      1. **Motive of the donor** is critical in characterizing receipts as gifts under §102(a)
   2. *Commissioner v. Duberstein*:
      1. Gift in the statutory sense proceeds from a **detached and disinterested generosity**, out of affection, respect, admiration, charity or other impulses
         1. Most critical consideration is the transferor’s intent, which is determined through a totality of the circumstances approach
      2. Ex. Duberstein and Berman did work together. Berman said he wanted to thank Duberstein for all his help and gave him a car, which he deducted as a business expense. Dubesrtein did not report it as GI, citing the §102 gift provision
         1. The car that Duberstein received was not a gift, because it was not disinterested generosity, it was to encourage future help for Berman
         2. Looking at transferor’s intent, he characterized it as business expense
   3. *Olk v. United States*
      1. From the TP’s point of view, regularity of the flow, equal division of receipts, and daily amount received indicate that a casino dealer, acting reasonably, would regard tokes (tips from gamblers) as a form of compensation
         1. Very regular and daily part of dealer’s take-home compensation
      2. Question over detached and disinterested generosity standard because dealer’s offer no real service back to gambler’s for the tips; however, court says tribute to gods of fortune can be described as an involved and intensely interested act
   4. *Goodwin v. United States* 
      1. The highly structured, rooted, and regular program establishes the money raised by the congregation, given to the pastor as compensation, not a gift
      2. Pastor argues that these are gifts out of love/respect, but this was not detached and disinterested gifts on part of the congregation bc they wanted to retain his services
      3. The Congregation’s (transferor) motive for this payment program was essentially for compensation purposes
3. Employer-Employee “Gifts”
   1. §102(c): Employee Gifts
      1. In general, §102(a) shall **not exclude** from GI any amount transferred by or for an ER to, or for the benefit of an EE
      2. Look to 74(c) for exclusion of employee achievement awards from GI, and 132(e) for excluding certain de minimis fringe benefits from GI
   2. Most significant limitation to 102(a) is the denial of an exclusion for amounts transferred by an ER to, or for the benefit of an EE
      1. Ex. Martha gives John a new car as a gift. Martha is John’s employer.
         1. §102(a) does not apply, under 102(c), John has GI
   3. §1.102-1(f)(2): Regulations “exclude extraordinary transfers to the natural objects of an ER’s bounty” from 102(c) if the EE can show it was not due to his employment
      1. Section 102(c) “**does not apply** to transfers to related parties, where the transfer can be substantially attributed to the familial relationship,” not to the employment
      2. Ex. Same as above, but John is Martha’s son, so 102(c) does not apply, gift is excludable from GI under 102(a)
4. Business Gifts
   1. §274(b) disallows a deduction under §162 or §212 to 3rd party recipients who receive gifts in excess of $25 from a business
      1. Business can transfer property to an individual and characterize the transfer as compensation and presumably entitle itself to a business deduction; **or** 
         1. Transferor’s motive would assuredly deny §102(a) exclusion to the recipient
      2. Business could support the recipient’s characterization of the transfer as an excludable gift, losing rights to claim a business expense deduction
   2. Keep in mind that §102(c)(1) negates gift status for transfers only from ER to EE
      1. ER to EE transfers do not implicate §274(b), as it applies only to items excludable as gifts under §102
5. The Nature of a Bequest or Inheritance
   1. **Threshold question** for a Bequest or Inheritance: Is the cash or property received a bequest, devise or inheritance, **or is it compensation** or some other form of taxable item?
      1. Case-by-case approach to characterization is required
   2. *Wolder v. Commisioner*:
      1. Wolder agreed to render legal services to client, and instead of billin her, client agreed to leave certain property to Wolder by her will
      2. The bequest was simply the form chosen to provide compensation for services, the property’s status as a “bequest” was irrelevant to its characterization for tax purposes, and it was held to be income
6. Statutory **Limitations** on the 102(a) GI Exclusion for Gifts, etc…
   1. §102(b): Subsection (a) shall **not exclude from GI**:
      1. Income derived from any property referred to in 102(a); or
      2. Any gift, bequest, devise, or inheritance that is income from property (the amount of such income)
      3. Where, under the terms of the gift, bequest, devise or inheritance, the payment, crediting, or distribution is to be made at intervals, to the extent of what is paid, credited, or distributed is income from property, it should be treated as such, with no 102(a) exclusion
   2. §102(b)(1) Ex. Income from property (the property itself is excluded as a gift, bequest, devise, or inheritance) is not excluded from GI
      1. Martha gives Peter share of IBM stock which pays a dividend every three months
      2. The value of the stock is excluded from Peter’s gross income under 102(a), but under 102(b)(1), the dividends are not excluded, and are income under 61(a)(7)
   3. §102(b)(2) Ex. Income from property, whether the gift is made during life or at death, is denied an exclusion from GI
      1. Mom dies leaving a portfolio to the benefit of the son and her grandchildren. Company will manage the portfolio, and distribute income annually to the son, and when the son dies, the grandchildren will receive value of property in equal shares
      2. Under 102(b)(2) the income from property is taxable, had she given him the stocks outright, he could have excluded value of portfolio, but still not income derived; the grandchildren will get exception to GI under 102(a)
      3. This section codifies the holding of *Irwin v. Gavit*

*B. Basis of Property Received by Gift Bequest or Inheritance*

1. §1015: Basis of property acquired by gifts and transfers in trust
   1. If the property was acquired by gift after 12/31/1920, the basis shall be the same as if it still belonged to the transferor; however, if the transferor’s basis is greater than the FMV of the property at the time of the gift, the transferee shall take a basis of FMV in the property
2. Gifts of Appreciated Property
   1. §1015(a): Substituted or Transferred Basis
      1. Effect of the transferred basis rule is to shift the tax burden associated with the appreciated value of the stock from the donor to the donee
   2. Ex. Claude buys a share of X stock for $200, and gives it to Mary when it is worth $400
      1. Claude does not realize gain, and Mary’s basis in stock is $200
      2. Donor’s gain and donee’s basis are necessarily related
         1. Bc there was no realization event, Claude realizes no taxable gain on the gift
      3. $200 untaxed, unrealized potential is preserved by requiring Mary to retain the same basis in the stock that Claude had
   3. *Taft v. Bowers*
      1. As to the property received donee’s voluntarily assume the position of the donor
      2. Additional limitation to general exclusion rule for gifts: Appreciation inherent in gifts is ultimately taxed to the donee
      3. In our progressive system, TP in a high bracket may be encouraged to gift appreciated property to a related TP in a lower bracket (who assumes the same basis the donor had) so the gain will be taxed at the lowest rate possible
3. Gifts of Property – Basis in Excess of FMV
   1. §1.1015-1(a)(1), (2)
      1. Though a donor may shift potential gain, §1015 prevents shifting of loss to the donee
      2. Where FMV of property is less than the donor’s adjusted basis in the property, the donee **for loss purposes only**, will take a basis equal to FMV of the property
   2. Ex. Claude buys stock for $200, when its value is $100 he gifts it to Mary. The value further declines to $75 when she sells it for that amount
      1. For loss purposes, Mary’s basis under 1015(a) is $100, and loss realized is $25
      2. Unrealized loss of $100 at the time of the gift from Claude just disappears
         1. Better of selling the stock, deducting the loss, and gifting the $100
   3. Ex. Same as above, but the stock’s value increases and is sold for $300
      1. Special loss rule of 1015(a) is inapplicable, because she has a realized gain, no loss
      2. Therefore entitled to use the general rule of 1015(a), takes Claude’s $200 basis and gain on a sale of $300 stock is $100
   4. When property is given away with inherent unrealized loss, 1015(a) realy provides a donee with two possible basis calculations
      1. Basis to use when determining gain (take on donor’s basis in property), and basis to use when determining loss (FMV of depreciated property)
   5. When selling a gift for an amount between the gain basis and loss basis you have no gain
      1. Same as first example, but sells stock for $125
      2. Using loss basis ($100) she has no loss, and under gain basis ($200), no gain
4. Basis of Property Received by Bequest of Inheritance
   1. §1014(a): Basis of property acquired from a decedent
      1. Generally, the basis of property in the hands of a person acquiring property from a decedent, or to who inherits property from a decedent (if it hasn’t been disposed of by then) will be the FMV of the property at the date of the decedent’s death
   2. This provision effectively steps up (or steps down) the basis of property acquired from a decedent to the FMV of the property at the time of the decedent’s death
      1. For appreciated property, 1014(a) provides tax amnesty for the gain inherent in the property at the time of a person’s death
         1. Only the appreciation occurring after decedent’s death will be subject to tax
      2. If property decreased in value during the lifetime of the decedent so that decedent’s basis exceeds the FMV, 1014(a) negates the inherent loss in property
   3. §1014(a) also applies to property acquired from a decedent though means other than will or intestate succession; also applies to joint tenancy or community property (1014(b))
      1. Ex. Tom and Sue are married; own a stock in joint tenancy. Assume they each contribute $50 to purchase the stock, so the total basis is $100
      2. 1014(b)(9) – Joint tenancy, do not live in community property state
         1. Sue holds stock with basis of $150, Tom’s half interest at death was $100, and Sue gets a stepped up basis for Tom’s interest by form of ownership
      3. 1014(b)(6) – Community Property States
         1. Sue will hold the stock with a basis of $200. Tom’s half interest will be included in his estate, and will get a basis step up of $100, and under (b)(6), Sue gets a step up to $100 as well, for an aggregate basis of $200
5. Limitation on Basis of property acquired from a decedent
   1. §1014(e): Appreciated property acquired by decedent by gift w/in 1 year of death
      1. If appreciated property was acquired by the decedent by gift 1 year before the decedent’s death, and that property is acquired by the original donor (or spouse) of such property, the basis of property in the hand of such donor (or spouse) shall be the AB of the property immediately before the death of the decedent
         1. When you gift property, you take on AB of the donor, but via bequest, etc… your new basis becomes the FMV of the property
      2. This rule prevents people from dumping appreciated property on terminally ill family members, so they can get a tax break with a higher basis after receiving it via bequest, etc… after that person dies
   2. Note that §1014(e) does not apply if the decedent lives more than on year after the gift is originally given, or if the decedent bequeaths the property to anyone besides the original gift-giver (or his spouse)

*C. Part Gift, Part Sale*

1. Part gift, part sale occurs when friends or family members sell property for less then FMV
   1. §1.1001-1(e): The seller-donor has gain to the extent that the AR exceeds her AB in the property; no loss is recognized on such a transaction where AR is lower then AB
      1. Ex. Sally sells property to her grandchild, Erin, for $10,000. Sally originally bought it for $20,000 and it now has value of $50,000 at time of sale.
      2. A: Sally has no gain or loss under 1.1001-1(e), AR (10k) is lower then her AB (20k); Erin’s basis is $20,000 (the greater amount under 1.1015-4)
   2. §1.1015-4: Donee’s basis will be the **greater** **of** (1) the amount the donee paid for the property, or (2) the AB of the donor (plus any gift tax paid)
      1. Consistent with 1015(a), **donee’s basis** is limited to the FMV of the property at the time or the transfer to the donee **for computing loss**
   3. Gain can be recognized on a part-gift, part-sale if, instead of payment (or in addition to), a liability assumed by the donee exceeds the seller-donor’s basis in the property
      1. Ex. Assume the lot in the previous example was subject to a liability of $10,000, and that Erin assumes that debt instead of paying $10,000 cash
      2. A: This is still part-gift, part-sale, Sally’s AR is still $10,000 under 1.1001-2(a)(i), (4)(ii), (iii), and neither gain nor loss is recognized on the transaction. Erin’s basis under “greater of” rule is $20,000

**VI. Sale of a Principal Residence**

*A. Ownership and User Requirements*

1. §121(a): Exclusion of Gains from Sale of Principal Residence
   1. GI **shall not** include gain from the sale or exchange of property, if during the past 5-years (ending on the date of the sale or exchange), such property has been owned and used by the TP as the TP’s principal residence for periods aggregating 2 or more years
2. Under the current §121, TP’s may exclude up to $250,000 ($500,000 with respect to certain joint returns) of the gain on the sale or exchange of a qualifying principal residence
   1. No requirement that the residence sold be the TP’s principal residence at the time of sale or exchange
   2. Requires that TP owned and used the property as a principal residence for periods aggregating 2 or more years during the five year period preceding sale/exchange
3. §1.121-1(c)(1): Ownership and use requirements may be satisfied during non-concurrent periods as long as the taxpayer satisfies each of them within the five year period ending on the date of the sale or exchange
   1. Ex. Renting a home between 2000-2005, then purchasing the home in 2005, and subsequently selling it in 2007. §121 exclusion applies because they used it for a principal residence in between 2002 and 2007, and owned it for 2 years between 2005 and 2007.
4. Short temporary absences, such as absences because of vacation or seasonal absence (even if accompanied by rental of the residence) will be counted as periods of use
   1. §1.121-1(c)(4) Ex. 5: Two month periods during which TP was in Italy each summer are short temporary absences, and counted as periods of use in determining whether TP used the residence for the requisite period
   2. §1.121-1(c)(4) Ex. 4: Spending his sabbatical lasting for 1 year in Italy would not be considered a short temporary absence and not counted towards TP use of property
5. §121(d)(2): If an unmarried individual sells or exchanges property following the death of his or her spouse, the individual’s **use and ownership period** for purposes of 121(a) will include the period the deceased spouse owned and used the property
   1. Ex. Mary owns home in 2003, marries Bob in 2006, Mary dies in 2007 and leaves Bob the home. He sells it in 2008, and although he owned and used the house for less than 2 years, his period of ownership and use includes Martha’s periods before her death, so he meets 121(a)
6. §121(d)(3)(a): If an individual receives property in a transaction described in 1041 (transfer of property between spouses or ex-spouses), that individual’s **ownership period** for purposes of 121(a) will include the ownership period of the transferor (§1.121-4(b)(1))
   1. Ex. Mary and Bob divorce, and under the property settlement, Anna transfer title to a home she owned to Bob. Although Bob never had any previous ownership interest, for 121(a) purposes, Bob is considered to have owned the home for the period that Anna owned the home
7. §121(d)(3)(b):If an individual continues to have an ownership interest in a residence, but is not living in the residence bc the other spouse was granted use of the residence under a divorce/separation settlement, individual will still be considered to use the property during the time that spouse or former spouse is granted the use of the property (§1.121-4(b)(2))
   1. Ex. Mary and Bob divorce, and under the settlement, Mary is forced to move out the home but continues to have an ownership interest in it. 5 years later the house is sold for a gain, and even though she did not use the home as her principal residence during that 5 year period preceding the sale, she will be deemed to have so used it
8. §121(d)(7): If an individual becomes physically or mentally incapable of self-care, as long as that individual owned and used the residence for one year in the 5 year period prior to sale, that individual will be treated as using the residence as his principal residence ofr any period during the 5 year period for which the individual, while owning the property, resides in a facility satisfying certain requirements

*B. Amounts Excludable*

1. §121(b): Limitations on 121(a) Exclusions
   1. §121(b)(1): Generally, 121 allows a taxpayer to exclude up to $250,000 gain
   2. §121(b)(3): The exclusion applies to only one sale or exchange every two years
   3. §121(b)(2): If the TP’s file a joint return, they may exclude up to $500,000 of the gain if certain requirements are met
      1. One of the spouses must satisfy the ownership requirements;
      2. Both spouses must satisfy the use requirement; and
      3. Neither spouse has used the exclusion within the past two years
2. Other circumstances also enable a married couple to claim exclusions totaling up to $500,000 on the sale of homes w/o satisfying 121(b)(2)
   1. Husband and wife each owned their own home before they married and the couple sold both of the houses shortly after marriage
      1. If one of the spouses had used the exclusion within the past 2 years, the other spouse could still exclude up to $250k for their individual property
   2. Husband and wife who work in different parts of the country and have separate principal residence are entitled to exclude up to $250,000 of the gain on the sale of each of the residences
      1. If husband can only exclude 200k on his property, but wife could exclude over 250k, wife cannot use her husband’s unused 50k exclusion to exclude gain in excess of the individual 250k limit
3. 121(b)(4): For sales and exchanges after December 31, 2007, a widowed taxpayer who has not remarried can sell or exchange his principal residence and claim an exclusion up to $500,000 if:
   1. The sale/exchange occurs not later than 2 years after the date of death of the TP’s spouse; &
   2. The requirements of 121(a)(2)(A) were met immediately before date of the spouse’s death
4. Under §121, two people who are not married but who jointly owned and used the same home as their principal residence would each be eligible to exclude up to @250,000 of their respective gain, assuming all other requirements of §121 were satisfied
   1. Ownership and Use Requirement
   2. No other sale or exchange of property in the past 2 years

*C. Exclusion for TP’s Failing to Meet Certain Requirements*

1. §121(c): Exclusion for Taxpayers Failing to Meet Certain Requirements
   1. If a sale or exchange occurs because of a change in place of employment, health, or certain unforeseen circumstances, and a TP cannot meet the ownership and use requirements of 121(a) or the once-every-two-year rule of 121(b)(3), 121(c) provides some or all of the gain may still be excluded
      1. The maximum excludable amount of gain will be a fraction of the $250,000 limit ($500,000 where 121(b)(2) is met)
   2. Ex. Sean buys and lives in a home for a year then is transferred by his ER to a different location. He sells and realizes a gain of $600,000
      1. Does not meet the ownership and use of 121(a), but under 121(c)(1), exclusion will be limited to a fraction of the $250,000 exclusion otherwise available
      2. Numerator is length of time Sean owned and used home as a principal residence, and denominator will be 2years; fraction is ½ of $250,000
      3. Sean is entitled to exclude up to $125,000 gain from the $600,000 gain realized, thus only required to recognized $475,000 gain
   3. Ex. Where both spouses have not used the home as their principal residence for at least 2 years during a five year period, the exclusion on their joint return will be the sum of each spouse’s limitation amount determined as if they had not been married
      1. Assuming house was previously owned and used as principal by the husband, and wife only lived there for year with him, husband gets a full $250k exclusion, and the wife is eligible to exclude $125k (1 yr/2yr x 250k), for a total of $375K exclusion
   4. Ex. Same as above, but the couple is not married and not entitled to file a joint return, but they are still tenant’s in common
      1. §1.121-3(c) provides that a sale will be treated as a sale by reason of change in place of employment If the primary reason is a change in the location of a qualified individual’s employment
      2. §1.121-3(f)(3) includes the co-owner of the TP’s residence as a qualified individual
      3. As a co-owner to the TP qualified individual, even though not married, entitle to an exclusion like above, assuming she lived there for one year
2. §1.121-3 addresses the reduced maximum exclusion under 121(c)
   1. Provides safe harbors relating to sales or exchanges by reason of change in employment, health, or other unforeseen circumstances
   2. §1.121-3(e)(1) provides that a sale or exchange is by reason of unforeseen circumstances if the primary reason is the occurrence of an even that the TP could no reasonably have anticipated prior to purchasing and occupying the residence
3. §1.121-3(e)(2) provides specific events deemed unforeseen circumstances
   1. Involuntary conversion of the residence; Natural or man-made disaster, or acts of war or terrorism resulting in a casually to the residence; Death; Divorce or legal separation; Multiple births resulting form the same pregnancy
   2. Sale or exchange not within the unforeseen circumstances safe harbor will not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence, or an improvement in financial circumstances

*D. Limitation on Exclusion for Depreciation Claimed*

1. §121(d)(6)
   1. Provides that the exclusion shall not apply to the gain realized on a sale of one’s principle residence to the extent that the TP claimed depreciate deductions for that residence at any time after May 6, 1997
   2. This provision is commonly applicable when a TP has used part of her home as a home office, and has claimed depreciation deductions w/ respect to that part of home
   3. Ex. If TP had properly claimed a total of $15,000 in depreciation deductions with respect to her home office, and the TP sold the home and realized a $75,000 gain, under 121(d)(6) only $60,000 of gain would be subject to exclusion under 121(a)
2. To the extent that a TP has claimed depreciation deductions with respect to property, §121 exclusion will be reduced

*E. Principle Residence*

1. Majority-of-Time Test
   1. §1.121-1(a)(2): If a TP alternates between 2 residences, the residence the TP uses a majority of the time during the year will ordinarily be considered the TP’s principal residence
   2. Ex. During a 5-year period, TP spends 5 months/yr at a house on a coast, and 7 months/yr at a house in the city. Although TP owned and used the home on the coast as a residence for a period aggregating more than two years during the period, the home on the coast will not ordinarily be considered her principal residence
2. §1.121-1(b)(2) and *Guinan v. US*
   1. Majority of time is not dispositive, regulations provide a non-exclusive list of other factors relevant to identifying a property as a TP’s principal residence:
      1. TP’s place of employment
      2. Principal place of abode of family members
      3. Address listed on TP’s federal and state tax return, license, registration, voter card
      4. Mailing address for bills and correspondence
      5. Location of taxpayer’s banks
      6. Location of religious organization and recreational clubs the TP is affiliated with
3. §1.121-1(b)(3) and *Bogley*
   1. The sale or exchange of vacant land is not a sale or exchange or the TP’s principal residence unless:
      1. Vacant land is adjacent to land w/ the dwelling unit of TP’s principal residence
      2. TP owned and used the vacant land as part of the TP’s principal residence
      3. TP meets the requirements in the sale or exchange of a dwelling under §121 **within** 2 years before or after the date of the sale or exchange of vacant land; and
      4. Requirements of §121 have otherwise been met with respect to the vacant land

**VII. Scholarships and Prizes**

*A. Prizes and Awards*

1. §74:Prizes and Awards Generally Taxable
   1. 74(a): Generally, GI includes amounts received as prizes & awards, as they represent a clear ascension to wealth
   2. 74(b): Gross income **does not** include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if:
      1. Recipient was selected w/o any action n his part to enter the contest or proceeding
      2. Recipient is not required to render substantial future services as a condition to receiving the prize or award; and
      3. Prize or award is transferred by the payor to a governmental unit or organization (*see* 170(c)(1), (2)) pursuant to a designation made by the recipient (74(b)(3))
   3. Because of §74(b)(3), the meritorious achievement exception now applies only if the recipient gives up the prize
      1. In order to qualify for the exclusion, the recipient must also designate a governmental unit or qualifying charity to which the payor transfers the prize
      2. Timely designation must be made and carried out before the award is used (§1.74-1(c)(1), (d), (e)(2))
   4. §1.74-1(f): Since no GI is generated, no charitable deduction is allowed either
2. §74(c): Employment Achievement Awards are Exempt
   1. Principal exclusion for §74 are for employee achievement awards
      1. Requires that the award consist of tangible personal property, given in recognition of a qualifying length of service or safety achievement, is not payment or compensation in disguise as an award
      2. When award is not in cash, §1.74-1(a)(2) states that the measure of income is FMV
   2. EE achievement awards establish “double tax benefits”; deduction for the ER and an exclusion for the EE in certain circumstances
      1. ER’s deduction for the cost of EE achievement awards is limited to $400/yr
      2. If the cost of the award is fully deductible to the ER, the EE may exclude the award from income
      3. If the cost is not fully deductible, the award constitutes gross income to the extent its value or cost (whichever is greater) exceeds the deduction limit
      4. Excess cost amount cannot be greater than the value of the award itself
   3. Qualified plan awards are EE achievement awards that are given as part of an established written plan or program of the TP that does not discrimination in favor of highly compensated EE’s as to eligibility of benefits
      1. EE achievement awards shall not be treated as a qualified plan award if the **average cost of all EE achievement awards** provided by the ER during the taxable years **exceeds $400**
      2. ER’s deduction (**BTL or ATL?**) limit increases to a maximum of $1600 with respect to qualified plan awards (compared to $400 for EE achievement awards)
   4. Ex. ER provides EE an EE achievement award of tangible personal property that is valued at $300 and cost the ER $300. This is not a QPA
      1. Award is fully deductible to ER, and EE has no gross income, because the value of the award does not exceed $400
   5. Ex. Same as above, however, award has value of $600 and cost the ER $500
      1. EE has a gross income of $200 because EE has GI to the extent value or cost, whichever is greater, exceeds $400 (value is higher here; 600-400 = $200)
      2. ER can deduct up to $400 of the $500
   6. Ex. Same as above, but the award is considered a QPA
      1. As long as the **average cost** of all QPA’s given out by the ER is under $400, the $500 would be fully deductible to the ER and the EE has no income on the $600

*B. Qualified Scholarships*

1. §117: Qualified Scholarships
   1. In general, GI does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization as described under §170(b)(1)(A)(ii)
2. Limitation on Exclusion under §117
   1. Exclusion for scholarships and fellowships are limited to **qualified scholarships** received by degree-seeking students at qualifying educational institutions
      1. There is no exclusion for scholarships or fellowships received by those who are not “candidates for degrees”
         1. Students attending a primary or secondary school, and undergraduate or graduate students pursuing an academic or professional degree at college;
         2. Students at institutions pursuing employment-training or programs acceptable for full credit towards a bachelor or higher degree
   2. Qualified scholarship is limited to that portion of a scholarship or fellowship used for tuition and course related expenses (qualified tuition)
      1. No tax benefit for personal living expenses to scholarship recipients, but still have a tax benefit with respect to tuition and fees
      2. Statute requires that the scholarship be used for tuition and related expenses in accordance with the conditions of the grant, but actual “tracing” of the funds is not required (§1.117-6(e)
   3. Ex. Mary receives a $10k scholarship at a University where she is a candidate for a B.A. Tuition and course-related expenses are $8,500
      1. The qualified scholarship amount is $8500, so she has income of $1,500
   4. Ex. Same as above, but the terms of the scholarship require her to apply $4,000 to room and board at the University
      1. Because room and board is not qualified tuition or a related expense, $4,000 will constitute GI, and the remaining scholarship of $6,000 is not GI since it does not exceed the $8,500 cost of tuition or related expenses
3. §117(c): Scholarships as Compensation
   1. No exclusion is allowed for scholarship amounts that represent payment for services
      1. Ex. Mary receives a $10,000 scholarship, but is required to work in the library 10 hours a week as a condition for the scholarship
      2. Some portion of the scholarship apparentsly constitutes payment for services, and that portion will contitute GI under 117(c)
   2. *Bingler v. Johnson* 
      1. TP’s received payments from their ER under a program while they were on educational leave from their job, pursuing postgraduate study. During a preliminary work-study phase, TPs were required to hold their positions with the ER, and following the educational leave they were required to work for the ER for a minimum of two years. They received stipends during their leave that related to their salaries and fringe benefits were maintained.
      2. SCOTUS held that the payments were in the nature of quid pro quo for services rendered (whether in past, present, or future) and were not excludable as scholarships, but were taxable as compensation under applicable regulations
   3. Additional Examples
      1. Medical interns and residents trying to cast the remuneration as a fellowship grants have particularly been likely to lose
      2. Graduate teaching and research assistants often lose where it was found they were primarily being paid to teach rather than paid to study
      3. Generally for ER-EE scholarships, it is difficult to avoid the quid pro quo reasoning that holds scholarships as taxable compensation
4. §117(d): Qualified Tuition Reduction
   1. Although ER-EE scholarships maybe unlikely to qualify under §117(a), some ER provided educational benefits are still tax-free
   2. Qualified tuition reduction programs, essentially a special fringe benefit for EE’s of educational organizations and their family members, are non-taxable
      1. They cannot discriminate however, in favor of highly compensated EE’s, even though the programs are compensatory in nature, of potentially great value, and limited to one category of EEs
5. §127: Educational Assistance Programs
   1. ER payments for educational assistance to the EE are excluded from GI, up to a maximum of $5,250 per year
      1. Program cannot discriminate in favor of highly compensated EEs and is subject to various other requirements
      2. Educational assistance includes tuition, and course related expenses, but payments for meals, lodging, transport and certain other expenditure do not qualify (127(c)(1))
   2. §1.127-2(a)(4): No requirement that the education be job-related or part of a degree program, and purely personal educational benefits may be obtained on a tax-free basis
      1. Qualified Scholarship treatment applies to grants from a private foundation established by a corporation to provide scholarships to children of EE, or to EE themselves as long as the grants are controlled and limited by substantial non-employment related factors so that the employment relationship is just an initial qualifying condition
6. Non-qualifying scholarships and fellowships are generally includable in income by virtue of 74(a)
   1. In this situation, the §102 gift exclusion (from GI) is inapplicable (§1.117-6(b)(1))

**VIII. Life Insurance, Annuities, and IRA’s**

*A. Life Insurance*

1. §101(a)(1): Certain death benefits
   1. Proceeds received under a life insurance k (whether in a single sum or on a payment plan) are generally excluded from GI if it is paid because of the death of the insured
2. Exclusion of Mortality Gains
   1. Life Insurance Bright Line Rule: Life insurance proceeds paid “by reason of the death of the insured” are excluded from GI
      1. Risk element: portion of an insurance premium that purchases insurance against the risk of dying at a given time
      2. Savings element: portion, if any, that exceeds the actuarial cost of pure risk insurance
   2. Term Life Insurance: Pure risk insurance and contains no savings element
      1. Ex. TP pays a $100 premium for a $50,000 one-year term life insurance policy
         1. If TP dies during the one-year period, beneficiary receives $50,000 on TP’s $100 investment, but the $49,900 mortality gain is tax free under 101(a)(1)
         2. If TP survives the period, he loses $100 and has a mortality loss; mortality loss in not deductible bc it is a personal expense (§262)
   3. Ordinary Life Insurance: Provide both life insurance over a period of time and act as investment vehicles
      1. Constant level premium is paid to provide a given amount of insurance over the life of the insured (premium is necessarily greater than it would be for the same amount of term life insurance)
      2. Only part of the premium insures the TP against risk of dying, the remainder is, in effect, invested by the insurance company on behalf of the insured, and “cash value” builds up over the years, reflecting both the excess portions of the premiums, but earnings on them as well (later the death, more cash value build-up in the insurance)
         1. Owner of the policy may typically borrow against the cash value, or obtain it outright by termination of the policy by surrendering it
         2. Neither the insured nor the insurance company is taxed on this “inside build-up” (invested cash value) while it accumulates (tax deferral is the main advantage of insurance as investment vehicle)
   4. Ex. Risk Element and Savings Element Under 101(a)(1) Exclusion
      1. TP has owned ordinary life policy with face value of $50k for 15 years, and paid $12,000/yr or $18,000 total in premiums. Term insurance would only have cost $10,000 over the same period, and insurance company has earned $4,000 for TP on the excess $8k ($18k – term life $10k) premiums; thus cash value of policy is $12k ($8k + $4k). TP dies and beneficiary receives $50k.
      2. Entire $50k is tax-free under 101(a)(1). Tax-free $50,000 consists of:
         1. $8,000 (return of the “excess portion” of premium)
         2. $4,000 (interest earned by the “excess amount; cash build-up)
         3. $10,000 (return of the risk portion (term insurance) portion of premium)
         4. $28,000 (net mortality gain; $50k – 12k = $38k (term insurance portion); $38k - $10k (actuarial cost of that term portion) = $28,000 net mortality gain)
      3. Mortality gains on life insurance and excess portions of premiums are tax-exempt; Interest earned on the savings element is not only deferred, but tax-exempt as well
   5. §101(a)(1) exclusion applies to the proceeds of “life insurance k’s” as defined under §7702
      1. Essential elements of insurance generally are the shifting of risk from policy holder to insurer and the distribution of risk among the policy holders
      2. Permits full tax advantages associated with life insurance to be available only to those k’s where the risk element is real and substantial
      3. If life insurance k does not meet requirements of §7702, mortality gains and excess portions (return of capital) are tax-free, but interest earnings/cash-build up are taxed
3. Death of the Insured
   1. **Requirement for §101(a) exclusion**: Proceeds received under the life insurance k must be payable “by reason of the death of the insured” to qualify
   2. Ex. Seller of property (on installment basis) takes out insurance on the life of the purchaser in an amount equal to unpaid balance of the purchase price
      1. Does not qualify for 101(a) exception since, in effect, proceeds would be collection of the unpaid purchase price, not for death of the insured
4. Surrender for Value
   1. If the insured (not chronically or terminally ill) surrenders an ordinary life insurance policy for its cash value, proceeds are **not** payable by reason of death; §101 does not apply
   2. Instead, rule §72(e) applies:
      1. Proceeds are taxable only to the extent they **exceed** the total consideration paid for the policy (insured’s basis in the policy – 72(e)(6))
      2. In effect, can deduct otherwise nondeductible (mortality loss) premiums
   3. Ex. TP received $10,000 for surrender of ordinary life policy after paying premiums equal to $9,000 total. Only $4,000 of the premiums represent actuarial cost of term insurance
      1. TP’s income is only $1,000; §72(e) permits not only the $5,000 “excess portion” to be returned, but also the $4,000 actual risk portion as well
         1. The normally nondeductible mortality loss of $4000 is made deductible
5. Interest Income
   1. §101(a)(1) applies to both life insurance proceeds (on account of the insured’s death) paid by lump-sum or in installments
      1. Exclusion is **not** intended to cover post-death earning on the proceeds
   2. §101(c): Interest payments on amounts withheld by the insurer under an agreement to pay interest on those investments **is taxable** 
      1. Ex. Life insurance proceeds are $100k, to be paid to beneficiary two years after TP’s death. In the interim, Beneficiary receives $6,000/yr interest from the insurance company on the proceeds
         1. $6,000/yr are taxable; $100k paid two years later is not
      2. Ex. Alternatively, assume life insurance proceeds of $100,000 are to be paid in five annual installments of $25,000
         1. §101(d) provides that the principal portion of each installment should be tax-free and the interest portion be taxable
         2. Amount held by the insurer is to be prorated equally over the given number of installments; payments excess prorated portions are taxable (§1.101-4(a)-(c)); $20,000/yr is tax free and $5,000 will be taxed
6. Transfer for Value
   1. The section 101(a)(1) exclusion does not require the insured to be the owner of the policy, nor does it prohibit the owner of a policy from also being the beneficiary of insurance on the life of another
      1. Ex. If A has an insurable interest in the life of B, A may take out a policy in which B is the insured and A is the beneficiary; proceeds A receives by reason of B’s death will be w/in 101(a)(1) exception
   2. §101(a)(2): If an individual purchases a policy from another, transfer for value rules apply
      1. Unless an exception applies (§101(a)(2)(A), (B)), the exclusion will be limited to the consideration A paid B, and any premiums or other amounts subsequently paid by A
      2. Insurance proceeds in excess of these payments will be taxable
      3. Applies not only to arm’s length commercial transactions, but to intra-family purchases as well
   3. Ex. B sells insurance policy to A for $5,000. The policy has a face amount of $25,000, and on B’s death A receives the $25,000. A may exclude from income only $5,000 plus any additional premiums or other amounts paid by A.
      1. Note that A could avoid the unfavorable tax results by simply purchasing a new policy on B’s life directly from an insurer
7. Group Term Life Insurance
   1. ER-paid cost of group-term life insurance is a tax-free fringe benefit up to $50,000
   2. ER’s cost for insurance in excess of the $50,000 level is taxable compensation

*B. Annuities*

1. §72(a): General Rule for Annuities
   1. Generally, GI includes any amount received as an annuity under an annuity, endowment, or life insurance contract
2. §1.72-1(b): Definition of an annuity
   1. Amounts received as an annuity are amounts payable at regular intervals over more than a year, provided the time period or the total amount payable is determinable on the date payments are deemed to begin
3. §72(b)(1): Exclusion ratio
   1. Determines how much of each annuity payment is excludable as a return of basis
      1. [Investment in the k / Expected return] x Amount received as an annuity
      2. Non-excluded portion is included in gross income pursuant to 72(a)
   2. Annuities are commonly set up to be paid for as long as TP lives, and by consulting mortality tables, can be determined how many ears TP is actuarially expected to live, so an expected return under an annuity k can be established (72(c)(3)(A))
      1. If TP outlives expected mortality, TP receives a “mortality gain,” and if TP dies before expected mortality date it is a “mortality loss”
   3. §72(b)(2): Once the investment in the annuity k is fully recovered, further payments on the mortality gain are fully taxable
   4. §72(b)(3): If a TP dies before fully recovering her investment, the unrecovered investment is deductible for her last tax year
      1. Ex. If investment is $10,000, expecting return o $1,000/yr for 25 years, $400 of each payment is not-taxed capital (basis) return. If TP dies after 20 payments, she only recover $8k of her $10k investment, can deduct unrecovered $2k for last taxable year
4. Annuities are typically deferred payment annuities; premiums are paid in for a number of years before payment commences
   1. During those “pay in” years, premiums are earning investment income free of tax, and earnings are not taxed until the annuity starting date
   2. Withdrawals before annuity starting date are taxable to the extent of earnings on the investment (§72(e)(2), (3), (4))
   3. Premature distributions from an annuity k may also be subject to a 10% penalty tax on that portion of distribution constituting income (§72q)

*C. Individual Retirement Accounts*

1. Deductible IRAs
   1. §219(a) authorizes an annual deduction for qualifying cash contributions to an IRA
      1. For 2008, maximum deductions is $5,000 (**what is inflation rate for 2010?)**
      2. §219(b)(5)(B): Max deduction amount increased by $1,000 for TP’s 50 or older
   2. Deduction is phased out where the TP, or the TP’s spouse is an active participant in certain pension plans and has an AGI in excess of the “applicable dollar amount” (219(g))
      1. **Look up applicable dollar amount and phase out for 2010**
      2. No deduction is allowed for contributions once the TP reaches age 70 ½
   3. Max allowed as a deduction cannot exceed the amount of the TP’s compensation income
      1. For married persons filing a joint return, the compensation of the TP’s spouse is taken into account in determining compensation
   4. IRAs are subject to rules of §408
      1. §408(e)(1): Accounts are exempt from taxation; accrued income in an IRA is not taxed until distributed
      2. §408(d)(1): Distributions from IRAs are includable in GI under annuity rules of §72
         1. Where contributions to an IRA are deductible, and the income accrued by the IRA has not been taxed, all distributions from the IRA will be fully taxable
   5. Investment-for-retirement purpose of the IRA is effectuated in two ways:
      1. Distributions from an IRA must commence by April 1 of the year following the year the taxpayer reaches 70½
      2. Conversely, a 10% penalty tax on early distributions from an IRA (72(t))
         1. Applies only to the income portions of the distribution;
         2. Does not apply to distributions after age 59½ or retirement after age 55
2. Nondeductible IRAs
   1. Active participants in certain pension plans, with AGI greater than the phase-out limits, cannot make deductible contributions to IRAs
      1. Still permitted to make non deductible contribution to an IRA under §408(o)
      2. Total annual contribution (deductible or not), which any TP makes to one or more IRAs cannot exceed the deduction limit dollar amount
      3. Similarly, nondeductible contributions cannot be made once the TP reaches 70½
   2. Although contributions may be nondeductible, they still enjoy advantage of tax deferral
      1. Income earned by the IRA is not currently taxed and grows tax-free until distribution
   3. Under annuity rules of §72, pursuant to §408(d)(1), distributions attributable to nondeductible contributions are taxable only to the extent of the income portions
      1. Ex. Don contributed $10k in n-d contributions to his IRA, and when balance reaches $15k, he receives $3k distribution.
      2. Because 2/3 of the balance represents nondeductible contributions, and 1/3 represents income earned on contributions, the two-thirds ($2k) of the distribution is nontaxable return of capital (basis), and $1,000 of distribution is income
   4. Early distributions are subject to the 10% penalty tax noted above with respect to the income portion of a distribution, and mandatory distributions must commence by April 1 of the year following the year TP reaches 70½
3. Roth IRAs
   1. §408A(b): Roth IRA must be so designated when it is established
      1. Contributions to a Roth IRA are nondeductible (408A(c)(1))
      2. Qualifying distributions from a Roth IRA are completely tax-free
   2. Contributions to all of one’s IRAs cannot exceed the annual deduction limit of §219
      1. Contributions to a Roth IRA are further limited based on TP’s modified AGI
      2. **What is 2010 inflation rate for phase out under 408A(c)(3)**
   3. Qualified distributions from a Roth IRA are excluded from income if (408A(d)(2)):
      1. They do not take place within the five-tax-year period that begins with the first tax year for which a contribution is made to a Roth IRA; and
      2. They are made after the TP attains age 59½, dies or is disabled
   4. Unlike deductible and nondeductible, contributions may be made to a Roth IRA after age 70½ and there is no requirement that distributions from a Roth IRA commence once the TP reaches 70½ (408A(c)(4), (5))

**IX. Discharge of Indebtedness**

*A. Case History*

1. *Bowers v. Kerbaugh-Empire Co.*
   1. TP borrowed money repayable in German marks, and did not constitute taxable income when TP repaid the loan with greatly devalued marks
   2. Because the borrowed money was lost entirely in a business venture (irrelevant), repayment of the loan with devalued marks only reduced TP’s loss (no gain recognized is the key point)
      1. Mere reduction of loss is not gain, profit or income
   3. Exclusion of loan proceeds from income is based on the existence of an offsetting obligation to repay the loan
      1. If the loan is not repaid in full, the TP-debtor should be required to report the excess of the loan proceeds over the amount repaid as income
2. *US. v. Kirby Lumber Co.*
   1. TP issued bonds for which it had received the par value of the bonds, and in the same year, repurchased some on the open market for $140k less than par
      1. In repurchasing, TP had an asset which was not offset by any liability, so TP had greater assets than it had before
   2. TP should recognize GI in the amount of the difference between the amount it received for the bonds when issued and the amount it paid for the bonds upon repurchase
      1. Distinguished from *Kerbaugh* bc the transaction there, as a whole, wasa loss
      2. By contrast, as a result of its repurchase, *Kirby Lumber* made available $140k in assets previously offset by the obligation of those bonds
   3. Holding emphasizes two (2) points for recognizing discharge of indebtedness income:
      1. Taxpayer was solvent at all relevant times; and
      2. Balance sheet of the TP reflected an increased net worth (or “clear gain”) as a result of the reduction of liabilities without a dollar-for-dollar reduction of assets

*B. Specific Rules Governing Exclusion*

1. Discharge of Indebtedness when TP is Insolvent (Pre-1980 Bankruptcy Tax Act)
   1. *Dallas Transfer*: If a TP were insolvent before and after the discharge or cancellation of a debt, no income results
   2. *Lakeland* Grocery: A debtor realizes income to the extent a discharge of indebtedness made the debtor solvent; TP realizes gain when it obtains assets clear of liabilities
2. Insolvency Exception under §108(a)
   1. There is no recognizable discharge of indebtedness income if the discharge occurs when:
      1. The taxpayer is insolvent (101(a)(1)(B)) or in a Title 11 [bankruptcy] case; **and**
      2. The amount excluded does not exceed the amount that the TP is insolvent (108(a)(3))
   2. Insolvent means excess liability over FMV of assets determined on the basis of TP’s assets and liabilities immediately before the discharge
      1. Except under 108(e), there is no insolvency exception from the general rule that GI includes income from the discharge of indebtedness
   3. Ex. Bill borrowed $50k from Kevin, and when Bill was insolvent, Kevin accepted $25k in satisfaction of debt. He also owed $40k to Julie. His total assets prior to paying bill as $60k
      1. After paying Kevin $25k, he still owed Julie $40k ($60-25 = $35k). He is still insolvent to the amount of $5k (40-35 = $5k), and under 108(a)(1)(B), Bill has no income as a result of the forgiveness of the debt by Kevin
      2. Assuming Bill only owes Julie $30k, he recognizes $5,000 of income from Bill’s forgiveness of debt; ($35k remaining in assets – $30k debt to Julie = $5k income)
3. Discharge on Indebtedness on Principal Residence
   1. §108(a)(1)(E) and (h): Exclusion for qualified principal residence indebtedness discharged on or after 1/1/07 and before 1/1/13
      1. Applicable to the discharge of any qualified principal residence indebtedness so long as the discharge is directly related to the decline in the value of the residence or to the financial condition of the TP (h3)
      2. TP taking advantage of the exclusion under 108(a)(1)(E) must reduce her basis in her principal residence by the amount excluded (but not below zero)
   2. Qualified principal residence indebtedness is up to $2 million of indebtedness secured by the TPs principal residence as long as the indebtedness is incurred constructing, acquiring, or substantially improving the residence
4. §108(f)(1): Discharge on Certain Student Loans
   1. Discharge of any student loan (whole or in part) are excluded from GI
      1. Discharge pursuant to provision of such loan under which all or part of the debt would be discharged if he worked for a certain period of time in certain professions
   2. Student loan includes any loan made by qualified lenders to an individual to assist in attending an educational institution with regular faculty, curriculum, student body (f2)
      1. Also includes loans may by a qualifying educational institution to refinance student loans that assisted in attending the education institution, but only if refinancing is pursuant to a program designed to encourage students to engage in public service
   3. Qualified lenders include the US (instrumentality or agency thereof), state or territory of the US, certain tax-exempt public benefit corporations, or the educational organization itself under 108(f)(2)(D)
5. §108(e)(5): Purchase-Money Debt Reduction for Solvent Debtors
   1. When debtors (purchaser) and sellers resolve disputes by agreeing to reduction in the remaining balance of the purchase price of a property, while the debt of the taxpayer has been canceled in part, under the circumstances **no income** results
      1. Reduction is considered a retroactive reduction in purchase price
      2. As a result, the basis of the TP in the property is correspondingly reduced
      3. Reduction **cannot** stem from a title 11 case, or purchaser **cannot** be insolvent
   2. Ex. Mike agrees to buy a house from Tom for $200,000, paid over 20 years. Five years later, the value of the house declines to $125,000 and Mike still owes $175,000. Tom agrees to reduce the remaining balance for owning the house under the k to $100,000. Mike remains solvent throughout the process.
      1. The $75,000 reduction in price does not trigger discharge of indebtedness income. Under 108(e)(5), treated as if the purchase price had been $125k rather than $200k
      2. Mike’s basis in the cabin will be $125,000
   3. Where the TP borrows money from a 3rd party lender in order to purchase property from another, reduction is treated as discharge of indebtedness income
      1. §108(e)(5)(A) focuses on the reduction of a debt of the purchaser of the property to the seller arising out of the purchase (requires a purchaser/seller relationship)
         1. Creditor/debtor relationship is insufficient
         2. Generic credit card transaction are **not** sales of property under 108(e)(5)
      2. An agreement to reduce a debt between a purchaser and a third-party lender (credit card company) is not a true adjustment of the purchase price paid because the seller of the property has already received the entire purchaser price from the TP and is not part of the debt reduction agreement
         1. While debt arose under purchaser of the property by A from B, debt was actually owed to C, thus no 108(e) debt between actual purchaser and seller
6. §108(e)(4): Acquisition of Indebtedness by Person Related to Debtor
   1. If a person related to a debtor (under 267(b) or 707(b)(1)) acquires the indebtedness, acquisition shall be treated as an acquisition by the debtor
      1. Relationships include individual and family members; shareholder and a corporation where shareholder owns more than 50%of the outstanding stock; partnership and a person owning more than 50% of capita or profit interest in the partnership
   2. Ex. Jackie owns more than 50% stock in XYZ and has a relationship under 108(e)(4). XYZ issues bonds for which it receives par value, and Jackie repurchases bonds on the open market for amount considerably under par (*Kirby Lumber*)
      1. Jackie is related to XYZ under statute. Jackie’s acquisition of bonds is attributed to XYZ, and 108(e)(4) prevents XYZ from avoiding discharge of indebtedness income
7. §108(e)(2): Exception to Discharge of Indebtedness Income for Deductible Debts
   1. Forgiveness of a debt does **not** generate discharge of indebtedness income if payment of the debt would have been deductible
   2. Ex. Finn owes Jess $20k for services she provided the business. Fin pays $15k and Jess forgives the $5k of debt. Assume the services would be deductible as a business expense.
      1. Because cost of services are deductible, Finn has no income on $5k forgiveness

*C. Disputed or Contested Debts*

1. *Preslar v. Commissioner* 
   1. If a taxpayer disputes the original amount of a debt in good faith, a subsequent settlement of that dispute is treated as the amount of debt cognizable for tax purposes
      1. If the amount of a debt is disputed (or contested liability), settlement of the amount does not constitute a discharge of indebtedness
      2. Excess of the original debt over the amount determined to have been due is not GI
   2. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated (debt in dispute as to proper amount)
2. *Zarin v. Commissioner*
   1. Liquidated debt (no ambiguity to the amount of debt allowed), if unenforceable, would implicate the contested liability doctrine
   2. Where a debt is unenforceable, the amount of the debt is in dispute, and settlement of that debt just fixes the amount of debt that is cognizable for tax purposes
      1. By paying that settlement amount, there can be no discharge of indebtedness income

*D. Discharge of Indebtedness as Gift, Compensation, Etc…*

1. Gift exclusions are not applicable where a debtor purchases his own obligations at a discount
   1. Doubtful any TP will be successful in arguing the discharge of indebtedness in a commercial context constitutes an excludable gift (*Jacobson*)
2. In certain contexts, cancellation of indebtedness can be an excludable gift
   1. Ex. If a parent lends money to a child and subsequently forgives the debt, forgiveness of debt would likely be considered a gift excludable under 102(a)
   2. Reasonable intent for forgiveness here, where similar intent just does not exist commercially
3. Cancellation of indebtedness under some circumstances may represent a form of compensation or some other form of payment which should not be considered income from discharge of indebtedness within 61(a)(12)
   1. Ex. Smith and Brown enter k, Smith refuses to pay Brown for goods bc he failed to complete the shipment. Brown sues to recover 10k he is owed for shipping, Smith counter claims for breach of k. Settle suit with Smith paying $7,500 and Smith dropping the suit, and Brown forgiving $2,500
   2. From a tax standpoint it is as if Smith pays $10k and receives $2,500 in damages for lost profits. Smith should be treated as receiving damages for lost profits for $2,500, not for having discharge of indebtedness income. §108 is inapplicable here.

*E. Inapplicability of §108 to Gain Realized on Transaction Involving Discharge of Indebtedness*

1. *Gehl v. Commissioner*
   1. §108 grants an exclusion to insolvent TPs **only** as to income from the discharge of indebtedness, it does **not** preclude the realization and recognition of income from other sources (such as where gain is realized on a transfer of appreciated property by an insolvent debtor to a creditor in partial satisfaction of a debt)
   2. Ex. Aaron owes Barney $50k, and accepts a tract of land in satisfaction of the full debt. Land had FMV of $30k and AB of $20k
      1. Aaron will have discharge of indebtedness income excludable under §108 of $20k
      2. He recognizes $10k gain ($30k FMV - $20k AB) and $20k discharge of indebtedness income ($50k - $30k) in $30k satisfaction of debt (FMV of property)
   3. Bifurcated analysis
      1. Transfer of the land in satisfaction of $30k debt is treated outside of §108 (income of $10k is recognized; $30 FMV - $20k AB), while the forgiveness of the remaining $20k ($50k debt - $30k FMV) falls within §108

**X. Compensation for Personal Injury, Sickness, and Property Damage**

*A. Damages*

1. Business or Property Damages
   1. General Rule: In lieu of what were the damages rewarded? (*Raytheon Products Corp.*)
      1. Recoveries which represent a reimbursement for lost profits are **income**
   2. Where the suit is not to recover lost profits but is for injury to good will, the recovery represents a return of capital and, with certain limitation, is not taxable
      1. However, even if recovery represents a return of capital because it takes the place of the business good will does not mean it does not contain taxable benefit
      2. If compensation for the loss of business good will is in excess of its cost, it is GI
   3. Ex. Maria filed suit seeking recovery of prepaid costs as well as $20,000 in lost profit. Settlement paid Maria $15,000.
      1. Under the “In lieu of test,” $10k of the $15k recovery should be treated as a return of the prepayment and will not constitute income. $5,000 represents lost profit (GI)
2. §104(a)(2): Damages Received on Account of Personal Physical Injuries or Sickness
   1. Excludes from income any damages received, whether by suit or agreement, as a lump-sum or periodic payment, on account of personal or physical injuries or physical sickness
   2. §1.104-1(c): Damages excluded under 104(a)(2) are those received through prosecution or settlement of “tort, or tort type rights”
   3. Prior to the 1996 amendment restricting exclusion to physical injury or sickness awards, EEs recovering awards for wrongful discharge, discrimination or any other employment related claims constituted a “personal injury” under *Threlkeld*
      1. EEs could exclude not only the damages received on account of emotional distress or other psychological injuries, but also lost wages
3. SCOTUS Limitations on the Pre-1996 104(a)(2)
   1. Personal Injury: *Burke v. US*
      1. Question to be asked in §104(a)(2) cases is whether the injury complained of is a tort type personal injury
      2. Limited nature of circumscribed remedies afforded by Title VII (back pay, etc…) are not damages received on account of personal injuries under the statute
   2. Damages Received “On Account of” Personal Injury: *Schlier*
      1. Only damages which are on account of personal injuries under 104(a)(2) are those that bear a close nexus to the personal injury
         1. If no appropriate nexus between damages and personal injuries, no exclusion
      2. Back pay under ADEA, Title VII is not intended to compensate for personal injury or its consequences, but rather to ensure that TP received those wages he would have earned had ne not been illegally discharged
4. Exclusion for Personal Physical Injury or Sickness: The 1996 Amendments to §104
   1. Distinction between Physical and Non-Physical Injuries
      1. Exclusion is limited to those damages received on account of physical injuries or physical sickness
      2. Emotional distress is not to be treated as a physical injury or physical sickens (except for the amount related to medical care expenses)
   2. Clarification for §104 Exception:
      1. Claim has its origin in a personal physical injury, a recovery for emotional distress may be excludable
      2. If the claim has its origin in a physical injury, it is not necessary that the recipient of the damages be the individual who suffered the physical injury
         1. Damages (not punitive) received by someone on a claim for loss of income due to physical injury or sickness of that person’s spouse is excluded from GI
   3. “Physical injury” under 104(a)(2) requires direct unwanted or uninvited physical contact resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding
      1. No physical injury status to a significant, but undefined range of physical symptoms grouped under “emotional distress” (insomnia, headaches, stomachaches, etc...)
   4. Ex. Doctor is seriously injured in a ski accident and brings negligence actions against the resort, seeking damages for medical expenses, pain and suffering, and lost income. Settlement between doctor and resort is $1.5 million.
      1. All damages flowing from the personal injury, including the lost income, will be excludable (104(a)(2) origin requirement is met)
      2. Assuming settlement was based solely of some libel and slander printed in a newspaper, not based upon and physical injury or sickness, the entire settlement would be taxable, including lost income (whereas it would be excluded above)
5. Punitive Damages
   1. Amendments to §104(a)(2) make clear that exclusion does not apply to punitive damages
      1. Pre amendments, *O’Gilvie* held that 104(a)(2) did not exclude punitive damages bc they did no meet the “on account of definition,” not compensation, were punishment
   2. Ex. Same facts w/ Doctor, but $500,000 of the $1.5 million settlement is punitive damages
      1. Settlement except for the $500,000 punitive damages is not GI under §104(a)(2), and $500,000 allocated to punitive damages is GI
6. Allocation of Awards
   1. Because punitive damages are not excludable, TP negotiating a settlement may try to allocate the entire settlement to physical injury to exclude the entire settlement from GI (even though he may have requested both compensatory and punitive damages)
      1. IRS is allowed to scrutinize settlements and dispute allocations resulting from settlement negotiations it considers not arms-length
      2. No bright-line rule for allocation questions, must determine under individual facts and circumstances of each case
      3. It TP quantifies demands (like in pleadings), Commissioner may assert that whatever % of total demand represents punitive damages, that same % of unallocated settlement should be deemed as amount of punitive damages
   2. *Bagley v. Commissioner*: IRS should not be bound by a settlement agreement allocation all of the $1.5 million award to personal injuries
      1. Jury previously awarded 1 million to injury and 5 million to punitive damages
      2. Based on the facts, TP could not expect more than 1 million for personal injury, thus the remaining $500,000 represents payment in lieu of punitive damages
   3. *McKay v. Commissioner*: Court respected an allocation settlement agreement of ¾ for personal injury and ¼ to TP’s k claim for 16 million settlement
      1. Adversarial nature of negotiation led to allocation of the award
      2. Jury originally awarded 12 million future damages, 1.6 lost compensation, and that ballooned to 43 million for RICO violations. TP insisted that not of the settlement was allocated to the RICO or punitive damages.
7. Periodic Payments
   1. §104(a)(2) explicitly states that period payments qualify for an exclusion
   2. Ex. Under a settlement, George agrees to pay Victor $3k per month for the next ten years under a personal physical injury action
      1. Victor will be entitled to exclude the entire amount he receives over the next 10 years, even though much of the payments constitute potential interest income lost
   3. If Victor received a lump sum payment and invests it in an annuity paying $3,000/month for the next ten years, he is entitled to exclude the lump sum, but must report a portion of each month’s annuity payments as income (portion that represents the non-basis)
      1. §104(a)(2) encourages TP’s to structure their settlement awards to exclude the interest component of periodic payments since this income portion is the economically identical interest income that was untaxed in the prior example

*B. Payment Under Accident and Health Insurance Policies*

1. Payments through Accident or Health Insurance Policies
   1. §104(a)(3): Payments received through accident or health insurance policies are excluded from GI, provided the policy was not finance by the TP’s ER or by ER contributions not includible in the TP’s income
      1. If TP finances his own accident and health insurance with after-tax dollars, payments made thereunder will be tax-free
   2. §105(a): Payments made by ER financed accident and health plans are generally included in EE’s GI but provides exceptions for medical expense reimbursements and certain payments for permanent bodily injury or disfigurement
2. Medical Expense Payments
   1. §105(b): Exclusion for medical care for the TP, spouse and dependents is limited to the actual medical expenses incurred under ER plans
   2. §104(a)(3): Payments that exceed medical expenses incurred remain tax-free for self-financed accident and health insurance plans
3. If TP has 2 policies, one policy is ER-financed and the other is self-financed, the excess reimbursement is allocated in proportion to the relative payments made by each policy
   1. Ex. Actual medical expenses are $900, but total payments are $1200, 70% ER financed ($840) and $30 self-financed ($360); 70% of the excess reimbursement of $300 ($210) would be included as income because it came form the ER, the remaining $90 is excludable
4. If a single policy is in part self-financed and in part financed by the ER, payment under such a policy is treated as self-financed in proportion to that port of the total premiums paid by the TP
   1. Assume that policy made 70% of payments for both policies, but payments were split between ER and the TP. The $210 excess reimbursement would be included in income, but bc ER only paid half, only half is included in income ($105)

*C. Previously Deducted Medical Expenses*

1. Amounts attributable to previously deducted medical expenses are not excluded from income under either §104 or §105
   1. Reimbursements for nondeductible medical expenses, however, are excluded form income under §104 and §105
2. IRS will respect an allocation made by the parties unless the allocation were unreasonable, and where no allocation was made, settlement would be presumed to be attributable first to medical expenses previously deducted, and thus includible in income to the extent of the prior medical expense deduction allowed
   1. As for future medical expenses, such awards may be excluded from income, but to the extent of the allocations to future medical expenses, the TP may not deduct those future medical expenses under §213 when they are incurred

*D. Workers’ Compensation*

1. §104(a)(1) Excludes from income, amounts received under the workers’ compensation acts as compensation for personal injuries or sickness
   1. §1.104-1(b): Exclusion also extends to payments under a statute in the nature of a workmens’ compensation act, but not to retirement payments to the extent based on age, length of service or EE contributions, even where retirement is caused by occupational injury or illness
2. Conversely, compensation for non-occupational injury or illness is not within 104(a)(10, even if the label of workers’ compensation is placed on the payment

*E. Certain Disability Pensions*

1. Military disability pensions and certain other government disability pensions are excluded from income under §104(a)(4)
   1. Sharply limited by §104(b) to persons receiving compensation for combat-related injuries and to those who would, on application received disability compensation from the VA
2. Exclusion available for disability income attributable to injuries suffered in a terrorist attack upon an EE of the US engaged in performance of official duties outside the US (§104(a)(5))

**XI. Fringe Benefits**

*A. Meals and Lodging*

1. Treatment of Meals and Lodging Pre-1954
   1. Convenience of ER Doctrine: Exclusions were based on the notion that the benefits given EEs were for the convenience of the ER
   2. Required TPs to establish that benefits accorded to them as employees were grounded in business necessity
   3. *Bengalia v. Commissioner*: Value of a suite of rooms provided free of charge to the manager of a resort hotel was excludable from his income
      1. Manager’s ER expected him to live at the hotel because his managerial duties were continuous and required him to be available at a moment’s call
2. §119(a): Excluding meals/lodging furnished to EE, spouse, and dependents pursuant to employment
   1. Shall be excluded from GI of an EE if paid by or on behalf of his ER for convenience of the ER, but only if:
      1. Meals are furnished on the business premises of the ER; or
      2. EE is required to accept such lodging on the business premises of his ER as a condition of his employment
3. §119(b): Meals or Lodging Furnished for the Convenience of the ER
   1. EE is required to accept the lodging in order to enable him properly to perform the duties of his employment; retains convenience of employer doctrine
      1. Exclusion of benefits provided for the convenience of the ER is justified because the EE had nothing he could take, use, and expend according to his own dictates, and the ends of the ERs business dominated and controlled (*Van Rosen*)
      2. Fact that certain personal wants and needs of the EE were satisfied is secondary and incidental to the employment
   2. Meals and lodging provided to an EEs spouse and dependents is excluded under §119
      1. Enough for TP to establish that he was required to be available for duty at all times (§1.119-1(b)); not required to show that the duties would be impossible to perform without such lodging being available
   3. *US v. Gotcher*: Convenience of ER Doctrine exists beyond §119
      1. Twelve-day all expense paid trip was excludable because the dominant purpose of the trip was clearly for business and not pleasure (even though some time was not business-related); Benefits of the TPs were subordinate to benefits to Volkswagen
      2. Cost of trip was attributable to TPs wife as income because the court considered her trip to be primarily a vacation

*B. Fringe Benefits and §132*

1. Eight (8) Categories of Excludable Fringe Benefits under §132
   1. (1) No-additional-cost service, (2) Qualified EE discount, (3) Working conditions fringe, (4) *De Minimis* fringe, (5) Qualified transportation fringe, (6) Qualified moving expense reimbursement, (7) Qualified retirement planning services, (8) Qualified military base realignment and closure fringe
2. No-Additional Cost Service
   1. Companies engaged in airline, railroad or hotel businesses may make their excess capacity available free of charge to EEs and their families
      1. No cost incurred by the ER in allowing an EE to occupy an otherwise empty seat
      2. The entire value of such services is excluded form income, subject to restrictions
   2. Service must be one offered for sale to customers in the ordinary course of business
      1. Ex. Allowing an EE to fly free on an empty seat on the corporate jet flown for business reasons fails the “for sale to customers” standard
   3. §132(b)(1): Line of Business Requirement
      1. An ER conglomerate (ex. Provides airline and hotel services) is considered to have separate lines of business, so EEs may only exclude services of the line of business that they specifically work for
      2. Performance of substantial services directly benefitting more than one line of business is treated as the performance in all such lines of business (1.132-4(a)(1)(iv))
      3. If an accountant does all the work for both the airline and hotel divisions of a company, he is deemed employed in each line of business and qualifies for the exclusion for both services under no-additional-cost standard
   4. §132(b)(2): The ER must incur no substantial additional cost (or no forgone revenue)
      1. Revenue is forgone when EE would not have purchased the services unless it were available to the EE at the actual price charged to the EE (1.132-2(a)(5))
      2. Permitting airline EEs to take personal flights at no charge and to received reserved seats results in forgone revenue (from the reserved seats not available to the public)
         1. These EEs not eligible for the no-additional-cost exclusion (1.132-2(c))
      3. Whether an ER incurs any substantial additional cost is determined without regard to any amount which an EE might be required to pay
         1. EE payment does not serve to transform an ER-provided service into a “no-additional-cost” service, although such payment may obviously be relevant in measure the income the EE receives from the service
      4. Costs of services merely incidental to the primary services are generally not substantial; housekeeping or maintenance (1.132-2(a)(5)(ii))
   5. §132(j)(1): Prohibits discrimination in favor of highly compensated EEs
      1. §1.132-8(a)(2): If nondiscrimination rule is violated, only the members of the highly compensated group, rather than all EEs receiving benefits, will be subject to tax
      2. §1.132-8(a)(1): Highly compensated EEs, defined under §414(q), can include officers and owners
   6. §132(i): Authorized Reciprocal Agreements Between ERs in the Same line of business
      1. Enables the ERS to provide tax-free benefits to one another’s EEs
      2. Reciprocal agreements must be in writing and the ERS may not incur any substantial additional costs (including forgone revenues) in providing such services
   7. §132(f): Exclusion is limited to services provided by “Employees”
      1. Section defines employee to include one’s spouse and dependent children as well as certain retired and disabled EEs and the surviving spouse of a deceased EE
   8. *Charley v. Commissioner* 
      1. TP argues that §132(a)(1) excluded from income amounts he received for frequent flier miles he converted to cash
      2. TP’s company did not offer frequent flyer miles for sale to customers in the ordinary course of its business, and the travel credit arrangement represented additional compensation for the TP from his company or the TP had simply sold his frequent flyer miles in which he had zero basis, either way it constituted GI
3. Qualified EE Discount
   1. §132(c) limits the amount of discount which will be excludable and provides separate limitation for property and for services
      1. Exclusion for EE discounts on services is limited to 20% of the price at which the services are being offered by the ER to customers
      2. Exclusion for EE discounts on property is limited to the gross profit percentage
         1. (Aggregate sales prices for the property sold by the ER – aggregate cost of such property to the ER) / aggregate sales price
      3. Real property and personal property held for investment do not qualify for the 132(c) exclusion (EE purchase of stocks, bonds, gold, real estate get no exclusion)
      4. 132(c)(4) defines qualified property or services
   2. Ex. of EE discounts on Property
      1. Total sales of merchandise was $1 million, and total cost to ER was $600,000
      2. Gross profit percentage for the year is 40% (1 million – 600k = 400k / 1 million)
      3. EE discount with respect to such merchandise is excluded from income to the extent it does not exceed 40% of the selling price of the merchandise to non-EE customers
      4. Here, if the discount allowed to the EE is 50%, then the excess discount on a purchase 10% (50% discount – 40% gross profit percentage) is EEs GI
   3. Reciprocal agreement rules of §132(i) are not applicable to qualified EE discounts
      1. Ex. Fred works for Blue Sky, and his dependent children are entitle to a 50% discount on any reserved sear purchased by them. Flight costs $500, saves $250 because of the discount
      2. Child is treated as an EE for purposes of the no-additional cost and qualified EE discount rules; no-additional cost rules is inapplicable bc seat was reserved
      3. EE still eligible to claim a qualified EE discount of up to 20% of the value provided
      4. Fred may exclude 20% of the value of his child’s ticket, $100 ($500 x .20), and the other $150 of the discount provided is income to Fred
4. Working Condition Fringe
   1. §132(a)(3): Excludes working condition fringe benefits from GI
      1. Property and services so closely connected to job performance that were the EE, rather than the ER to pay for them, the EE would be entitled to deduct their cost as a business expense are not considered compensation to the EE
      2. Anti-discrimination rules do not apply to these fringe benefits
   2. §1.132-5(a)(1)(v): Cash payments to the EE do not qualify as working condition fringe benefits unless the EE is required to use the payments for expense incurred in a specific or pre-arranged qualifying activity, verify such use, and return an excess to the ER
      1. §1.132-5(b): Rules for determining working condition fringe benefit portion of vehicle usage, where EE uses an ER-provided vehicle for business and personal use
   3. ER-provided outplacement services are excludable by EEs as working condition FBs
      1. If an ER derives a substantial business benefit from the provision of such outplacement services that is distinct from the benefit it would derive from the mere payment of additional compensation (positive image, maintaining morale, etc…), the service may generally be treated as a working condition fringe
   4. Ex. Where trip is voluntary, but all EEs felt an obligation to attend, and legitimate business discussion took place among those attending, the ER had a reasonable expectation to gain concrete benefits from the trip based on its knowledge of the small company, utility of interpersonal interaction, knowledge of its own past experience
5. De Minimis Fringe Benefits
   1. §132(a)(4) excludes de minimis fringe benefits, which are property or services, the value of which is so small as to make accounting for it unreasonable (taking into account the frequency with which similar fringes are provided by the ER to the EEs)
      1. Frequency is a main factor for determining whether a benefit is *de minimis*
      2. There does not need to be an ER-EE relationship between provider and recipient
      3. Anti-discrimination rules do not apply to de minimis fringe benefits
   2. §1.132-6(d)(2): Special Rules for excluding as de minimis fringe benefits, meals and occasional meal money
   3. §1.132-6(e): Variety of common benefits that do not qualify as de minimis
      1. Occasional cocktail parties, picnics for EE and guests, flowers provided to EE in sickness or crisis are all excludable FBs
      2. Season tickets, use of an ER-owned facility for trips are not excludable
   4. §1.132-6(c): De minimis fringe status is denied to any cash or cash equivalent benefits, other than those allowed by the special rules
6. Qualified Transportation Fringe
   1. §132(a)(5) excludes qualified transportation fringe benefits from income, which include:
      1. Transportation in a commuter highway vehicle in connection with travel between the EEs residence and place of employment;
      2. Transit pass; or
      3. Qualified parking (132(f)(1), 5(A)-(C))
   2. §132(f)(3): Cash reimbursements for these items are also excludable
      1. Exclusion is subject to specified dollar limitations
      2. $100/month for commuter highway vehicle and $175/month for qualified parking, adjusted annually for inflation (**FIND INFLATION #**)(§132(f)(2), (6))
   3. Qualified parking includes parking on or near the EEs business premises, but does not include parking on or near property used by the EE for residential purposes (132(f)(5)(C))
      1. Ex. Apartment that is located ten blocks away from work, and parking rental located across the street from the residence is not qualified parking, no exclusion

*C. Valuation*

1. §1.61-21(b)(1): Fringe benefits that are not excluded from income under §132 or another section of the Code are subject to tax pursuant to §61(a)(1)
   1. Measure of income is the fair market value of the fringe benefit, minus any excludable portion of the fringe benefit and any amount paid by the recipient
2. §1.61-21(a)(4): Regulations explicitly tax the value of the fringe benefit to the EE, even though the benefit may actually be received by someone else

Deductions

**XIV. Business and Investment Expenses**

*A. Business Deduction under §162*

1. §162: Trade or business expense
   1. Generally, all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade/business shall be allowed as a deduction
      1. §61(a)(2): gross income derived from business, means the total sales, minus the cost of goods sold
      2. Ex. Painter is paid $25k, but pays $5k for paint, he will be taxed on $20k ($25k gross income, but $5k deduction for trade/business expense)
   2. Most 162 deductions are taken above the line (deducted in computing AGI, and can be deducted whether the taxpayer itemizes or claims the standard deduction)
      1. Generally, §162 deductions are not subject to §67 limitation on certain itemized deductions (the 2% floor on certain miscellaneous deductions)
   3. Requirements under §162 to establish a deduction for costs associated with a business
      1. Cost must be an expense;
      2. Expense must be ordinary;
      3. It must be “necessary”;
      4. It must be paid or incurred during the taxable year; and
      5. It must be paid or incurred in carrying on a trade or business

*B. Is the Expense “Ordinary and Necessary”?*

1. Is the Expense “Ordinary”
   1. “Ordinary requires that a cost be customary or expected in the life of a business; life in all its fullness must supply the answer (*Welch*)
      1. Paying former ERs discharged debts to reestablish relations with customers of his former ER is not ordinary
   2. Ordinary expenses are apparently to be distinguished from capital expenditures such as reputation (goodwill) or learning
      1. In *Jenkins*, Conway Twitty repaid investors to protect his business as a country singer, not as a burger guy, so was allowed a deduction
   3. Transaction which gives rise to the “ordinary expense” must be of common or frequent occurrence in the type of business involved (*Deputy v. Dupont*)
      1. “Ordinary” is determined by time, place, and circumstance
   4. Where costs are adjunct to, and not a direct cost related to trade or business, not obliged to allow a deduction for the expenditure
      1. Direct relationship between expenditure and business is needed
      2. Ex. Deduction allowed for settling a negligence action out of an accident that occurred while driving on business (driving lapses are inseparable part of driving a car which is directly related to trade or business)
2. Is the Expense “Necessary”
   1. “Necessary” has been interpreted as “appropriate and helpful”
      1. Courts have indicated that they are not likely to override the judgment of a business person regarding the necessity of nay costs incurred
      2. Is the expense a response that one would normally expect a business in the TP’s circumstance to make?
      3. Necessary is a factual determination
   2. *Henry v. Commissioner*: Denied deductions to a TP for depreciation and maintenance costs associated with his yacht
      1. Argues that it was used to advertise his business (had a flag saying 1040), but did not use it to entertain or meet clients
      2. Expenses were not ordinary or necessary expenses of his business
3. §162(a)(1): Deduction for Reasonable Salaries
   1. Only reasonable salaries may be deducted
      1. Unreasonably large salaries are not an ordinary and necessary expense of a business
      2. Reasonableness is inherent in “ordinary and necessary”
   2. Factors in determining reasonableness of compensation
      1. Position held by the EE
      2. Hours worked and duties performed
      3. General importance of the EE to the company
      4. Comparison of past duties and salary with current responsibilities and compensation
      5. Comparison of the EEs salary w those paid by similar companies for similar services
      6. Size of the company, complexities of the business, and general economic conditions
      7. Existence of potentially exploitable relationship btwn taxpaying company & its EEs
      8. Existence of a bonus system that distributes all or nearly all of the pre-tax earnings of the company
   3. §1.162-7(b)(3): reasonable compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances
4. Clothing Expenses
   1. Clothing is ordinary viewed as an inherently personal nondeductible expenditure, and clothing expenses are deductible only if:
      1. The clothing is of a type specifically required as a condition of employment
      2. It is not adaptable to general usage as ordinary clothing, and
      3. It is not so worn
   2. Clothing that is deductible for uniform acquisition and maintenance for police offices, firemen, post officers, nurses, bus drivers, rail men, etc…
      1. When work clothing may be worn off-duty, its suitability for such wear may not make it deductible
      2. If clothing is adaptable for personal or general use (fits into to accepted ordinary street wear), cannot deduct costs of clothing expense
5. Public Policy Considerations
   1. Courts sometime deny business deductions solely on the grounds that its allowance would frustrate public policy
      1. Disallowed truck company’s deduction of fines paid for violating maximum weight laws, concluding that such costs are not necessary bc it would frustrate sharply defined national or national state policies proscribing conduct
      2. Allowance of a deduction for fines would have avoided consequences for violating state maximum weight limits (*Tank Truck Rentals*)
   2. Test of non-deductibility always is the severity and immediacy of the frustration resulting from the allowance of the deduction
      1. §162 amended by adding provision disallowing deductions for certain fines, penalties, bribes and anti-trust payments; meant to be all-inclusive
      2. Public policy, on other circumstances is not sufficiently clearly defined to justify disallowance of deductions

*C. Carrying on a Trade or Business*

1. What constitutes a “Trade or Business”
   1. To be engaged in a trade or business, the TP must be involved in the activity with continuity and regularity and the TP’s primary purpose for the activity must be for income or profit
      1. Sporadic activity, a hobby, or an amusement diversion does not qualify
      2. Status of an enterprise as a trade or business will depend on the facts
         1. *Groetzinger*: Gambler who devoted himself full time and hoped to earn a living from the gambling was engaged in a T/B
   2. §1.183-2(a), lists for hobby losses applicable to trade or business determination under 162:
      1. Manner in which TP carries on the trade or business
      2. Expertise of the TP or their advisers
      3. Time and effort expended by TP in carrying out the activity
      4. Expectation that assets used in activity will appreciate in value
      5. Success of the TP in carrying on other similar or dissimilar activities
      6. History of income or losses with respect to the activity
      7. Amount of occasional profits, if any, which are earned
      8. Financial status of the TP
      9. Elements of personal pleasure or enjoyment or recreation
   3. Trader v. Investor
      1. Trade is considered as engaged in a trade or business, because directed toward short-term trading with income derived principally from sale of securities
      2. Investor is not considered engaged in trade or business, as they generally seek dividends and interest
         1. Ex. No matter how large the estate or continuous or extend the work of managing your own investments, not engaged in trade or business (*Higgins*)
2. The “Carrying On” requirement
   1. Investigatory stage: Conduct that is preparatory to locating a T/B venture is non deductible as an ordinary/necessary business expense incurred in carrying on a T/B
      1. TPs may be able to deduct a loss for business investigatory expenses incurred in an unsuccessful attempt to acquire a specific business
      2. Generally, these investigatory expenses are viewed as nondeductible personal expenses, or as not ordinary and necessary T/B bc no business exists
   2. Preparatory stage: Even when TP makes firm decision to enter business and spends money preparing to enter, still has not engaged in carrying on any T/B under §162
      1. TP required to treat pre-operating expenses as capital expenditures
      2. Cannot deduct as ordinary/necessary business expense incurred in carrying on a T/B until business is functional and operational
   3. Carrying on requirement forces the TP to establish that expenses are actually associated with the operation of a trade or business, making it more likely that expenses are genuinely business-related, not just personal expenses
3. §195 and the Amortization of Certain Pre-operational or Start-up costs
   1. §195 permits the TP to elect to amortize (pro-rate at an even level) business start-up expenditures over a period of at least 60 months
      1. TP can deduct up to $5,000 of start-up expenditures in the taxable year in which the active trade or business begins
         1. $5,000 amount is reduced (but not below 0) by the amount the start-up expenditures exceeds $50,000
         2. Remainder of the start-up expenditure is amortized over 180 month period, beginning with the month in which active T/B begins
   2. Amortization must satisfy two requirements
      1. Expenditure must be paid or incurred in connection with creating or investigating the creation or acquisition of, a T/B entered into by the taxpayer
      2. Eligible expenses consist of:
         1. Investigatory costs incurred in reviewing a prospective business prior to final decision to acquire or enter into T/B
         2. Startup costs which are incurred subsequent to a decision to establish a business and prior to when the business actually begins
   3. Ex. Linda opens an art gallery for business. Before opening the gallery, she spends $10k in rental costs, $15k in pre-operating wages, and $6k in advertising.
      1. Total pre-opening expenses are $31k, which is lower then $50k
      2. She can deduct $5,000, and the remaining $26,000 is amortized over the next 180 months, starting with the first month she opens for business
4. Application of the “Carrying On” Requirement to EEs
   1. TP may be in the trade or business of being an EE, and EEs may have more than one T/B
      1. Ex. TP who works as a tax specialist with a firm, and regularly teaches tax as an adjunct professor is in 2 T/B, tax accounting and teaching
   2. If an EE incurs costs in seeking a job with a new ER, EE may deduct those costs as T/B expenses under 162 if they were incurred in carrying on a trade or business
      1. If expenses were incurred in an effort to commence a new trade or business, there is no deduction under 162
      2. EE business expenses are generally below-the-line, miscellaneous itemized expenses subject to the 2% floor of §67
   3. Expenses of seeking employment, even if not successful could be deducted
      1. Determination of “carrying on” can be pretty general, such as a “financial corporate executive” or an “administrator”
   4. Generally, an EE can be unemployed for 1 year without losing T/B status
      1. Prolonged period of unemployment terminates one’s status as being engaged in T/B, and expenses for searching for a new job are not deductible w/ a lack of continuity
   5. If it is possible for the EE to retain, at least temporarily, his status of carrying on his own T/B independent of receiving any compensation from a particular ER, he is considered to be carrying on a T/B and can deduct those T/B expenses
      1. Ex. Teacher who takes one year off to obtain a master’s degree in her field, was carrying on T/B for the year, and allowed to deduct the educational expenses

*D. §212 Deductions for Expenses in Production of Income (BTL aka Itemized)*

1. §212 allows a deduction for the “ordinary and necessary” expenses of
   1. Producing or collecting income
   2. Maintaining property held for the production of income, or
   3. Determining collecting or refunding any tax
2. Ex. Investment fees, custodial fees, office rent and clerical help are all deductible in connection with §212 activities, as are rental property expenses and administration expenses
   1. Conversely, commuting expenses, rental costs for a safe deposit box for jewelry and other personal item, home residence expenses are not deductible under §212
3. No deduction is allowable for expenditures allocable to tax-exempt income
   1. Sam incurs $500 investment fees attributable to $10k in tax-exempt bond interest, the fees are non-deductible because they are allocable to tax-exempt income
4. Distinction between allowing deductions for the expense of producing or collecting income, where one has an existent interest or right, and expenses incurred in an attempt to obtain income by creation of some new interest
   1. Ex. judge seeking reelection cant deduct under §212 expenses of a campaign, because contributions were not expenses incurred being a judge, but in trying to become one

**XV. Nondeductible Capital Expenditures**

*A. Deductible Expense or Capital Expenditure?*

1. §263: Capital Expenditures
   1. Denies deductions for the cost of new buildings or for permanent improvement or betterments increasing the value of the property, and for restoration costs for which an allowance is made
   2. Examples of capital expenditure are available under §1.263(a)-2(a)
2. §1.263(1)(-1(b): Disallowance applies to expenditures that:
   1. Add to value,
   2. Substantially prolong the useful life of property, or
   3. Adapt property to a new and different use but not to incidental repairs and maintenance
3. §1.162-3: Current deduction for incidental materials and supplies is allowed when no record of consumption is kept or where physical inventories at the beginning and end of the year are not taken
   1. Ex. TP purchases cleaning materials for her business but fails to use all of them in 1 year
   2. TP can deduct the entire cost of the cleaning materials, provided her taxable income is clearly reflected by this method
   3. Allowed a current deduction for the entire cost of materials rather than capitalizing, and only getting a deduction for the cost of the materials actually used during the year
4. §1.162-6: Current deduction is permitted for amounts paid or accrued for books, furniture, and professional equipment, the useful life of which is short

*B. Defining Capital Expenditures*

1. *INDOPCO Inc. v. Commissioner* 
   1. Although the mere presence of an incidental future benefit may not warrant capitalization, a TP’s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization
      1. Creation of a separate and distinct asset may well be a sufficient but not necessary condition to classification as a capital expenditure
      2. Deductions are strictly construed and allowed if there is a clear provision for it
   2. Expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses (failing for T/B deduction under §162(a)
2. §1.263(a)-2(a): Key Inquiry for Capital Expenditure
   1. Whether the creation of significant future benefit is essentially equivalent to the acquisition of property having a useful life substantially beyond the taxable year
   2. Focus on whether the expenditure at issue generated future benefit and whether those benefits were significant
   3. Fixed one-year items where the benefit will never extend beyond that term are ordinary, necessary, and recurring expenses for the business in question, and treated as deductible under 162(a)

*C. Selected Categories of Capital Expenditures*

1. Cost of Acquisition and Costs Incurred in Perfecting and Defending Title
   1. Acquisition costs constitute capital expenditure
      1. Ex. purchasing tangible property such as a building, machine or vehicle, or intangible property as a copyright, patent, interest in a corporation
      2. Asset produces a continuing, long term benefit, and its cost must be capitalized
   2. Where costs are related to the origin of the claim, those costs must be capitalized
      1. Ex. TP tried to currently deduct costs he paid for appraisal and litigation costs associated with repurchasing stock from dissenting shareholders
      2. Because those costs were related to their original stock, capital expenditure
   3. Costs incurred in defending or perfecting tile are also capital expenditures and cannot be currently deducted (1.263-(a)-2(c))
      1. Ex. legal fees incurred in resisting efforts to cancel the TP’s trademark were held as capital expenditure
      2. Where the dispute does not relate to the title to property, but to income from it, the expense has been held deductible
   4. Cost of Disposing of an asset may be regarded as part of the cost of its acquisition
      1. Disposition costs are to be treated as capital expenditures, hence, on disposition of the asset, the gain is reduced or the loss is increased by treating the disposition costs as a reduction in the amount realized
   5. §263(a) requires capitalization of direct and indirect costs (including certain interest costs) incurred by taxpayers who manufacture, construct, or produce real or tangible personal property, or who acquire or hold inventory property for resale
      1. Company must capitalized depreciation on equipment used to build their own facility
      2. Paying another publishing company to prepare another edition of an encyclopedia must be capitalized bc it will yield income to TP over numerous years
2. Repair or Improvement
   1. §1.162-4: Expenditures for repairs or maintenance, which do not materially add to value or appreciably prolong useful life, are deductible; Replacement or improvements are not deducted and are capitalized (1.263(a)-1(b))
      1. “Repair” is to restore to a sound state, expenditure for the purpose of keeping the property in an ordinarily efficient operating condition, does not add to value of property or appreciably prolong its life
         1. Keeps property in an operating condition over its probable useful life for the uses for which it was acquired and should be currently deductible
         2. Addition that permits the TP to continue normal operations and did not change the scale of operation is considered a repair
      2. Replacement, alterations, improvements, or additions prolong the life of the property, increase its value, or make it adaptable to a different use
         1. Adds to capital investment and should be capitalized
   2. Amounts paid or incurred for incidental repairs may have some future benefit, but these costs are considered business expenses which are generally deductible under 162
      1. If a major component or a substantial structural part of the asset Is replaced, and as a result the asset as whole has increased in value, life expectancy, or use then the costs of the replacement might be capitalized
   3. Series of repairs (which individually could be currently deducted) may in the aggregate bring about an improvement to property that requires capitalization
      1. Expenditure made for an item which is part of a **general plan** of rehabilitation, modernization, and improvement of the property must be capitalized
         1. High cost of work performed may be considered, but is not dispositive
      2. Repairs with no replacement, alteration or improvement, and only maintains current condition = no general plan and currently deductible
      3. Replacement of certain items along with regular maintenance = no general plan, but replacement has to be capitalized and maintenance is currently deductible
         1. Under these circumstances, did not plan to rehabilitate, but merely perform discrete capital improvements
      4. Replacement of major components and significant portions of substantial structural parts increasing value and substantially prolonged useful life
         1. Because value was materially increased, all of the work, including the general maintenance, was incurred pursuant to a general plan, and capitalization
   4. Costs of maintaining quality of business workforce
      1. Training costs (including costs of trainers and expenses incurred in updating manuals) have been deemed currently deductible expenses
      2. Training costs must be capitalized only in unusual circumstances where the training provides benefits significantly beyond those traditionally associated with training in the ordinary course of business
         1. Ex. Costs in preparing workers in transition to a nuclear power plant from a coal plant is capitalized expenditure
3. Intangible Assets
   1. §1.263(a)-4(b)(1): Capitalization is required for amounts paid to acquire or create an intangible asset, to facilitate the acquisition or creation of an intangible asset, or to create or enhance a separate and distinct asset
      1. Acquired intangibles: ownership interests in corporations, partnerships or other entities; debt instruments; options to provide or acquire property; leases; patents or copyrights; and franchises or trademarks
         1. Cost of acquiring such intangibles must be capitalized
      2. Created intangibles: financial interests (including ownership interest in corporations, partnerships and other entities; and options to provide or acquire property); prepaid expenses; certain membership fees; amounts paid to create or terminate certain k’s for property or services; amounts paid to defend title to intangible property
         1. Costs of creating the intangibles must be capitalized
   2. Prepaid expenses must generally be capitalized
      1. Advance rentals, payments of bonuses for acquisition and cancellation of leases, and commissions for negotiating leases are all matters which the TP amortizes over the life of the lease
      2. To permit the TP to take full deduction in the year of payment would distort income
   3. Amounts paid to facilitate a transaction (the acquisition or creation of an intangible) must be capitalized if the amount is paid in the process of investigating or otherwise pursuing the transaction (§1.263(a)-4(e)(1)(i))
      1. EE compensation and overhead, and de minimis costs (amounts not exceeding $5,000) are treated as amount not facilitating the transition, and currently deducted
   4. Amounts paid to generally facilitate the acquisition of a trade or business or to change the business’ capital structure must also be capitalized
      1. Inherently facilitative amounts must always be capitalized, or else, amounts paid to investigate and pursue the transaction, but which are not inherently facilitative, are deemed to facilitate the transaction (and require capitalization) only with respect to activities performed after a letter of intent has been executed or the material terms of the transaction have been approved by the governing authority (1.263(a)(-5(e))
      2. EE compensation and overhead, and de minimis costs (amounts not exceeding $5,000) are treated as amount not facilitating the transition, and currently deducted
      3. Costs incurred to investigate and otherwise pursue an acquisition are not subject to this capitalization requirement (not a T/B or profit seeking event, no deduction)
   5. 12-month Rule
      1. Capitalization is not required for amounts paid for a right or benefit that does not extend beyond either
         1. 12 months from first realizing the right or benefit; or
         2. The end of the tax year following the year of payment
      2. Ex. Mia purchases a 12 month license on June 15, year 1, and the license period runs from July 1, Year 1, to June 30, Year 2
         1. Right or benefit does not extend more than 12 months beyond July 1, the dat it is first realized, and because the right or benefit does not extend beyond year 2 (end of the year following the year of payment), the payment need not be capitalized
      3. Suppose the right runs from June 14 to July 1, it must be capitalized because the right extends more than 12 months beyond the date first realized
      4. Or, if Mia pays for the license on December 30, year 0, with the period extending form February 1, year 1, to January 31, year 2, because the right or benefit extends beyond year 1 (year following payment) it must be capitalized
4. Expansion Costs
   1. Taxpayer engaged in expansion activities incurs currently deductible expenses, it is not capitalized expenditure
      1. Establishing a franchise division to promote sales in new retail outlets was held to be currently deductible, not capitalized
      2. The mere ability to sell in new markets and to new customers without more, does not result in significant future benefit
   2. Severance payments may produce some future benefits, but do not have to be capitalized, and can be currently deducted
5. Advertising Expenses
   1. §1.162-1(a); 1.162-20(a)(2): Generally treat advertising expenses as currently deductible
      1. Only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized
   2. §1.263(a)-4(l): Capitalization is not required for product launch costs that include payments to develop and implement a marketing strategy and an advertising campaign to raise consumer awareness for a new pharmaceutical product
      1. Amounts are not paid to acquire or create or facilitate the acquisition or creation of one of the specified self-created intangibles subject to capitalization; nor
      2. To create a separate and distinct intangible asset
6. Purchase or Lease
   1. §162(a)(3) specifically authorizes the deduction of rental payments with respect to property used in T/B, but only if the TP does not take title and has no equity in the property
      1. Ex. TP “leased” a sprinkler system for $4,000/year for four years. At the end of the lease he had option to purchase the system for $100. Had the TP purchased the system outright, it would have cost $14,500.
      2. Sprinkler system was purchased, not leased. Had it been characterized as a lease, TP could deduct lease payments currently, but because it was a purchase, TP required to capitalize the cost of the system, depreciate the cost of the system over a 5 yr. period
      3. The excess amounts paid would presumably be deductible as interest

**XVIII: Entertainment and Business Meals**

*A. Business or Pleasure*

1. §274(a): Disallowance of certain entertainment, etc., expenses
   1. Generally, no deduction for an activity generally considered to constitute entertanment, amusement, or recreation, **unless** the TP establishes that the item was either
      1. Directly related to the active conduct of TPs T/B; or
      2. Associated with (where item directly precedes or follows a substantial and bona fide business discussion) the active conduct of TPs T/B
   2. §274 is applied in addition to the ordinary and necessary rules of §162
      1. Statute also denies any deduction for most entertainment facilities
2. Percentage Cutback
   1. §274(n) generally limits the deduction for business meals and entertainment to 50% of the otherwise allowable amount
   2. The 50% cutback does not apply in a number of instances (*See* 274(n)(2), (e)(2), (3), (4), (7), (8), or (9); or §132 de minims fringe for food or beverage expenses)

*B. Entertainment Activities*

1. No deduction is permitted for any activity of a type generally considered to constitute entertainment, amusement, or recreation unless the TP satisfies one of two tests
   1. The expenditure must be either:
      1. Directly related to the active conduct of the trade or business; or
      2. Associated with the active conduct of the trade or business and directly preceded or followed by a substantial and bonafide business discussion
2. “Directly Related” Entertainment
   1. Generally, the directly related standard requires that the TP reasonably
      1. Anticipate some income or specific benefit from the expense;
      2. Actively engage in a business discussion; and
      3. Be motivated principally by the business aspect of the business-entertainment combination
      4. Not necessary that more time be spent on business than on entertainment
   2. Alternative satisfaction of “Directly Related”: Clear business setting test (1.274-2(c)(4))
      1. If the TPs are not present, or there are substantial distractions, the expenditure is generally considered not to be directly related to the TPs business (1.274-2(c)(7))
3. “Associated with Entertainment”
   1. TP must have a clear business purpose for making the expenditure, but an intent to maintain business goodwill or obtain new business satisfies the requirement (1.274-2(d)(2))
      1. Substantial, bonafide business discussion that precedes or follows the entertainment must be for the purpose of obtaining income or other specific business benefit; and
      2. Business aspect must be the principal aspect of the combined business and entertainment
      3. It is **not** necessary that more time be spent on business than entertainment, nor must the business and entertainment take place on the same day
   2. No requirement that any business be conducted during entertainment that is associated with the TPs business
      1. Entertainment expenses for spouses, both the host’s and the guest’s are allowable
   3. The availability of this deduction is fairly broad
4. Business Meals
   1. Where 274(n) generally limits the deduction for any food or beverage expense or entertainment expense to 50% of the otherwise allowable amount, 274(k) adds on
      1. No deduction is allowed unless the meal is **not lavish or extravagant**, and the TP or the TPs employee is present
      2. There is also a face value limitation on most entertainment tickets (274(l)(1)
   2. Because §275(n) applies to the otherwise allowable expenses, other limitations (274(k)) should be applied first
      1. Ex. If under 274(k) a $150 meal is lavish or extravagant to the extent of $50, only $100 is otherwise allowable, and the 50% limitation results in a $50 deduction (transportation costs to or from a business meal, is not subject to reduction)
   3. The 50% limitation does not apply to EEs who receive reimbursement from the Ers, provided the EE substantiates to the ER as required under §274(d)
      1. It is then the ER who is subject to the 50% limitation

*C. Entertainment Facilities*

1. §2749a)(1)(B) generally denies any deductions for entertainment facilities
   1. Ex. hunting lodges, swimming pools, airplanes and vacation homes (1.274-2(e)(2))
2. Exception to the rule of nondeductibility:
   1. Where the facility is a club that is used primarily for business purposes (more than 50% business use 1.274-2(e)(4)(iii)), (only) the portion directly related to the active conduct of the TPs business can be deducted
   2. No deduction is allowed for club dues, regardless of satisfaction of the primary use test
3. The material difference between an entertainment activity that includes the use of real or personal property and an entertainment facility is whether the property used for the entertainment is occupied **exclusively** by the TP for, or during the recreation or entertainment
   1. Expenditures relates more to **entertainment activity** than to entertainment facility went the TP has no control over the use of property by others, or exclusive occupancy, and no right to access property beyond the limited time permitted, and **deduction is allowed**
   2. Where the TP is granted exclusive use of and unfettered access to the property, the expense is for the continuing enjoyment of the property itself for the specified recreational purposes, not an expense incurred solely in connection with that particular activity, and **no deduction**
4. Exclusivity language refers to the right of the TP to bar the general public from participation
   1. Where the TP dominates the rights of the lease, rights should be treated as exclusive ones, and the lease payments should be disallowed, and not deductible

*D. Substantiation Requirements*

1. §274(d) imposes special substantiation requirements on entertainment expenses, travel expenses, and other listed expenses
   1. If substantiation is not provided, the deduction is disallowed even though it is otherwise properly deductible
2. Taxpayer is required to substantiate either by adequate records or by sufficient evidence corroboration his own statement with:
   1. Amount of the expense
   2. Time and place it was incurred
   3. Business purpose for the expense
   4. Business relationship to the TP of the persons entertained
3. Adequate records requirement generally involves maintaining entries made at or near the time of the expense with documentary evidence (receipts) in support (1.274-5T(c)(2))
   1. Documentary evidence aspect of the rule will be waived for expenditure less than $75
   2. If adequate records is not met, TP must establish substantiation by his own statement, with sufficient corroborative evidence (uncorroborated statement will not support a deduction)
4. Exceptions to the general substantiation requirement
   1. EE incurring reimbursed expenses does not have to report the reimbursement or the expenses if he makes an adequate accounting to the ER (1.274-5T(f)(2))
   2. No substantiation is required for certain per diem and mileage allowances (1.274(d)-1, 5T(j)
   3. Excess reimbursements are reportable as income

*E. Exceptions*

1. §274(e) provides a number of exceptions to the disallowance rule of 274(a)
   1. Expenses for food and beverages furnished on the business premises of the TP primarily for his EEs, expenses treated as compensation, and reimbursed expenses are deductible
   2. Substantiation is still required for 274(e) expenses, except to the extent waived under 274(d)

*F. Business Meals*

1. Previous Treatment of Meals
   1. 162(a)(2): deduction for one’s own means when away from home on business
   2. 119: excludes meals furnished for the convenience of the ER from income
   3. 132: Excludes occasional supper money from income
2. Personal Portion of Business Meals
   1. Cost of meals, entertainment, and similar items for one’s self and dependents is a personal expense and presumptively nondeductible
      1. Presumption of nondeductibility can be overcome by clear and detailed evidence that the expenditure was different from, or in excess of that which would have been made for the TPs personal purposes
   2. TP is permitted to deduct the whole price, provided the expense is different from or in excess of that which would have been made for the TPs personal purposes
      1. Matter of degree and circumstance
   3. To deduct business entertainment or meals under 162 or 274, an EE must show that the ER required or expected her to incur and to bear the expenses w/o reimbursement
      1. Must satisfy requirement to business customers and co-workers
3. *Moss v. Commissioner* 
   1. Each member of small law firm met at lunch every day at the same place to discuss business, and one of the lawyers tried to deduct his share of lunch expense
   2. While eating together foster camaraderie, they know each other well already (small firm) and don’t need the **social lubrication** that a meal with an outsider provides
      1. At least they don’t need these meetings daily
   3. They met at Café everyday due to convenience and not too expensive, and did not incur a greater daily lunch expense than thy would have incurred had there been no lunch meeting
      1. Case might be different if location of the courts required the firm’s members to eat at a disagreeable restaurant, so they derived less value from the meal than it cost them to buy it
      2. Or in a restaurant too expensive for their personal tastes, so they would have gotten less value than the cash equivalent
4. Compare occasional lunch meeting of a medium law firm, to a public defender occasionally taking members and guests to dinner
   1. Costs are not ordinary and necessary for the usual civil servant, so no deduction, and is considered a personal expense
   2. This was something that might be ordinary and necessary within a medium sized firm, hence it is deductible business meal under 274(a), (k) (T/B necessity, EE there, no lavish)

**XIX: Educational Expenses**

*A. Deducting Educational Expenses under §162*

1. §1.162-5(a): An individual may deduct educational expenses that either:
   1. Maintain or improve skills required in his employment or trade or business; or
   2. Meet the express requirements of his ER, or applicable law, necessary to retain his established employment relationship, status, or rate of compensation
2. §1.162-5(b)(2): An expense is nondeductible (even though it may satisfy the skill-maintenance or ER requirement test) if it either:
   1. Meets the minimum educational requirements for qualification in the TP’s employment or trade or business; or
   2. Qualifies the TP for a new trade or business
3. §1.162-5(b)(1): An individual’s educational expenses that are in the nature of capital expenditures are disallowed; Such costs constitute an inseparable aggregate of personal and capital expenditures

*B. The Skill-Maintenance or ER Requirement Tests under §1.162-5(a)*

1. Assuming the expense is not disallowed, an individual may deduct educational expenses that maintain or improve skills required in his employment or trade or business
   1. §1.162-5(c)(1): Refresher courses or courses dealing with current developments as well as academic or vocational courses fall within this category
   2. Typically, professional update seminars are routinely deductible to those in the field under the skill-maintenance test
2. Under the S-M test, TP must show a sufficient relationship between the education and the particular job skill required by employment, so the expense is not considered a disallowed personal expense
   1. College courses are not necessarily nondeductible, but courses that are generally and basically unrelated to the TP duties under employment are a personal expense
   2. Educatinal expenses that lack sufficient connection or germaneness to the TPs job skills is ruled nondeductible
3. TP must be established in a trade or business before educational expenses are deductible
   1. Where factors indicate the TPs employment is merely temporary hiatus for a continuing series of academic endeavors, educational expenses are disallowed
      1. Short period of time working at the ER is relevant
      2. On a continuum, was only employed for 3 months out of 6 years of schools, before returning right back to school after ceasing employment
   2. When a TP clearly, at one time, carried out a T/B, suspension of employment for a year incurring educational expenses will be considered a temporary leave from T/B and remain deductible as a T/B expense
      1. There is no magic one year limit, all facts and circumstances need to be considered
      2. Have found a two-year suspension of employment to attend business school as a temporary leave from employment, and education as deductible
4. §1.162-5(c)(2): Alternative to the S-M Test, TP may deduct educational expenses that meet the express requirement of his ER, or applicable law in order to retain employment status
   1. Applies only with respect to express requirements
   2. Requirements must be imposed for a bona fide business purpose
   3. Only the minimum education necessary to retention of job, status, or pay will qualify
      1. Education beyond the minimum may satisfy the S-M test though
5. Ex. *Hill v. Commissioner* 
   1. In order to renew teaching certificate, the public teacher could take college courses
   2. The cost of attending summer school to acquire the credits needed to keep her certificate were deductible as an ordinary and necessary T/B expense

*C. Minimum Education Requirements and New Trade or Business Tests under §1.162-5(b)*

1. §1.162-5(b)(2): TP may not deduct educational expenses required to meet the **minimum educational requirements for qualification** in his employment or T/B
   1. Once an individual has met those requirements, the expenses incurred to satisfy a subsequent change in the requirements will be deductible
   2. Once an individual has met those requirements, the expenses incurred to satisfy a subsequent change in the requirements will be deductible
2. Ex. Susan has completed 2 years of law school and is hired by a law firm to do LRW. ON a condition to continued employment she is required to complete the JD and pass the bar.
   1. Law courses and bar review course constitute education requirements to meet the minimum educational requirements for qualification in the T/B of law
   2. Thus, expenditures for such courses are not deductible (1.162-5(b)(3)(ii) Ex. 2)
3. §1.162-5(b)(3)(i): Individuals are prohibited from deducting educational expenses that are part of a program of study that will lead to qualifying him in a new trade or business
   1. This is an objective test
   2. Even if the individual does not intend to pursue the new T/B (and only wants to improve skills for current job), it does not make the expenses deductible
   3. If the education qualifies the individual for anew trade or business, no deduction
   4. Taking one or more courses that are not part of a degree-granting course of study, that do not lead to qualification for a new T/B could be deductible under S-M Test
4. Ex. Minister goes to school and receives a bachelors degree, course deemed relevant to ministry
   1. Applying the objective test, these courses qualified him for new T/B, with a background in a variety of social issues could work non-profit or for public agencies
   2. Almost impossible to establish a B.A. does not qualify the TP for a new T/B
5. Ex. Obtaining a law degree qualifies for a new T/B
   1. Engineer cannot deduct cost of obtaining a J.D. (even if required by ER and intends to keep being an engineer)
6. Change of employment duties is not equivalent to a new T/B if the new duties involve the same general type of work at the present employment
   1. 1.162-5(b)(3)(i): All teaching and related duties involve same general type of work (even switching subjects, grades, to guidance counselor or school administrator); no new T/B
7. Common sense approach to change of employment duties
   1. Comparison is made between the types of tasks and activities which the TP was qualified to perform before the acquisition of a particular title or degree, and those which he is qualified to perform afterwards
   2. Where such activies and abilities are significantly different, educational expenses deductions are disallowed bc TP qualifies for a new T/B
      1. Ex. public accountants and CPAs considered in separate T/B; fixed-wing airline pilots and helicopter pilots are separate T/B; qualified lawyer moving from NY and obtaining a CA license are separate (no deductions for education expense)
   3. Earning professional degrees are distinguishable from one another depending on whether a course of study qualifies a TP for a new professional certification or license
      1. MBA does not qualify him for anything new and is deductible as a qualified education expense, roles before and after do not change overwhelmingly
      2. Conversely, JD grants you license after passing bar, and what you can before and after certification is huge in terms of job duties

*D. Travel Expenses*

1. §274(m)(2) disallows any deduction for travel as a form of education (e.g., going to Italy and walking around to learn by soaking up the culture)
   1. §1.162-5(e)(1): Travel expenses, meals and lodging remain deductible where an individual travels away from home primarily to obtain education, the expenses of which are deductible
2. Facts and circumstance test to determine primary purpose of a trip
   1. Factor relative amount of time spent in personal and educational activities
3. Even when the trip is not primarily personal, expenses properly allocable to personal activities may not be deducted
   1. When the trip is primarily personal, the transportation costs are nondeductible, but meals and lodging allocable to the educational activity may be deducted

*E. Education Tax Incentives*

1. Hope Scholarship Credit (new phase outs applied)
   1. §25A(i): Tax credit of up to **$2,500/student**, for a maximum of four years for the qualified tuition and related expenses of higher education
      1. Credit consists of 100% of the first $2,000 of qualifying expenses, plus 25% of the next $2000 of qualifying expenses
      2. May be claimed for the qualifying expenses of the TP, the spouse, and dependants
   2. Eligibility requirements:
      1. Enrolled at least half-time in one of the first two years of postsecondary education in a program leading to some recognized educational credential
      2. Credit is allowed for a max of 2 years, and only the first 2 years of higher education
      3. Credit is phased out for TPs whose modified AGI is in excess of $80k (individual), with complete phase out at $90k
         1. This is for filing individually, double numbers if file jointly
2. Lifetime Learning Credit (? **Do new phase outs in intro to book, or old ones**?)
   1. 25A(b)(2): Tax credit of up to **$2,000/taxpayer** for the qualified tuition and related expenses of higher education, and may be claimed for the qualifying expenses of the TP, spouse, and dependants
      1. Cannot take both the hope and lifetime credits for the same student in the same year
      2. It is permissible to claim a Hope credit on account of one student’s qualifying expenses, and to claim a lifetime learning credit on another’s
   2. Differences from the Hope Scholarship credit
      1. Not limited to a max number of years, or to the first two years of higher education
      2. Subject to the same phase out, but for TPs whose modified AGI exceeds $50k, and completely phased out at $60k
      3. No requirement that student be enrolled at least on a ½ time basis in a degree-granting program
      4. Credit is calculated on a per taxpayer basis, not on a per student basis, as the maximum credit remains $2,000 (married TPs must file jointly to claim credit)
   3. In any case, neither the Hope nor Lifetime Learning may be allowed for any expense for which a deduction is allowed

**XX. The Interest Deduction**

*A. Deduction of Personal Interest*

1. §163: Interest
   1. Under (a), generally a deduction shall be allowed on interest paid or accrued within the taxable year on indebtedness
   2. However under (h)(2), there is no deduction of personal interest, which is any interest allowable as a deduction under this section **other than**:
      1. Trade or business interest
      2. Investment interest, under (d)
      3. Passive activity interest, under §469
      4. Qualified residence interest, under (3)
      5. Certain interest on unpaid taxes
      6. Interest on educational loans pursuant to §221
2. Trade or Business Interest
   1. §163(h)(2)(A): **Interest paid or accrued on indebtedness properly allocable to a trade or business** (other than the trade or business of performing services as an EE) is deductible as a non-personal interest
      1. §1.163-9T(b)(2)(i)(A): **Personal interest** includes interest paid on underpayments of individual Federal, State, or local income taxes, regardless of the source of the income generating the tax liability
   2. Interest paid by a TP on deficiency of taxes, even if the sources of the income for the liability was a business **cannot be deducted**, bc it is a personal interest
3. Qualified Residence Interest
   1. §163(h)(3)(A): QRI is another exception from the rule disallowing deduction of personal interest, preserving the deduction for mortgage interest on personal residences
   2. QRI is interest paid or accrued during the tax year on **certain acquisition indebtedness** and **home equity indebtedness** secured by the TP’s principal residence and on one other residence
   3. Acquisition indebtedness is indebtedness (not in excess of $1,000,000) incurred in acquiring, constructing, or substantially improving any qualified residence of the TP
      1. It also includes indebtedness resulting from the refinancing of acquisition indebtedness not in excess of the refinance indebtedness. 163(h)(3)(B).
   4. Home equity indebtedness is indebtedness (that is **not** acquisition indebtedness) secured by a qualified residence (ex. a second mortgage)
      1. It is limited to the excess of the FMV of the qualified residence over the amount of acquisition indebtedness with respect to such residence
      2. For purposes of the interest deduction, home equity indebtedness may not exceed $100,000. 163(h)(3)(C).
      3. The overall limit of indebtedness on a principal and second residence, the interest of which will be deductible, is $1,100,000.
   5. Ex. Will purchased a home 25 years ago, and it is worth 300k today. He still owes $5,000 on the mortgage, and can deduct whatever interest he pays on the outstanding mortgage because it represents acquisition indebtedness
   6. Ex. Same facts, but Will borrows $250k to buy a summer home
      1. Will can deduct the interest payments on the $250k acquisition indebtedness
      2. The acquisition indebtedness in the cabin and on her principle residence is under $1 million, thus it is all considered QRI
   7. Ex. Same facts, but takes out an additional $100k on the home and uses $70k on adding a room and $30k in helping his daughter’s business
      1. $70k is acquisition indebtedness and interest off those payments can be deducted
      2. Bc value of the home is 300k – 75k left in acquisition indebtedness = $225k, the interest payments on the remaining $30,000 is deductible as home equity indebtedness because it is under $225k
   8. Ex. Same facts, but Will borrows $130k to buy a car, and gives a 2nd mortgage on the home
      1. Can deduct interest payments on $100k of the $130k loan as home equity indebtedness (limit for HEI is 100k)
      2. The other $30k is considered personal indebtedness w/ no deduction
4. Education Loans
   1. Deduction of interest on education loans is outside the scope of §163, but it is authorized by section §221 for a limited deduction on qualified education loans
   2. Qualified education loans are those incurred to pay higher education expenses
      1. Tuition, fees, room and board and related expenses of the TP, his or her spouse, or dependants. §221(e)
      2. Does not include any indebtedness owed to a person related to the TP under either §267(b) or 707(b)(1)
   3. Deduction is limited to $2,500 and is phased out for individuals with modified AGI from $50 to $65k (filing individually), **adjusted for inflation (WHAT IS INFLATION RATE)**

*B.* §*163(d): Limitation on Investment Interest*

1. Investment interest for any taxable year cannot be deducted in an amount greater than the TP’s net investment income
   1. Investment interest is interest paid or accrued on indebtedness properly allocable to property held for investment
   2. Net investment income is the excess of investment income over investment expenses
      1. Includes GI from property held for investment, interest, dividends, royalties annuities not attributable to a trade or business. 163(d)(5)(A)
      2. Generally, investment income does not include net capital gain from the disposition of investment property. 163(d)(4)(B)
      3. Qualified dividend income is treated in a manner similar to net capital gain
      4. Investment income does not include income subject to the passive activity of §469
   3. Investment expenses are deductible expenses (other than interest and expenses taken into account under §469) which are directly connected with the production of investment income
2. Ex. TP has interest income of $2k and dividend income of $3k, for total investment income of $5k. TP pays a fully-deductible $1,000 for investment advice related to dividend-producing stock for a total of $1,000 in investment expenses
   1. TPs net investment income for the year is $4,000.
   2. If the TP has paid or incurred interest expenses on debt allocable to property held for investment (say by borrowing money to purchase stock and paying interest on that borrowed money), such investment is deductible only to the extent of $4,000
   3. The TP must be able to allocate interest expenses in order to apply the §163(d)
3. §163(d)(4) provides that net investment income will include QDI, only to the extent the TP agrees to forego the lower net capital gain rates (15%) applicable to such dividends under §1(h)(11)
   1. If the TP agrees, the dividends will be subject to tax at ordinary income rates, depending on the TPs tax bracket
4. Investment interest expenses that cannot be deducted in one taxable year under 163(d)(1) may be carried forward to the succeeding taxable year under (d)(2)
   1. Carryover of a TPs disallowed investment to a succeeding taxable year under 163(d) is not limited by the TPs taxable income for the taxable year in which interest is paid or accrued
   2. TP will be entitled to use the interest deduction if and when the investment becomes profitable
5. TPs may not avoid the §163(d) limitation by claiming the interest expense is deductible under §212

**XXI. Deduction for Taxes**

*A. Taxes Deductible Under §164*

1. Specifically lists as deductible the following common taxes:
   1. State, local, and foreign real property taxes
   2. State and local personal property taxes
   3. State, local, and foreign income taxes
      1. Instead of this, TP can choose to deduct state and local general sales taxes in its place, but not both. 164(b)(5)
2. §164 constitutes a significant exception
   1. Allows taxpayers to effectively deduct certain taxes paid or accrued outside of a trade or business or other income producing activity
   2. §164 deductions are below the line, but not miscellaneous and not subject to 2% floor of §67
3. Taxes that are **not deductible** under §164 (but might be under 162 T/B or 212 income producing)
   1. Federal income tax
   2. Social security tax
   3. Hotel, gasoline tax
   4. Highway tolls

*B. Party Eligible to Claim Deduction*

1. Taxes are generally **deductible** **only** by the person **upon whom they are imposed**. §1.164-1
   1. Paying a tax that is deductible under 164 does not necessarily entitle a payor to a deduction
   2. Ex. Bank paid state tax assessed against its depositors and requested no reimbursement
      1. IRS concluded the depositors received income in the taxes paid on their behalf and were also entitled to a deduction under §164
      2. Could not deduct under §164, but could deduct tax payments paid as business expenses under §162
2. Exceptions to the general rule (Real Property Tax)
   1. Real property taxes must be apportioned between a buyer and a seller of real property regardless of which party is liable for the tax under state or local law
   2. If real property is owned by several co-owners, one of the co-owners may pay and deduct the entire real property tax
   3. Proper test is whether the person satisfied some personal liability or protected some beneficial interest in property (owner of a 1/6 undivided interest can pay and deduct fully)

*C. Deductions for Real Property Assessments*

1. §164(c): Real Property Assessments
   1. To determine whether a TP paying these **assessment**s may treat them as deductible real property tax, meaning of tax under §164 and nature of the assessment must be considered
      1. Ex. Specific services rendered, collection and disposal of trash, improvements to specific areas, maintenance of existing improvements, payment of interest
   2. Tax is an enforced contribution, imposed and collected for the purpose of raising revenue to be used for public or governmental purposes, and **not as a payment for some special privilege granted or service rendered** (water, sewer services, etc…)
2. If a special assessment is levied to pay for local benefits which **increase the value of the property assessed**, *except for the amount allocable to maintenance or interest charges*, it is **not deductible** as a tax under §164
   1. Ex. Amounts imposed by local government for benefits such as streets, and other improvements are **not deductible** **when assessed only** **upon those properties** **directly benefiting from the improvements**, **and when measured by the benefits each property receives**. §1.164-4(a).
   2. Distinguished from deductible real property taxes that are levied for the general welfare at a like rate against all property under their jurisdiction
3. Disallowance of deduction for amounts assessed against local benefits still have tax benefits
   1. If the benefit does not fall under §263 (disallowance of deductions for capital expenditures), such taxes are deductible under either §162 or §212 if they are ordinary and necessary trade or business expenses, or are incurred in an income producing activity
   2. Generally, the assessment represents the cost of improvements in the nature of capital expenditures, the assessment may beaded to the basis of the property subject to the assessment

*D. Apportionment of Real Property Taxes Between Buyer and Seller*

1. §164(d): When real property is sold
   1. The portion of real property taxes allocable to that part of the real property tax year ending the day before the sale is treated as imposed on the seller;
   2. The portion allocable to that part on the real property tax year beginning on the day of the sale is treated as a tax imposed on the purchaser
2. Ex. Real property tax year is a calendar year. Real property taxes for a given property in that year are $3,650. The real property is sold by S to B on March 1.
   1. $590 of tax (59/365)x(3,650) is imposed on S
   2. $3,060 of tax (306/365)x(3650) is imposed on B
3. Apportionment cannot be reallocated by an agreement between the buyer and the seller
   1. No deduction for a real property tax treated as imposed on another TP §164(c)(2)
   2. For deductions, makes no difference if the purchaser was reimbursed by the seller later for the seller’s share of the “tax,” the real property tax year and the date of the sale control the apportionment
4. Special rules govern when the apportioned tax is deductible
   1. Cash method accounting rules generally permit a deduction only upon actual payment of the expense in question
   2. However, if real property is sold and the other party to the sale is liable under local law for the tax for the real property tax year, a cash method buyer or seller is treated as having paid, on the sale date, the tax treated as imposed under the apportionment above. (d)(2)(A).
   3. If neither party is liable for the tax under local law, the party holding the property when the tax becomes a lien is considered liable for the tax
   4. The fact that a TP is considered liable for the tax does not mean such a TP can deduct more than the apportioned share of the tax
5. Cash method TP who is not liable for the tax can elect to deduct the apportioned share either for the taxable ear of the sale, or if later, for the year the tax is actually paid. 1.164-6(d)(1), (2)
   1. Cash basis seller who is liable for a real property tax that is not payable until after or in a later year when the tax is actually paid. 1.164-6(d)(1)(ii)
   2. Unnecessary for the seller to determine when a tax is later paid, given the option of treating the tax imposed on the seller as paid on the sale date
6. Accrual basis TP may elect to accrue any real property tax, which is related to a definite time period, ratably over that period §461(c)
   1. For accrual basis TPs who have not elected ratable accrual of their real property taxes and who would otherwise be unable to deduct the tax treated as imposed on them, the tax so imposed is treated as accruing on the date of the sale. 164(d)(2)(B).

**XXII: Losses and Bad Debts**

*A. §165 Losses Introduction*

1. Generally, §165(a) authorizes a deduction for any uncompensated loss sustained during the year
2. §165(c) restricts the loss deduction for individuals to:
   1. T/B losses
   2. Losses in profit-seeking transactions
   3. Casualty or theft losses
3. Casualty or theft loss involving the TPs business or investment property is governed by (c)(1) or (2)

*A(1). §165(c): The Business or Profit Requirement for Individuals*

1. **Personal Losses are not deductible**, only losses under T/B or profit-seeking activities
   1. §165(c)(1) clearly echoes the trade or business language of §162(a)
   2. Activities that constitute a T/B for §162 purposes do so also when focus shifts to §165
2. Generally, individual will be indifferent as to whether deduction is under §165(c)(1) or (2)
   1. However, business losses may be deducted ATL, where losses on profit-seeking transactions are BTL deductions, unless resulting from sale/exchange of property
3. Separating profit-seeking activities from personal activities
   1. §165(c)(2) recalls language of §212
   2. Where an expense with respect to property is deductible under §212, a loss on that property is generally allowed under §165(c)(2)
      1. Ex. Loss an investor incurs upon selling stock for less than he paid for it
         1. Possible for another IRC provision to disallow loss (sale between related members), or postpone it (1211(b) limiting deducibility of capital losses)
      2. Ex. TP buys a personal residence for $50k, and later sells it for $45k when it is still her residence; the loss of $5k is **not allowed** because not incurred in T/B, or profit-seeking transaction, and is not a casualty loss
   3. Even if TP insists he was hoping to make a profit at the time they offered the home for sale, it is still nondeductible; must be transaction entered into for profit
      1. 1.165-9(a): Losses not allowed – a loss sustained on the sale of residential property purchased or constructed by the TP for use as personal residence and so used up to time of sale is not deductible under §165 (provision applies beyond real estate obvi)
   4. The fact that prior to disposition, it may have been clear a loss was inevitable, does not negate the transaction being entered into profit, and subsequent deductible loss
      1. TPs primary purpose in this regard will be controlling
         1. If there are multiple purposes to the transaction
      2. Doubtful that the profit-motive will be considered dominant when the TP is making personal use of residential property
4. **Conversion of Personal Use Property to Income Producing Property** 
   1. Personal-use property can be converted into income-producing property to qualify for the §165(c)(2) deduction. 1.165-9(b)(1)
   2. Deduction is limited to the loss sustained after the property has been converted from personal to business or profit-seeking use
      1. Basis for loss purposes is the AB of the property **or** the value of the property at the time it was converted to business use, **whichever is lower**. 1.165-9(b)(2)
      2. Loss attributable to the period of personal use is nondeductible, and only the subsequent business or profit-seeking loss is allowed
   3. Where property is actually used at times for personal purposes (nondeductible) and at other times for business or profit-seeking purposes (deductible), allocation is required
      1. Ex. Allocation required w/ respect to a loss realized on selling an car used partly for business and partly for personal purposes
   4. No loss will be allowed for a conversion from business property to personal use
      1. Where a loss is thereafter realized, no deduction allowable under §165(c)(1), (2)

*A(2). When is a loss sustained?*

1. §1.165-1(b)
   1. Loss must be evidenced by closed and competed transactions, fixed by identifiable events
   2. Sale or exchange of property typically fixes the loss under §165, but mere decline in value is not a loss sustained
      1. Ex. ABC stock was purchased for $10k and declines in value to $500. Cannot claim a loss because no loss has yet been sustained.
      2. If stock is subsequently sold, the $9,500 loss has been sustained and can be deducted
   3. Loss may be sustained by the abandonment of an asset
      1. To establish abandonment under §165, TP must show both:
         1. Intent to abandon property; and
         2. Affirmative act of abandonment (an identifiable event that is observable to other and irrevocably cuts ties to the property)
      2. Conversely, the continued holding of an asset for possible future use or gain, or to the mere non-use of an asset does **not** establish abandonment
2. §165(g): Worthless Securities
   1. Loss is allowed for **securities** when they become worthless
      1. Share of stock in a corporation;
      2. Right to subscribe for, or to receive a share of stock in a corporation; or
      3. Bond, debenture, note or certification, or other evidence of indebtedness issued by a corporation
   2. Extensive shrinkage of value is not sufficient to establish worthlessness. 1.165-4(a)
      1. Normal 3 year SOL is extended to 7 years for refund claims based on 165(g)
   3. Obsolescence (1.165-2) or permanent abandonment of property (1.167(a)-8(a)(4)) may also give rise to a loss deduction
      1. Ex. C paid $25k for equipment to use in business (capital expense). 3 years after purchase, technology changes make the equipment useless. At the time he has an AB of $7,250 ($17,750 in depreciation deductions) and discards the equipment
      2. C will be entitled to a business loss deduction under §165(c)(1) in the amount of the AB or unrecovered cost in the equipment ($7,250)
3. §165(e): Theft Losses
   1. Theft losses deducted under (a) are treated as sustained in the yr the theft loss is discovered
   2. Ex. B operates a guide business and a rifle he used for the business was stolen in 2001, but did not discover the loss until 2002
      1. Under §165(e), B may not deducted the loss on the rifle in 2001 (even if amending return), but must deduct it in his return for (2002), when he discovered loss

*A(3)*: *Amount of the Deduction*

1. §165(b): Amount of the loss deduction is limited to the AB of the property in question
   1. Ex. TP sustains an uninsured loss to business or investment property that had value of $100k, and an adjusted basis of only $60k
      1. Deductible loss is only $60k. The $40k in lost value was not included in TPs income, and to allow a loss for $40k would be double tax benefit
2. Reimbursement
   1. To the extent a TP receives insurance or other compensation, the loss is offset and deduction is reduced
      1. If there is a reasonable prospect of recovery, loss is not treated as sustained until the matter of reimbursement is determined with reasonable certainty. 1.165-1(d)(2), (3)
   2. Ex. Same as above, but the loss occurs and an insurance claim is filed in year 1, and in year 2 they receive $40,000 of insurance proceeds
      1. Sustained loss occurs in Year 2 and must reflect the reimbursement
      2. TPs deductible loss will be $20k ($60k loss - $40k reimbursement)
3. Post-Conversion Losses
   1. Ex. House is purchased in year 1 for $100k. In year 5, when the house is worth $80k (with basis still $100k), it is rented out and converted to income-producing purposes.
      1. Allowable depreciation is based on $80k (lower of value or basis at conversion)
      2. If $10k total in depreciation is allowed for years 5-10, and the house is sold for $65,000 the allowable loss deducted is $5,000
         1. AR = $65k; AB for loss purposes is $70k
      3. For gain purposes normal basis rules are employed, not the lesser of basis or value
         1. If house was sold for $80k, there would be no gain (gain basis is $90k) or loss (loss basis is $70k)
   2. Ex. Car is purchased for $5k and used solely for personal purposes (and is not depreciable property). Car is later converted to business use when value is only $2000.
      1. Basis for depreciation and loss purposes is $2,000
      2. Loss under §165 cannot exceed $2,000 without dipping into the value of the car while it was for personal use (which is not allowed)
4. Disallowed Losses
   1. Losses otherwise allowable under §165 may be disallowed by other provisions of the IRC
   2. Ex. §267(a)(1) disallows losses on related party sales or exchanges, and §1091 denies losses on wash sales of stock or securities (*see* chapter 27)

*B. Bad Debts*

1. §166: Bad debts
   1. Allows a deduction for debts that become worthless w/in taxable year
   2. No distinction between corporate and individual TPs
   3. Does draw a line between business and nonbusiness bad debts
2. Bona Fide Debt Requirement
   1. §166 is not enacted unless a bona fide debt exists
      1. Requires a debtor-creditor relationship based on a valid, enforceable obligation to pay a fixed or determinable sum of money
      2. Does not apply to worthless securities
   2. Gift is not a debt
      1. Presumed, subject to rebuttal, where the relationship is a close one, a gift and not a loan was intended
3. Worthlessness
   1. Debt must be a bad debt for a deduction to be allowable
      1. Even when bona fide debt is present, forgiveness or cancellation of the debt may itself constitute a gift rather than evidence of worthlessness, and be nondeductible
      2. 7 year SOL for refund claims under §166
   2. No deduction is allowed unless debt was worthless or partially worthless, but if provisions of §162 are otherwise met, deduction would be allowed as a T/B expense
4. §166(d): Business or Nonbusiness Debts
   1. Business debts are deductible under §166(a)(1) in the year they become wholly worthless
      1. Partially worthless business debts are also deductible up to the amount charged off within the yr
      2. Business bad debts rules do not distinguish between individuals and corporations
   2. Nonbusiness bad debts are deductible only upon becoming wholly worthless
      1. Even if completely worthless, deductible only as short term capital losses, rather than as ordinary losses (as in the case of business debts)
      2. Deduction of capital losses is limited under §1211, where capital losses are deductible only to the extent of individual’s capital gains, plus $3,000
   3. Non-business debt is defined as debt other than:
      1. Debt created or acquired in connection with the TPs business, or
      2. Debt, the loss from the worthlessness of which, is incurred in the TPs business
         1. Ex. Where shareholder-EE has made un-repaid advances to a closely held corporation is a non-business debt (investing is not a T/B)
   4. EE is engaged in business as an EE
      1. If an EE can demonstrate that a loan to one’s ER is, in effect, required as a condition of employment to insure continued employment, the loan is a business debt arising out of the T/B of being an EE
      2. Loan must bear a proximate relationship to the TPs T/B. 1.166-5(b)
   5. When a loan is prompted by both investment and business reasons (often when the TP is both shareholder and EE), the business motive must be dominant for the debt to be characterized as a business debt
5. §166(b): Amount Deductible
   1. Amount of a bad debt deduction is the debt’s AB
      1. Mary lends George $1,000, and George repays $200. The balance of the debt ultimately becomes worthless. Mary’s AB in the debt is $800, and that is amount of her loss.
   2. No bad debt deduction is allowed unless such amounts have been included in income, which would not be the case of the cash method TP
      1. If a TP performs services w/o compensation, the TPs net worth is unchanged, and no income is recognized; No loss is appropriate and no deduction is allowed
      2. If income was recognized, as with an accrual method TP, a deduction is in order to reflect such recognized, but uncollected compensation, and this applies to interest
   3. Ex. Unpaid interest of $100 accrued on Mary’s $1,000 loan to George. If Mary is cash method, basis remains $1,000. IF Mary is an accrual method, and properly accrues basis, basis in loan and unpaid interest increases to $1,100.
6. Guarantees
   1. Losses arising out of loan guarantees are treated as losses from bad debts, and are classified as business or nonbusiness debts based on their connection with TP’s T/B

*C. Bad Debts and Losses: Interplay of §166 and §165*

1. TPs may seek to characterize a loss under §165 rather than §166, vice versa
   1. Investment related losses are subject to capital loss treatment if they fall under §166, where that is not necessarily the case under §165
   2. Conversely, if the loss in question is a personal one, §165 denies a deductions, where §166 at least offers a short-term capital loss
2. Under §166 personal bad debts are deductible
   1. This assumes the debt is bona fide, despite the absence of any business or profit-seeking motivation on the part of the lender
3. §165 and §166 are mutually exclusive, and where both provisions apply in a given situation, §166 supersedes

**XXIII: Limitations on Deductions**

*A. §267 Losses Between Related Parties*

1. Section §267(a)(1) Loss Rule
   1. To prevent the deduction of artificial losses, Congress enacted §267(a)(1), denying deduction for any loss incurred on the sale or exchange of property “directly or indirectly” btwn certain **related persons**
      1. Members of a family (brothers and sisters, spouse, ancestors, and lineal descendants
      2. Individual and a corporation more than 50% in value of the outstanding stock of which is owned (directly or indirectly) by or for such individual
      3. Other forms of stock constructively owned by a person
   2. Ex. Pete has a basis of $15,000 in stock with a FMV of $10,000. He sells stock to his daughter.
      1. Pete cannot deduct $5,000 loss due to father-daughter relationship under 267(b)
   3. Ex. Assuming daughter buys the stock from Pete for $10k, she sells it to unrelated 3rd party for $12k
      1. Daughter’s basis is a §1012 cost basis of $10,000
      2. Under 267(d), daughter only has to recognize gain to the extent that the gain exceeds loss disallowed to her father
         1. Father’s loss was $5,000; Daughter’s gain only $2,000, and no gain recognized for GI
         2. Other loss of $3,000 by father disappears
      3. 267(d) treats daughter and father as one TP by giving daughter the benefit (but only a limited extent) of the father’s loss
   4. Ex. When to old friends sold e/o stock at a loss at the end of the year and repurchased the stock from one another at the start of the following year
      1. Both paid FMV and no legal obligation to repurchase, sufficient dominion existed to assure repurchase and negated bonafide sale
   5. Ex. No loss where TPs (husband and wife) owned stock in their individual names, and husband managed the independent estate of his wife, ordering broker to sell stock owned by his wife and to buy the same number of share for the husband’s account at the same approximate price, and vice versa
      1. Negated possibility that related TPs could time their losses on investments while at the same time essentially continuing to hold the investments
      2. 267(a)(1) was broad enough to encompass transactions where stock was sold through exchanged to unknown purchasers and different certificates of stock in same company were purchased
   6. §267 contains an absolute prohibition against the allowance of losses on any sales between members of certain designated groups
2. §267(a)(2) Matching Requirement
   1. Conditions the deduction of expenses on the inclusion of related income
      1. Places an accrual method taxpayer on the cash method of accounting with respect to the deduction of amounts owed to related cash method TPs
      2. Accrual method: deducts an expense when all the events occur and fix amount owed
      3. Cash method: includes an amount in income upon receipt
   2. Ex. X is a corporation, John is the president and GM of X and owns 75% of X’s stock. John is a cash method TP, while X is an accrual method TP.
      1. X owes John $50k for services, and as an accrual method TP, the corporation would normally claim a $50k deduction in Year 1.
         1. John as a cash method TP would not be required to include anything in income until payment is actually received.
      2. Under §267(a)(2), X may not claim a $50k deduction in Year 1 for the amount owed to John
         1. X will claim a deduction in the year in which X pays John the $50k
   3. Ex. Individual is more than 50% owner of corporation and is a related party, if the individual (cash method TP), makes a loan to the corporation (accrual method), §267(a)(2) denies an interest deduction to the corporation until the interest is actually paid to the individual by the corporation
      1. Interest deduction **barred bc of the relationship in the year it accrued** is deductible only when the interest is paid to the cash method TP (even if they are no longer related in the future)
      2. Interest that accrues after the parties are no longer related is deductible immediately

*B. §265: Expenses Related to Tax-Exempt Income*

1. §265(a)(1) General Rule
   1. Disallows all deductions allocable to tax-exempt income, other than tax-exempt interest
      1. Includes deductions under 162 (T/B), 165 (losses), 212 (investment expenses)
   2. Ex. TP purchased for investment contingent remainder interests in 2 estates, and to protect his investment, he purchased policies of life insurance on the remainderman
      1. TP sought to deduct the premiums paid on the policy
      2. Bc the proceeds from the life insurance polices would have been tax exempt under §101, deduction for the premiums was disallowed under §265(a)(1)
   3. Ex. No deduction was allowed for home mortgage interest and real property taxes allocable to a tax-exempt housing allowance received by an EE of the INS stationed abroad
   4. Ex. Is an otherwise allowable §162 deduction for expenses incurred in taking a flight training course disallowed by §265 bc the TP received reimbursement for 90% of the costs under federal law?
      1. Reimbursement received by the TP was tax-exempt
      2. Proximate one-for-one relationship between the reimbursement and the deduction overrides the underlying relationship between deduction and the employment income, making it directly allocable under 1.265-1(c)
   5. Also disallows expenses allocable to tax exempt interest, but only for §212 (*?)*
      1. Other deductions are not subject to this disallowance (T/B or state and local taxes), but are subject to disallowance of tax-exempt interest under 265(a)(2)
2. §265(a)(2): Tax-Exempt Interest
   1. Disallows interest expense deductions associated with the production of tax-exempt interest
      1. **Specifically, disallows a deduction for interest on indebtedness incurred to purchase or carry obligations the interest on which is wholly exempt from taxes**
      2. Ex. Where interest (income) generated by municipal bond may be excludable, TP may not deduct any interest paid on money borrowed to purchase the bond
   2. TPs would realize a double tax benefit from using borrowed funds to purchase or carry tax-exempt bonds bc the interest expense would be deductible, while the interest income would escape federal tax
      1. The interest disallowance rule applies whenever a taxpayer uses borrowed funds to purchase or carry tax-exempt bonds
      2. Ex. TP has 10k savings, but instead receives a loan and purchases a tax-exempt bond, so he gets deductions on interest paid on loan while income from the bond is tax-free (double benefit)
      3. Makes no difference that the TP actually realizes tax-exempt interest income form the obligations, only necessary that the obligations would produce interest wholly exempt from tax
   3. The mere fact that the TP has incurred or continued a debt while holding tax-exempt obligations will not trigger the 265(a)(2) disallowance
      1. Direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness
      2. Where a TP uses a portfolio of tax-exempt obligations as collateral for a business or personal loan, the interest on the loan will not be deductible
   4. Ex. TP intending to invest in both tax-exempt bonds and real estate uses $50k of her savings to purchase the tax-exempt bonds, and borrows $75k to purchase property
      1. Purpose to purchase or carry tax-exempt obligations generally does not exist with indebtedness incurred/continued in connection with active T/B
      2. Rebuttable presumption that the purpose to carry tax exempt obligations exists where the TP reasonably could have foreseen at the time of purchasing the tax exempt obligation that indebtedness probably would have to be incurred to meet future economic needs of the business of an ordinary, recurrent variety
   5. Special rule for individual taxpayer who incurs indebtedness to purchase goods or services for personal consumption or a personal, while owning tax-exempt obligations
      1. 265(a)(2) will not apply to indebtedness of this type bc the purpose to purchase or carry tax-exempt obligations cannot reasonably be inferred where a personal purpose unrelated to the tax-exempt obligations ordinarily dominates the transaction
   6. Where a TP holds tax exempt obligations and has outstanding indebtedness which is not directly connected with personal expenditure or incurred in active conduct of T/B, there will be a rebuttable presumption that the TP has a purpose to carry the tax-exempt obligations
      1. This presumption can be overcome by establishing that: (1) tax-exempt obligations could not be sold at the time; (2) tax-exempt obligations could only have been liquidated w/ difficult or at a loss; or (3) an investment advisor recommended he should maintain a particular % of assets in tax-exempt obligations
   7. Ex. A owns readily marketable municipal tax-free bonds. A borrows $100k to invest in a limited partnership real estate company and pays $8k interest on the loan, and claims an interest deduction
      1. Under these facts and circumstances, presumption that the $100k indebtedness incurred to finance A’s portfolio investment is also incurred to carry A’s existing investment in tax-exempt bonds since there are no additional facts or circumstances
      2. Accordingly a portion of the $8,000 interest payment will be disallowed under 265(2)
3. Allocation
   1. Expenditure may be indirectly allocable to both taxable and tax-exempt income
      1. Only the portion of the expenditure allocable to the tax-exempt income is subject to 265
   2. Regulations requires that reasonable proportion of the expenditure in light of all the facts and circumstances be allocated to the exempt income
      1. In absence of other bases for allocation, expenses will be allocated to the taxable and tax-exempt income in the same proportions as the taxable and tax-exempt income bear to the total income received

Miscellaneous

**XXVI: Hobby Losses**

1. §183 applies to activities not engaged in for profit
   1. Each activity must be tested separately as to whether it is an activity not engaged in for profit
      1. Activities that do not qualify for deductions under §162 or 212
   2. Nine relevant factors to determine whether an activity **is** engaged in for profit
      1. Manner in which TP carries on the activity
      2. Expertise of the TP or his advisors
      3. Time and effort expended by TP
      4. Expectation that assets used in activity may appreciate in value
      5. Success of the TP in carrying on other similar or dissimilar activities
      6. TP’s history of income or losses w/ respect to the activity
      7. Amount of occasional profits, if any which are earned
      8. Financial status of the TP
      9. Elements of personal pleasure or recreation
   3. Deductions are not allowable under 162 or 212 for activities carried on primarily as a hobby
      1. 183(d) creates a rebuttable presumption that the activity was engaged in for profit, with respect to a given year, if the activity was profitable for three years in the five year period, ending with the year in question
   4. §183 aplies to individuals, S corporations (small business), estates and truts, partnership activities
      1. For corporations other than S corporations, no inference from 183 that any corporate activity is or is not a business or engaged in for profit
   5. Ex. Based on financial analysis of the cash flow from the yacht chartering venture, TP could not have anticipated making a profit on the operation w/in the foreseeable future, I fever
      1. TPs may have liked to make a profit, but on the above facts, the chartering venture was an activity not engaged in for profit under §183
2. Deductions Allowable under §183
   1. If the activity in question constitutes a T/B, or one engaged in for the production or collection of income, or for the management, conversation or maintenance of property held for the production of income, deductions are allowable under §212 or 162 (and §183 is not applicable)
      1. If activity in which deductions are not allowed under 212 or 162, section 183 allows deductions as set forth under 183(b)
   2. §183(b): Three categories of permitted deductions for activities not engaged in for profit
      1. Category 1: Home mortgage interest 163(h), or state and local property taxes 164
         1. Deductions attributable to the activity but which do not come within Category 1 are allowed to the extent the GI from the activity exceeds the total Category 1 deductions
      2. Category 2: Deductions that do not result in a basis adjustment and that would otherwise be allowed if the activity were engaged in for profit (under 162 or 212)
      3. Category 3: Deductions, such as depreciation, that result in basis adjustments and that would be allowed if the activity were engaged in for profit
   3. Ex. An activity not engaged in for profit generates $1,000 GI and has expenses attributable to the activity of $500 local property tax, $400 current wages paid, and $300 depreciation
      1. Deductions would be allowed for full amount of Category 1 ($500), the full amount of category 2 because combining 1 and 2 do not exceed GI from the activity ($400), and $100 of category 3 so as not to exceed the $1000 ceiling

**XXV: Like Kind Exchanges**

*A. Introduction*

1. §1031: Exchange of Property held for productive use or investment (nonrecognition rule)
   1. Under §1031, no gain or loss is recognized when property held for productive use in a trade or business or for investment is exchanged solely for property of like kind to be held for productive use in a trade or business or for investment
      1. Besides exchanges under 1031, gains or losses realized on the sale or exchange of property must generally be recognized (1001)
   2. 1031 nonrecognition does **not** apply to any exchange of:
      1. Stock in trade or other property held primarily for sale
      2. Stocks, bonds, or notes
      3. Other securities or evidence of indebtedness or interest
      4. Interest in a partnership
      5. Certificates of trust or beneficial interests
      6. Choses in action
2. Continuity of Interest
   1. Property received in a like kind exchange is viewed as a continuation of the TP’s investment in a modified form
   2. Bc the investment in substance is a continuing one, TP has technically, but not effectively realized gain or loss, and the exchanges is thus regarded as an inappropriate time to levy a tax or permit deduction
3. Like Kind Requirement
   1. Like kind refers to the nature or character of property, or its kind or class (not grade or quality)
   2. Like kind requirement is satisfied if depreciable tangible personal property is exchanged for property either of a like kind or of a like class
   3. Transfer of multiple assets must be analyzed in terms of the underlying assets

*B. Holding Requirements*

1. §1031(a) requires the property exchanged be property held for productive use in T/B or for investment, and the property acquired be property to be held either for productive use in a T/B or investment
   1. Excludes personal-use property
   2. Ex. Exchange of residential real estate used as rental for another piece of real estate used as a personal residence does not satisfy to be held requirement
2. Applicability of 1031 to one party in the exchange does not depend on its applicability to other parties
   1. Exchange of T/B property for investment property, or vice versa, if properties are otherwise like kind may qualify for recognition
   2. Ex. land held for investment exchanged for business realty is held under 1031 nonrecognition
3. If a TP owns property which he does not intend to liquidate or to use for personal pursuits, he is holding that property for productive use in T/B or for investment under 1031
   1. Intent to exchange property for like-kind property satisfies the holding requirement bc it is not intent to liquidate the investment the investment or use for personal pursuits
   2. Exchange may not qualify for nonrecognition where the intent at the time of the exchange is to make a charitable contribution of the property received, or to give property to one’s children
4. Two year holding period between related persons (no specific holding periods otherwise)
   1. Restrains the TP, for two years at least, from effectively cashing out business or investment property through a related property while using 1031 for nonrecognition
   2. Applies to the property received by TP and the property transferred by the TP to related persons
   3. If holding period requirement is not satisfied, the gain or loss that was nt recognized is reported in the year the subsequent, disqualifying transfer occurs
   4. Using intermediaries has the same effect and will not be allowed nonrecognition
5. Ex. Kurt exchanges undeveloped lot for a tract of land owned by his son. Kurt’s AB in the lot is $10k, and its FMV is $250k. The son’s land has a value of $250k and he has an AB of $200k. Kurt qualified for 1031 nonrecognition on the exchange but the son did not (personal purpose land). 6 months later, son sold the lot acquired from his dad for $250k.
   1. But for 1031, Kurt would be forced to recognize $240k in the exchange
   2. Under 1031, Kurt will recognize no gain and take a 10k basis in land from the son
      1. Bc son did not qualify for 1031, he must report $50k in gain (250k – 200AB he had) and take a 1012 cost basis of 250k in the lot
   3. If the son sells the lot 6 months later for $250k no additional gain, but Kurt will be required to report at that time the gain in the exchange that he was previously not required to recognize (240k)

*C. Solely for Like Kind Property: Presence of Boot*

1. Like kind properties transferred in a 1031 exchange are almost always unequal in value and at least one of the parties will have to transfer cash or non-like kind property (boot) to even the exchange
   1. Party giving, but not receiving, cash or other nonqualifying property, remains within the language of 1031 bc he receives solely like kind property for what he gives up
   2. Party receiving cash or nonqualifying property is not receiving solely like kind property
      1. Does not disqualify this exchange but requires recognition of gain on the like kind property to the extent of boot received (but not in excess of gain realized)
   3. Ex. TP exchanges property worth 50k with AB of 20k for like kind property worth 40k and 10k cash
      1. TP will realized gain of 30k, however only 10k of realized gain is recognized
      2. However, if property exchanged had a basis of 80k instead of 20k, none of the realized loss would be recognized
2. Gain or loss on non-like kind property is not governed by 1031, and such gain or loss is recognized under 1001c
   1. The party giving nonqualifying property in an exchange recognizes gain or loss to the extent of the difference between the value received and the AB of the property given up
   2. Ex. TP exchanges land worth $500k with $200k AB and a piece of business equipment worth $50k with AB of $100k for a parcel of real estate worth $550k. Assume holding requirements are met.
      1. Gain inherent in TPs land will not be recognized, but the loss of $50k incurred in exchange of the equipment (50-100) will be recognized
      2. Bc the equipment and real estate are not like kind, 1031 is inapplicable to that part of exchange and loss is thus recognized
      3. TP is viewed as exchanging $500k for $500 or real estate, with recognized loss of 50k
      4. Other party receiving the non-like kind must recognize 50k gain

*D. Treatment of Liabilities*

1. Where one or more of the properties in a like kind exchange is transferred subject to a liability, or for one party to assume liability of another, such liability relief is treated under 1031 as money received by the TP
   1. Liability is a form of boot
   2. If both properties in a like kind exchange are transferred subject to liabilities, only the net liability relief constitutes money received. 1.1031(d)-2 ex. 2
   3. Must also offset the net liability with any money received
2. 2 apparent rules
   1. Cash received always counts as money received
   2. Net liability relief, reduced by any cash paid, also constitutes money received

*E. Basis Calculations*

1. Unrecognized gain or loss is preserve by using as a starting point the total bases of all the property given up
   1. Liability relief is treated as money received, thus decreasing basis
   2. Liabilities taken on are treated as money paid
   3. Money paid increases basis
2. Where non-like kind property aka boot is received
   1. Basis is first allocated to the non-like kind property to the extent of its FMV, thus preserving in the like kind property the unrecognized gain or loss
   2. When money is received, or liability relief occurs or loss is recognized, the TP is in effect receiving a partial return of investment, and it is appropriate to reduce basis
3. Basis of the like kind property received:
   1. The adjusted basis of all like kind and non-like kind property given up
   2. Plus any gain recognized, liability taken on, or cash paid
   3. Minus any loss recognized, liability shed, or cash received
   4. With the resulting total basis allocated first to non-like kind property received to the extent of its FMV
   5. With the remaining basis constituting the basis of the like kind property

*F. Sale or Exchange*

1. If the transaction is in substance an exchange rather than a sale and purchase, 1031 governs
   1. Ex. TP sold used business equipment to a dealer under one k and purchased new like kind equipment from the same dealer under a new k
      1. Two transactions were reciprocal and mutually dependant and were treated as a trade-in exchange rather than a sale and purchase
   2. Ex. TP initially contracted to exchange unimproved land for improved land, but when the other party failed to make improvements on time, TP sold his land for cash to other party and three months later (when improvements were made), purchased the improved land
      1. Sale and purchase, not a exchange under 1031
   3. Ex. If the lease runs 30 years or more, the leasehold and a fee interest will be treated as like kind
      1. If a TP sells real property for cash but at a loss, and simultaneously enters into a long-term lease of the property, 1031 bars the loss