Staudt Fed Inc. Outline

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Exceptions to sec 61
- Everything of economic valuable is taxable unless it’s been taxed → basis 1001
- Gifts – 102
- Sec 132
- Sec 119
- Imputed income – no specific exception, but it is excluded.

The general rule is that all economic benefits are taxable unless you can find an explicit exemption.

When is the benefit taxable?
- Eisner v. Macomber – when you sell

INCOME
- **Exclusion** – works at the gross income level, you don’t include the taxable item into the gross income
- **Exemption** – subtract from the gross income
- **Deduction** – gross income minus a deduction equals a taxable income (multiply this by the tax rate to get to the taxes owed)
- **Credit** – tax owed minus credit equals the taxes you pay

The first three are used to reduce the gross income (they’re pretty much the same in function). There are different rules that apply to these. The most fundamental rule is there is a limit to the amt of deductions you can take, but the same isn’t true for exclusions and exemptions.

A credit is different in that it’s an absolute number that isn’t affected by the tax rate. It’s literally money that the government is giving you by reducing your taxes by that amt of money. As opposed to a deduction which is adjusted by the tax rate. EX: 100 taxable income, 10 deduction at 10% tax rate = tax of 9 dollars. This means that the 10 dollar deduction is really only worth 1 dollar. A credit of ten dollars is always worth 10 dollars. Credits are more valuable than exclusions, exemptions, or deductions.

What about installment sales, when do you tax when you know there was an economic benefit?
- sec 453

Constructive Receipt

Economic benefit

**DEDUCTIONS**

1) Personal expenses – 262,
- Gen rule - no deduction
- Exceptions – 165 (c ), 170, 213, 280A, 165(d)
2) Hobbies – 183
- Gen Rule – partial deductions (losses to extent of profit)

3) For Profit – 212
   - Gen Rule deductibility
   - Exception 280A, 274

4) Trade or Business – 162
   - Gen rule – deductibility
   - Exception 274

What Congress is doing is setting up a hierarchy
In context 3 or 4, the expense is a means to an end. In context 1, what’s happening is consumption
In context 2, you can take a deduction for losses to extent of profit → They did this bc they were tired of TP arguing that they were in a 212 or 162 situation

- Taxation is tied to one’s ability to pay, that’s why we have the progressive tax rate

GROSS INCOME
Adjusted gross income – after taking out all of the exclusions and deductions.
Is there an economic benefit → sec 61 – gross income – all income from whatever source derived, including the following items….
When doing an analysis start with sec 61 and look if there is an economic benefit, then look to see if there is an exception
- Gross income includes income realized in any form
  o Policy: Taxing non cash benefits good bc it keeps people from bartering to avoid taxation; however, it raises problems of administrative feasibility or practicality
- General rule is that all economic benefits are taxable unless you can find an explicit exemption
- Income is an economic gain
- Freedom and control

- 61 embraces cash and non-cash benefits.  Non cash items present valuation difficulties
  o dealings in prop
  o comp for services
  o dividends, rents

Exceptions to Sec 61
Sec 119 – Benaglia – if the room and board is provided for the convenience of the ER, then it’s not taxable income
- forced consumption on the TP, no freedom and control, not much value to the benefit

Sec 132 – Fringe Benefits → raise problems of valuation, enforcement, and of political acceptance, the value of a particular benefit to the person receiving it may depend on the circumstance of that person.
The implication of Benaglia (119) is that ERs are going to try to move to a non cash world. ERs and EEs are going to try to be in cahoots and get around taxes. Instead of trying to figure out everything that’s going on, why not just let some of these things go.
Policy – in 132 Congress is trying to exclude things that are small or are things that EEs wouldn’t have taken advantage of unless it were free, so they aren’t things that would keep the government from getting taxed (like unused airline seats).
If you have a benefit and it turns out sec 142 doesn’t control then you go to sec 61. So, if it was a seat that could have been sold you have to pay.
1) No additional cost services – seat on a plane that wasn’t taken
2) Qualified EE discounts – limited to 20% on qualified prop or services
3) De minimis fringe – any prop or service, the value of which is so small as to make accounting for it unreasonable or administratively impractical.
4) Must be qualified products and services
5) Dan’t discriminate in favor of highly compensated EEs.
   - *Charley* – taxed on FFV bc seen as a sale of miles for cash
   - *Turner* – cruise contest winners; ticket definitely income bc TP derived economic benefit, but valuation is difficult.

**Imputed Income** – use of one’s own prop or their own services to provide benefits directly to themselves or to members of their household – Income from a non-commercial activity. It’s something associated with value, but not paid for.
- Arguments to include as income - fairness
- Ex: income from prop (household durables) and income from services
  - not taxable under 61
    - administrative hassle
    - valuation problems
    - just having go’t workers coming around to value things is too much of an intrusion into people’s lives.
- Horizontal equity problem – 2 exactly alike are treated differently

**Barter System**
- Income is FMV of goods received
- If they were paying in straight out cash instead of services, it would definitely be taxed \( \rightarrow \) this is compensation for services
- **Policy** – people would always use the barter system to get around taxes

**Windfalls** – punitive damages taxed

**Gifts**

*Sec 102 – Gifts* – gross income does not include the value of prop acquired by gift, bequest, devise, or inheritance
- Detached and disinterested generosity – look to donor’s intent
- Donor cannot deduct the gift and the donee isn’t taxed - balance
- **Policy:** may exist bc of intra-familial exchanges
  - administrative hassles
  - the legislature views the family as a unit. If we tax any transactions bw them, we are taxing the parent and child, but there has been no economic change within the family unit
- 102 can never be used in business circumstances
- Donee inherits the donor’s basis \( \rightarrow \) **Policy** – donor was never taxed on appreciation.
  - **Sec 1015** – Basis of prop for gifts - if the prop was acquired by gift the basis shall be the same as it would be in the hands of the donor
    - Amt realized = basis = amt recognized
    - **APPLICATION**
      - If FMV > basis on date of gift, donee gets transferred basis (same as above)
If FMV < basis on date of gift, basis for calculating gain is transferred basis
  ▪ Basis for calculating loss = FMV on the date of the gift (less of a loss taken by donee)
  ▪ If prop is sold for amt bw basis and FMV, no loss or gain recognized (basis=sales price)

- **Sec 1001** – the amt realized is the amt you get paid. The amt recognized (taxable income) is the amt gained or lost (amt realized is the sum of all monies received plus the FMV of any prop received)
- **Sec 1012** – basis is the cost

  - Amt realized – Basis = amt recognized; Amt realized = sum of all cash received + plus FMV of prop received
  - **1015 controls when there is a sale of a gift.**
  - **1012 controls when original purchaser sales** (basis is the price acquired)
  - **1014 controls when there is a bequest and sells** (donee’s basis is the value at the day of death, stepped-up basis)
    - This is a huge loophole and is troubling; it encourages people to hold prop until death, economically troubling (immobility of cap). But helps the donee, bc now he won’t have to pay huge taxes.

**RECOVERY OF CAPITAL**
- 1001 – amt recognized = amt realized – basis; amt realized = cash received + FMV of prop received.
- Income includes interest, rents, dividends, and other returns on one’s capital or cost or investment. It also includes gains from the sale (or other disposition) of that capital. But it does not include returns or recoveries of one’s capital.
- Recovery-of-capital exclusion

  - **Inaja Land Co v. Commissioner** – city pollutes TP’s prop
    - IF the land is easily apportionable, like farm land, then we make an adjusted basis and do it straight up → this is always what you do first; however, if you can’t apportion, then we do it like Inaja Land, and reduce the basis.
    - This rule applies when sale of land is involuntary and not susceptible to easy valuation.

**Recovery of Loss**

- **Clark v. Commissioner** – guy who messed up tax returns
  - reimbursement was not includable in the TP’s gross income, bc it was, in fact, compensation for a loss which impaired petitioner’s capital
  - TP only owed 13K of the 32K, so this 19K shouldn’t be taxed. Govt isn’t going to tax more than they’re supposed to.
- **Burnet v. Sanford** – dredging the Delaware
  - When TP receives award to compensate for losses, should income be recognized in current yr or should it offset past losses? This case no good anymore, look at 172

- **Sec 172 – Net Operating Loss Deduction** - we can carry the loss forward 20 years and back 2 years. The beauty of this is that the loss doesn’t have to be related to any gain. Any loss can be put forward to go with any gain.
  - unused losses must be used in the earliest year possible – cannot reduce income to less than zero.

Let’s say A buys prop for 70 in the past, now it’s worth FMV 500.
HYPO:
B buys land in the past for 600, now it’s worth FMV 500.

The 2 want to swap land. What’s A’s gain on this transaction? Amt realized for A is $430. For B, amt realized is - $100.

The new basis for each party is $500.
- sec 1012 – the basis equals the cost; the cost was 500 for each party.
- A paid taxes on 430 and 70 in the past, so tax has been paid on 500
- B paid taxes on 600 and got a deduction of 100, so the basis is 500
- This is something like a barter transaction, you have to pay taxes when the exchange takes place, you don’t need to have sold the land for cash for you to realize the gain or loss.
- You can’t avoid taxes by engaging in prop transactions
- Sec 1001(b) – the amt realized from the sale or other disposition of property shall be the sum of any money received plus the FMV of the prop received.
- Not a gift, no detached and disinterested generosity.

What if later A sells her prop for 300? She has a loss of 200.

What if B uses the new prop he has and it cause air pollution. A is pissed off bc the pollution is causing damage to the land. Let’s say that B gives A 300 for not saying anything about the illegal pollution? 300 could be taxed as A’s service for keeping quite. Or, like in Inaja Land, it could be payment for damage to A’s land (partial sale of property), and the 300 would just be reduction in the basis of A’s land. IRS is probably going with the 300 as income so they can tax. If we go the Inaja Land route, the new basis will be 200.
- if the payoff was 500, then the basis would be adjusted to 0. The basis has no reflection of the FMV, just because the basis is 0 doesn’t mean that the property is worthless.
- (Taxpayer usually wants a higher basis, so they can either get a loss or pay less in tax)
- basis never changes unless there is a sale or exchange of prop

Claim of Right
- You pay taxes in the year you have a claim of right to it. What matters is when the TP has control and unrestricted use over the prop.
- What if you get a lot of money, get taxed on it in a high tax bracket, have to then give it back, and only get a deduction at a lower tax bracket?

Sec 1341 – item was included in gross income for a prior taxable year bc it appeared that the TP had an unrestricted right to such item. Deduction is allowable bc it was established that the TP did not have an unrestricted right to such item or to a portion of such item; and the amt of such deduction exceeds 3K.
- Have to satisfy 1341 (1)(2)(3) to get to (4) or (5). If you don’t satisfy, then you have to take the deduction the ct gives you.
  - (a)(4) - Just deduct it in the later year (this reflects Lewis) (want to use this when the tax bracket you’re in is higher in year 1, when you receive the money, than in year 2 when you have to give it back) or
  - (a)(5) – You figure out your tax burden in the year you pay money back without accounting for the deduction for the payback, then subtract out the tax that you paid in the previous year (tax credit) (want to take this
tax credit when the tax bracket you’re in is lower in year 1 than in year 2 when you have to give it back).

RULE OF THUMB – if the taxable year (the year you return the money) has a lower tax, use a5. If the taxable year has a higher tax rate use a4.

- a5 is really saying you get the deduction in the previous year not the taxable, like a4 let’s you do.
- So basically, you choose in what year you take the deduction

**Tax Benefit Rule** – addresses the opposite question of the claim of right
- what if you take a deduction in year one and then you get it back later in year 2
- only declare income to extent that you used the deduction
- recovery is included in current yr’s inc to the extent the corresponding deduction was used to offset income in the prior year.

**Sec 111**
- The unfairness is that Sec 111 doesn’t’ take into account any differences in tax bw the 2 years. You pay the tax in the tax bracket you’re in, in the year that you get the money back.
- Let’s say that in year 1, you lose 90K, but you can’t use the deduction
- In year 2, you have income of 80K, so you can use the 90K deduction here, but you have a left over 10K.
- So, 111 works as an exclusionary rule and as an inclusionary rule
  o You get to exclude the item returned to you if you never got the benefit of the deduction when you lost the item, and the deduction expires (20 years, 172 net operating loss): if deduction did not offset any income in prior year, amt recovered is not included in current income.
  o You have to include it to the extent that you got a benefit: if entire deduction was used to offset income in prior year, entire amt is included in income.
  o Basically, you only recognize, 80K, the amt you used deduction

**Transactions involving loans and income from discharge of indebtedness**
- Loan proceeds are not included in gross income and loan repayments are not deductible, applies to cash and accrual method TPs. Loans do not improve economic positions bc are offset with corresponding liability.
- don’t have to pay tax on loans bc there is a presumption of an obligation to pay back. There is no unambiguous claim of right, so there is no tax.
- If debt is discharged, you have to pay tax on it → sec 61
- If you don’t pay back the loan, you get taxed on it.
- Taxable income when you buy back bonds for lower then you sold them.
- **Analysis of a hypo:**
  o What if you have a friend that wants to open a store, and you want to help, so you transfer to him 10K, and you agree on a 5% interest rate? There is no loan agreement, and there is no repayment schedule. Basically, the friend is going to pay back whenever they make some money. Friend doesn’t make any money and says that he can only pay back 8K. Well, is the 2K taxed or do we say that it is a gift?
    ▪ Well, if lender takes a tax loss, well maybe it isn’t a detached and disinterested generosity. It may be a loan and a discharge of the debt
    ▪ But, if we look at the circumstances, no tax schedule, no K, well it may be that it is a gift.
Even if there is loan, the failure to repay may be the gift.

Let’s say we do have a loan from a bank for 10K

- 6000K paid in cash, and 2K in services → let’s say that the services really were worth 2K
- So, we say that there is a repayment of 8K
- There is a 61a12 – 2000 discharge of indebtedness
- Can we say that there is also a tax on the 2K worth of services on the borrower based on compensation? If the borrower performed the services for a third party, he would definitely have been taxed. So, yes, we do say that the borrower has to pay the tax on 2K or else a lot of people would get out of taxes. Take for instance that a teller of the bank wanted to borrow 10K from the bank, and then just get to work it off. This is not a loan, it’s just a pre-payment for services. Another reason is that the borrower only paid back 6000 in cash and has free use of the other 4K.

- **Misconceived Discharge Theory** – if the ER pays the debt of an EE off as a bonus, this doesn’t fall under discharge of indebtedness bc the loan was paid in full. This should be taxed under 61 as compensation.

- **108d1a and b** defines debt – any indebtedness subject to which the taxpayer is liable, or subject to which the taxpayer holds property.
  - So we have to look if the TP is liable or holds prop
  - Liability implies a legally enforceable obligation to repay
  - **Zarin**
    - Just bc he pays something isn’t an acknowledgment that he has a debt
    - The ct said told the casino not to lend him money, but they did, so he isn’t liable → no debt

- **Contested liability doc** – if a TP, in good faith, disputed the amt of a debt, a subsequent settlement of the dispute would be treated as the amt of debt cognizable for tax purposes.
  - There has to be a ligit dispute to the amt owed.

- **Diedrich**
  - Donors gave gift of stock to their children
  - Basis is 51K, Gift tax is 63K
  - This transaction is a conditional gift – kids get the stock if they pay the gift tax
  - the Donee’s basis is 63K, the amt that they paid in gift tax. The original basis was 51K, but the Donor’s paid tax on the difference bw 51K and 63K (this is their amt recognized). Therefore, the donee’s basis is going to be 63K bc the appreciation from 51K to 63K has been taxed already, and they should only be taxed on the rest of the appreciation.

The following cases → in the case of nonrecourse debt incurred to acquire or improve the prop, the rationale for this rule is: The debt relief is included in the TP’s amt realized bc the debt will have been included in the TP’s basis for the prop when the TP acquired the prop (Crane). The amt realized includes the debt relief even if the encumbered prop is worth less than the amt of debt at the time the TP disposes of the prop (Tufts)

- **Crane v. Commissioner** – inherited land subject to debt – what is the basis?
  - Here, FMV was greater than the mortgage when sold
  - Non-recourse is equal to regular loan for tax purposes – therefore, when sold, the TP will realize a gain from the discharge of indebtedness
  - Amt realized = cash received + discharge of indebtedness

- **Tufts** – what if the FMV is less than the amt of mortgage?
  - What gain/loss should be recognized when TP has taken depreciation deductions and then transfers land in exchange for buyer assuming mortgage?
- Amt realized will be cash received plus discharge of indebtedness
- Basis will be cash invested plus mortgage amt minus depreciation.
- These 2 cases demonstrate that tax symmetry is important – if debt is treated as cash for determining basis, then it should also be for determining gain – when buyer assumes a loan, treat as if buyer gave seller cash to pay off loan with.

Symmetry theory: the debt was included in the TP’s basis for the prop, permitting the TP to take depreciation deductions on the prop in excess of the TP’s cash investment in the prop, so the debt relief should be included in amt realized on the sale of the prop

- **Gilbert** embezzler
  - Did TP gain income when he illegally used co money to cover his own debts
  - No, TP does not have income until he defaults on loan bc TP fully intended and reasonably expected to pay the co back. When a TP has these intentions, even if he is an embezzler, the transaction is treated as a loan.

**Problems of Timing**

**Gains and Losses from investment in Prop**

- **Eisner v. MacComber**
  - Is receipt of a stock dividend a realization event?  
  - No, bc stock dividend did not increase TP’s ownership interest in co. Argument that it is like receiving cash and reinvesting is invalid bc TP has no choice how to invest money.
  - **Policy:** ability to pay concerns – if you have to pay taxes on appreciation, you may be forced to sell some of the stock. If she got a cash dividend, she would have had to pay tax

**HYPO**

A – 100 shares  
B – 100 shares  
Cap acct – 200; Earned surplus – 100
- the co says that A and B can either get 50 of stock or 50 of cash. Is this taxable? 
- Let’s say A opts for stock and B opts for cash. A and B may have the same economically, but A now owns more of the corp. The 2 are in very different circumstances. **Bc A owns more of the pie there are tax consequences. In Macomber, if your ownership of the corp did not change, then you owe no tax. But, if it does change, you owe tax. In Macomber their was no change in ownership.**
- Another reason that A should pay taxes is bc she had the choice at the beginning to get cash or stock, so she had control and dominion.
- After the transaction, the net of the co is 250 (50 was given out in cash to B). The pie has gotten smaller.
- Macomer would not have to pay taxes if the interest he held didn’t change.
- This case sets out a standard of realization – you don’t have a realization event if your interest in the property hasn’t changed as a result of the transaction.

**Tenant Improvements**

- **Helvering v. Bruun – reversed**
  - Lessor leased land, and when he got it back, he got more value bc there was a new building on it in place of his old one.
  - **109 and 1019** – reversed the Bruun decision
    - **109** – if you get real prop at the termination of the lease, you won’t get taxed on it
- Macomber is different from Bruun in that the building on the land in Bruun increased the interest he had in the property.
- What factors do you look at to see if there is an underlying change in your circumstances – percentage of ownership? Macomber had more shares, but it didn’t change his rights and circumstances. In Bruun, it wasn’t just a formalistic change in ownership rights, but Bruun owned an entirely different building at the end of the transaction. There was a substantive difference in what Bruun earned
- Have to look to see if there is some substantive underlying change in the buyer’s ownership.
- There is nothing that the corp gave to Macomber that gave Macomber anything more to show that the co is doing well. On the other hand Bruun got something completely new
- Appreciation isn’t taxed. It’s not realization
- 1001(b) – Amount Realized – the amt realized from the sale or other disposition of prop shall be the sum of any money received plus the FMV of the prop (other than money) received.
  - There was a disposition of prop in Bruun, but all there was in Macomber was that there was appreciation
- Woodsam – post acquisition mortgages
  - Is the acquisition of a non-recourse loan in excess of the basis of the prop that the loan is secured on a taxable gain? No bc it is not within the 1001 def of disposition of prop. Realization of gain is postponed until the prop is properly disposed of through sale or default on loan.
  - A post-acquisition loan isn’t included in the basis (1012 – basis of the prop is the cost of the prop). A gain, however is realized when the prop is disposed of bc there is a discharge of debt.
  - Illustration: TP purchases a building for $K, paying 1000 out of his own funds and borrowing 3000 on a nonrecourse mortgage. The prop appreciates to 10K and the TP borrows an additional 6KI by adding that amt to the mortgage. What is the TP’s basis for the prop? 4000. The subsequent borrowing of 6000 represents untaxed prop appreciation and is not included in the TP’s basis. The earlier borrowing of 3000 is part of his original cost, however, and is included in basis under Crane.
- Cottage Savings
  - Ordinarily we say that there is a realization when one prop is exchanged for another.
  - Gains or Losses are recognized only when realized, and a realization occurs only when the properties exchanged are materially different from one another
  - "Material difference" is the test under 1001(a)
  - Sec 1031 – adopts what the ct in Cottage Savings was implying
  - 1031(a)(2)(b) – doesn’t apply to exchanges of stock, bonds, or notes
  - This seems justified bc the shares of stock were of different corps, so it seems materially different.
  - Stock is not considered a 1031 transaction bc Congress views stocks, bonds, and notes as cash, but here, they are stock of different cos
  - (b) – the property has to be like kind. However, 1031(a)(1) stipulates that land must be held for productive use in a trade or business or for investment, if such prop is exchanged solely for prop of like kind which is to be held either for productive use in a trade or business or for investment. So, can’t be using the land for personal purposes
o (c) - there are limited circumstances where you can get cash in hand for prop, 1031(a)(3), and use the proceeds to buy another piece of land and get to do this without tax consequences
  ▪ cts are reluctant to let this happen. One of the policies of 1031 is that you may not have cash on hand to pay the tax if it’s just a swapping of prop, this isn’t a problem with cash in hand. Another motivation of 1031 is that you don’t know the actual values of the props when you swap, but you do know the exact price of the prop when you get cash in hand because you sold it in the market.
  ▪ The major reason associated with this is this lock-in-effect, if you own a piece of prop that has appreciated, you are hesitant to sell it, so to avoid the lock-in effect, you can swap land without tax consequences under 1031.
  ▪ In tax what we’re trying to do is impose tax consequences when your substantive economic position has changed. If you switch like kind prop, there is no substantive economic change.
  o Ex: gold for silver swap – not like kind bc they are used in different ways. If the underlying reason for holding items is different from an objective POV, they are not materially the same

-  **Jordan Marsh**
  o Sale and leaseback transaction → cts will not deny loss – this is a sale not an exchange of like kind prop

**SHE LOVES THIS NEXT STUFF**

**1031(a)** – Nonrecognition of gain or loss from exchanges solely in kind
- In general, no gain or loss shall be recognized on the exchange of prop held for productive use in a trade or business or for investment if such prop is exchanged solely for prop of like kind which is to be held either for productive use in a trade or business or for investment.
- Exclusions
- BASICLY – can only get like-kind prop for other like-kind prop → the key word here is “solely”

**1031(b)** – gain from exchanges not solely in kind

**1031(c)** – loss from exchanges not solely in kind
- If it were not for the fact that the prop received in exchange consists not only of prop permitted by such provisions to be received without the recognition of gain or loss, but also of other prop or money, then no loss from the exchange shall be recognized.

**1031(d)** – Basis
- If prop was acquired on an exchange described in this section, then the basis shall be the same as that of the prop exchanged, decreased in the amt of any money received by the TP and increased in the amt of gain or decreased in the amt of loss to the TP that was recognized on such exchange. If the prop so acquired consisted in part of the type of prop permitted by this section, to be received without the recognition of gain or loss, and in part of other prop, the basis provided in this subsection shall be allocated bw the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other prop an amt equivalent to its FMV at the date of the exchange.

- HYPO 1: TP has a basis of 50 and a FMV of 90
  o There is a like kind exchange. Let’s say it had a FMV of 90.
  o There is no argument for gain or loss bc this falls strictly within 1031(a)
- HYPO 2: TP gets prop with FMV of 60, plus 30 in cash
  o We are no longer in 1031(a) bc we are also getting prop that is not like kind
- 1031(b) controls – if an exchange would be within (a) if it weren’t for the fact that you got boot, then the gain if any will be recognized, but in an amt not in excess of the sum of such money and the FMV of such other prop
- Under 1031(b), you can only recognize up to the amt of your boot (as opposed to a 1001 analysis)
- So, first, you do a 1001 analysis: you receive 90 and drop 50 = 40, but this is in excess of the boot, which is 30, so we only recognize up to the amt of the boot. So, the recognized gain is 30.

- HYPO 3: you receive prop of FMV 35, plus 55 in cash
  - Well, we do our 1001 analysis: 90 – 50 = 40. And, so we only recognize up to the amt of the boot, we recognize 40.

- HYPO 4: Let’s say the guy’s basis is 90, FMV of 90, and receives prop worth 50 and 30 cash
  - Well, under 1001, you have amt realized of 80 minus basis of 90 = -10
  - 1031(b) doesn’t control, so we go to 1031(e) – no loss from an exchange shall be recognized. You can never get a loss in 1031.

**RULE**

- if you’re in a 1031(a) – no prob, prop for prop
  - in 1031(b), first do a 1001 calculation and figure out gain, then look at boot and see which is lower, whichever is lower, you pay taxes on.

**Basis Calculations – 1031(d)**

- you have new prop now.
  - If the prop was acquired on an exchange described in 1031(a), then the basis shall be the same as that of the prop exchanged. (No need to increase basis if you’ve never paid taxes)  \( \rightarrow \) if there is no boot, the basis of the new prop is the same as the basis of the prop relinquished.
  - HYPO: we had a 30 recognized taxable gain, and an original basis of 50, so the new basis for everything we received will be 80, but we have 2 pieces of prop – prop and cash, so we subtract out from 80 the amt of cash we received, 30, to get the basis of the new prop acquired, so the new basis should be 50

  - Ex: basis of 10 and gets a farm of 100, plus 15. This suggest that the FMV of his prop at the exchange is 115. The tax consequences are that he gets a gain of 105, but he can only have recognized a gain of up to the boot, so you have a recognized gain of 15.
    - The basis in the new prop is: start with basis of 10 and subtract any cash received (FMV of the boot), 15, then add gain taxed, 15  \( \rightarrow \) therefore the new basis is 10.
  
    - **FORMULA**  \( \rightarrow \) **basis of prop relinquished – FMV of boot (at the time the exchange took place) + gain recognized = basis in new prop.**

  - 2 parts of 1031(d)
    - figure out total basis  \( \rightarrow \) take original basis, subtract cash, and add gain recognized
    - Allocate total basis bw all the assets, but forget about cash. Fro boot, give a basis equal to its FMV

  **HYPO**

  - Basis = 50, FMV = 90
    - A) like kind prop worth 90  \( \rightarrow \) taxable gain is 0  New basis is 50
    - B) like kind prop worth 60 + 30 \( \rightarrow \) amt realized of 90, basis of 50, we recognize 40, but only pay tax on 30  New basis is 50
    - C) Like kind prop worth 35 + 55 \( \rightarrow \) realize 40, and recognize 40  New basis is 35
  
  - Basis = 90, FMV = 90
    - D) Like kind prop worth 60 + 30 \( \rightarrow \) gain is 0  New basis is 60
    - E) like kind prop worth 50 + 30 \( \rightarrow \) we don’t recognize a loss. New basis is 60
The way to get out of 1031 is to make an argument that the prop isn’t LK or you could argue that the prop wasn’t being used for productive use in a trade or business or for investment.

Revenue ruling 84-145
- The airline bought rights to routes to fly to certain cities. There was then deregulation and the rights to the routes depreciated a shit load in value
- The ct said that you can’t get a loss unless there was a transaction to dispose of the prop. There has been no substantive change in the TP’s circumstances – they still own the prop and it still has some value. Look to Eisner v. Macomber → there has been no sale or exchange of prop, so there has been on substantive change in the TP’s circumstances.
- The difference bw this case and Eisner is that in Eisner the appreciation seemed to be associated with market fluctuations and we don’t want to force a TP to recognize a gain from market fluctuations.
- **But, we can distinguish this from Eisner is that there is no possibility of the rights to the routes to ever appreciate in value again.** This case has nothing to do with market fluctuations, this is a regulation by the government, which has complete control over the value of the rights. It’s like a taking. Eisner shouldn’t govern here bc it has nothing to do with market fluctuations.

Well, what if you sell your route to some one who has the same route and then later they sell their route to you in order for you to both get losses. Well, will the ct treat this as a 1001 transaction where you get your loss or will the ct treat it as a 1031 transaction of like-kind prop? I think the ct will say it’s L-K prop, and they couldn’t take the loss under 1031©. If they didn’t treat it like 1031, everyone will be getting around shit. **Look at substance over form**

**Installment Method**

**HYPO:**
- Basis = 200K
- FMV = 400K
- Payout = 100K over 4 years

**SEC 453**
- Income from an installment sale shall be taken into account for purposes of this title under the installment method
- A method under which the income recognized for any taxable year form a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when the payment is completed) bears to the total K price.
- First find the ratio bw the payment received in that year to the total K price
  - The total K price is 400K (the amt realized)
  - The profit on the deal is 200K.
  - 200K/400K = 50% so the payout is going to the basis and the other half is going to amt recognized
- 453(d) – you can elect out of 453, but if you do, use the closed method, the commissioner’s method

**Constructive Receipt v. Economic benefit**
- **Constructive Receipt doc** – if someone is waiting to give you money, and you can just go and get it, then you have constructively received it and you should get taxed then. There is no ability to pay problem – if you go and get the money, you’ll be fine in paying taxes.
- **Economic benefit theory** – When you have complete right to the funds and you can’t forfeit them, you have received an economic benefit even if you can’t go get it immediately.
  - some factors that make something an economic benefit are that the item be non-forfeitable and there be no contingencies, and no creditors can get to the money
  - control factors

**Deferred compensation**
- When are the TPs engaged in deferment purely for tax avoidance reasons and when do they do it for a legit reason
- 2 mechanisms used by the ct to tax up front are the
  - constructive receipt and
  - economic benefit doc

**Olmsted and Drescher** – these are both annuity problems
- In Drescher, the co was said to have an economic benefit and therefore taxed at that time
  - The thing here is that the co was putting in pre-tax dollars into an annuity account for the EE. The EE had a right to the future earnings, there was no risk of not getting the money, there right wasn’t assignable, and the money wasn’t subject to any creditors.
- In Olmsted, there was no economic benefit
  - Here, Olmsted traded in his renewal commissions for an annuity K, the co and Olmsted contracted for this trade. The thing was that Olmsted, if he kept the renewal commissions, he would have gotten paid annually and have paid taxes annually. The annuity took the place of the renewal commissions and was therefore treated the same.

**Marital Property Transfers**
*Sec 1041* – no gain or loss is recognized on certain transfers of prop bw spouses or former spouses if incident to divorce
- 2 prongs
  - transfer of prop (cash is considered prop) and
  - transfer is incident to the divorce
- no gain or loss shall be recognized on a transfer of prop from an ind to a spouse, or a former spouse
- **Incident to Divorce** – for purposes of subsection (a)(2), transfer of prop is incident to the divorce if such transfer
  - Occurs within 1 year after the date on which the marriage ceases, or
  - Is related to the cessation of the marriage

**Alimony, Child Support, and Prop Settlements**
*Sec 71* – Alimony and separate maintenance payments are included in gross income
*Sec 215* – allows payor to deduct alimony and separate maintenance payments
*Sec 166* – Bad Debt
- (d)(1)(b) non business debt
  - in the case of TP other than a corp – where any non business debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.
- He owned her some money, debt. He doesn’t pay. She says that there was a debt owed to here, she wasn’t paid, so she was going to deduct.
But, one of the requirements for a non-business bad debt, the debt has to be totally worthless.

What does it mean to be totally worthless? The guy still owes it, and he may pay it back.

But, let’s say she convinces the judge that he will never pay it back and that it is totally worthless.

The ct says that the TP doesn’t have a basis, and bc she doesn’t have a basis in the debt, she can’t deduct. (In another situation, if she had loaned the money to him, and he didn’t pay it back, she would have a basis in it and would be able to deduct.)

But, the thing is, she basically loaned him money by using her own money to pay for the child that he was supposed to be paying. Using her own money to support her own children should have been a basis. And, she should have been able to use a 166 bad debt argument.

But, the ct didn’t go along with this. The thing is the debt is owed to the child, and just bc she stepped in to pay doesn’t mean she gets to take the deduction.

• **note – deduction is limited to your basis in the prop.** This is bc you can’t deduct expected income. Ex: You loan 4K to someone and you’re supposed to get 5K back. But, if the debt goes bad, you can only deduct 4K. The 1K interest is expected income, and you can’t get a deduction on that.

### Deductions Exemptions and Credits

- Personal deductions are subtracted from AGI to arrive at taxable income.
- Individuals may elect to give up the itemized deductions and instead claim the standard deduction.
- All TPs are also entitled to a personal exemption deduction for themselves and for each of their dependents.
- The benefits of these deductions are reduced once adjusted gross income rises above a certain threshold amount.

### Personal Deductions

- **sec 262 – personal family and living expenses – there is no deductions bc they have nothing to do with the production of income**
- **There are some exceptions to this:**

#### Casualty losses

- 165(c )(3) – losses from fire, storm, shipwreck, or other casualty, or from theft
- you can get deductions for these
- minimum floor is now 10% of adjusted gross income
- losses must be of the same character as that of above
- You are not allowed a loss when you cause the destruction bc that goes against public policy.

#### Extraordinary Medical Expenses

- 213(a) – allows a deduction for all medical and dental expense paid by the TP for herself, her spouse and dependents
- Med expenses are deductible to the extent that they exceed 7.5% of AGI
- The medical expense and casualty loss deductions serve the purpose of refinement of the TP’s net income base by excluding from it large and unanticipated outlays or losses that impair the individual’s ability to meet her tax obligations
- Sec 213 speaks primarily of medical care and does not refer to other increased costs of illness. However, this is crap – *Medical care means amts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.*
- If it doesn’t fall within 213, then we kick it up to 262 and say that personal expenses and these aren’t deductible

**Charitable Contribution**
- 170 – allows a deduction for contributions to charity up to a limit of 50% of TP’s adjusted gross income.
- Charitable contribution – contribution or gift to or for the use of certain enumerated eligible donees. The orgs must operate on a non profit basis
- No deduction is allowed to the extent that the donor receives something of value.
- 501 – exemption from tax on corps, certain trusts, etc.

**Ottawa Silica**
- First thing we do is look at 170
  - This is met bc we are allowed to give charitable donations to gov’t and can take a deduction
- To be considered a charitable contribution, it has to be given for public benefit, and not for benefit to the donor
- Quid pro Quo contributions – the amt of any non business related deduction for a charitable contribution is limited to the excess of the payment of the charity over the value of any benefit (other than trivial ones) received by the donor.
- In determining the amt of the reduction, it is the value to the donor that counts. The value to the donor is assumed to be the FMV of whatever is received by the donor – that is, what the item or service would cost the donor if purchased. The cost to the donee organization is irrelevant
  1) is it a qualifying org
  2) was the gift made exclusively for public purposes
  3) Is the benefit to the business substantial? If substantial then don’t get any deduction.

**Analysis**
1) start with sec 262 – nothing personal is deductible
2) exceptions
   a. 165 – casualty (10% of AGI floor); if not compensated for by insurance
      i. public policy
   b. 213 – Medical (7 ½ of AGI)
      i. Medical care means amts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.
   c. 170 – Charitable Contributions
      i. for personal QPQ (like at an auction, get a benefit)
      ii. PP

**Sec 262** – general rule – Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses → **Nothing personal is deductible unless there is an exception.**

1) Personal expenses – 262,
   - Gen rule - no deduction
   - Exceptions – 165 (c ), 170, 213, 280A, 165(d)
2) Hobbies – 183
   - Gen Rule – partial deductions (losses to extent of profit)
3) For Profit – 212
   - Gen Rule deductibility
   - Exception 280A, 274
4) Trade or Business – 162
   - Gen rule – deductibility
   - Exception 274

Sec 162 and 212 – business items
   - everything in business is deductible unless there is an exception
   - 162 – Trade or business expenses
     o all ordinary and necessary expenses paid or incurred in carrying on any trade or business are allowed, specifically includes salaries, travel expenses, leases.
   - 212 – Expenses for production of income
     o allows deductions for ordinary and necessary expenses: 1) for the production or collection of income, 2) for management, conservation, maintenance of prop, held for production of income, 3) in connection with the determination, collection or refund of any tax.

Why the general rule that you can’t give deductions for personal expenses, but the general rule that every business expense is deductible?
   - We’re only trying to tax economic gains here, if we don’t allow deductions fro business expenses, and we taxed all of the revenue coming in, then we would have taxed too much because they didn’t have a gain of revenue, we had a gain of revenue minus the cost of getting the revenue. So, we give a deduction for expenses, and tax completely the revenue.
   - But, can’t you say the same thing in the personal context? Let’s say you get income of 1 mil, but in order to get that income, you had to have a car and gas and a house, so why don’t we deduct that?
   - When you buy the car and the house, you’re consuming, you wouldn’t say that a person with a house and car is any worse off than a person with 1 mil in cash. There is no loss when you buy a car.
   - In the business oriented context, the purchases are viewed as a loss unless there is an exemption

Sec 67 – 2% floor on miscellaneous itemized deductions

Nickerson - hobby
   - Are farming losses deductible? Losses are deductible bc farm was a business, not a hobby. The important thing to prove is whether the TP believes he will profit, and TP bears burden of proof. *Cts will look at primary purpose if there are 2 purposes*
   - Start-up expenditures are deductible.
   - Sec 183 – activities not engaged in for profit → intended to capture the activities that fall bw 162 and 212 and 262.
     o In circumstances where it’s not a 162 or 212 activity, you can still take a deduction under 183 if you’ve made income – take a deduction up to the extent of income. It wouldn’t matter if it was personal, if the Nickersons had earned some income, they would be allowed some deductions, but only up to the amt that they made.
     o This covers hobbies.

Moller – professional investor with home office
   - 280A(a) – in the case of a TP who is an individual, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the TP during the taxable year as a residence (takes off the books any home office)
- 280A(c) – (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis as the principal place of business for any trade or business of the TP
- Congress was worried about everyone making home offices to deduct taxes
- Gen rule is take a deduction for 212 → only problem is if Congress makes an exception

**Witten** – Wheel of Fortune
- he claimed 165d – losses are deductible to the extent of the winnings
- Ct said that costs of getting to the casino don’t count as deductible items. Only costs of actually gambling will be included

**Henderson** – office decoration
- expenses aren’t deductible bc they aren’t necessary.
- TP was provided with all necessary furnishings to do her job, so decorations were 262 personal expenses.
- She claims business expense under 162
- Ct does a plain reading of 162 – **have to have ordinary and necessary expenses**
- What is the **custom** of your trade or business
- Objective standard

**Rudolph** – travel and entertainment expenses
- sec 274 – no deduction otherwise allowable under this chapter shall be allowed for any time with respect to an activity which is of a type generally considered to constitute entertainment unless the TP est that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion

**Moss** – business lunches
- These guys were taking something personal like lunch everyday, and deducting it. If it was less frequent, it may be deductible
- To be deductible, an entertainment expense must meet the requirements of both 162 and 274.
  - First – the expense must be either directly related to or associated with the active conduct of the TP’s business
  - Second – the expense must be either directly related to or associated with the active conduct of the TP’s business

**Danville Plywood** – super bowl trip
- 162 is limited by 274
- not directly related to or associated with TPs trade or business

**Smith** – child care expenses
- these are personal and fall under 262
- Can’t use the but for argument
- Sec 21 is the response – child care credit

**Flowers** – Commuting Expenses
- 3 prong test to determine when traveling expenses can be deductible
  - reasonable and necessary traveling expense
  - incurred while away from home
  - incurred in pursuit of business
- Commuting expenses bw home and business are not deductible bc where to live is a personal choice

**Hantzis** – law student
- Not deductible bc expenses were not incurred while away from home. Home is usually considered place of employment, unless employment requires TP to have 2 homes

**Pevsner** – Yves St. Laurent
- 3 part test to determine deductibility of clothing expenses
  - the clothing must be a type specifically required as a condition of employment
clothing must not be adaptable to general usage as ordinary clothing
clothing must not be worn as ordinary clothing

Gilmore – divorce/conserving prop
- Are the TPs legal expenses to protect assets from wife during divorce deductible under 212?
- Not deductible bc must look to origin of claim, not consequences to TP. The origins (divorce) were personal, so the expenses are not deductible under 212.

Carroll – student policeman
- Are TPs education expenses deductible under 162?
- Not deductible bc education did not maintain or improve skills required for the TPs employment. TPs classes were for general education, which is unrelated to his specific job skills

SPLITTING OF INCOME

Lucas v. Earl
- splitting is not allowed bc salaries are taxed to those who earned them.

Poe v. Seaborn
- in response to this case:
  - Joint return schedule → all couples could split their income in half
  - In response, singles got a lower tax rate
  - So, there is a marriage penalty when the 2 are earning nearly the same incomes, but not when only one spouse is earning all the income

Armantrout – education plan
- money was TP’s income bc receipt was based on quality of work and used to recruit EE, and therefore compensation for services

Blair – father assigns trust interests to children
- horizontal cut
- father no longer had control of the money when he assigned it and he didn’t have a reversionary interest

Horst – bond coupon
- vertical slice
- maintained a reversionary interest

Eubank – assigning renewal commissions
- you can’t assign income from services

Heim – inventor assigns royalties to wife and kids
- even though income from patents and copyrights can be thought of as income from services, we’re going to think of them as prop so if you assign rights to a patent or copyright, you’ll be seen as Blair, as you satisfy the horizontal rule

Capital Gains and losses

1221 – capital asset means prop held by the TP but does not include
- inventory held primarily for sale to customers in ordinary course of business
- real/depreciable prop used in trade/business
- copy rights held by creators but no purchased copyrights
- accounts receivable acquired in the ordinary course of business

- Rationale for favorable treatment of cap gain
  - Bunching, lock in, inflation, incentive for investment, incentive for new industries, reduce corp double taxation

- Rationale for limitation on deduction of capital losses
  - Prevent manipulation and recognition of false losses, discourage TPs from selling loss assets and retaining gain assets – this is adverse to investors.