

Scope of the IRC:

I. Tax liability

A. **§§1(a) – (c), 11** “Impose” tax on income of “every indiv./corp.

1. **§7701(a)(3)** def. of corp (include for an not for profit entities but non exclusive)

II. Limits of liability

A. **§115** GI of states excluded if exercise of “essential gov’t function” or pub. utility

1. If acting more like a corp. could argue falls w/ “includes” corp. def.

B. “Of” connotes there must be ownership interest in the income (CU)

1. Ownership = Assign. of Income Doct. = beneficial use/control (CU)

2. **§1(g)** “Kiddie Tax” applies parent’s rate to kids income if kid has a lot of net unearned income (gross income – income from labor)

C. **§§2(d), 871, 877** only limits to **§1** (“every individual”): No tax if indiv. not a resident, not a citizen, and not getting income from sources in US

D. Tax Rates of **§1, §55** = limit liability on ability to pay based on resources available for consumption or savings (consumption core of tax base) (**Main tax policy theme**)

1. **§1, §55** progressive rates: bracket rates apply to income > next lowest bracket (can never be financially worse off by making more money) (**§1(i)** annual inflation adj.)

a. Policy: VE; TP Compl.; benefit based prin.; can’t squeeze blood from turnip

b. Counter arg – Violation of EN (deter productivity)

2. Other alternatives

a. Proportional: increasing flat rate on all income (really discourage productivity)

b. Regressive: tax decreases as income increases (better EN; worse fair

c. Head tax: everyone tax same regardless of income (solves EN but violates VE)

Scope of Gross Income

I. **§61(a)** “gross income means all income from whatever source derived”

A. Income = increase in resources available for consumption or savings = accession in wealth/enrichment (see formula under deductions section)

II. Types specified in **§61(a)(1) – (15)**

III. Indirect benefits - Payment by a 3d party to discharge an obligation of TP (Old Colony)

A. Substance over form – econ. equivalent transactions must be taxed the same; Ignore plain meaning if yield result contrary to policy (EN; HE)

IV. In-Kind Income (non-cash benefits) – need obj. valuation of enrichment

A. Transferable goods/services = Net amt. (FMV – cost of sale) TP could get if sold

1. Exception: If TP gets benefit greater than FMV, use that measure (ex. takes deduct

B. Non-transferable goods/services: If TP doesn’t use = \$0 b/c no enrichment. If TP does use = Expenses avoided (objective; HE)

Non-Statutory Exclusions – Look to these first to see if enrichment even qualifies as GI, then look to realization, recognition, exclusions, deductions.

I. **Imputed Income** - Congress chooses not to tax b/c valuation prob & encourage activities that have social benefits (living in home)

A. Violates EN, HE, and SO (b/c TP receiving indirect benefit) but better than alternative (taxing I I or not taxing consumption alt. to I I)

II. Damages

A. If damages received “in lieu of” non-taxable income, then damages are not taxable (**Raytheon** – collapse 2 step trans. into 1 for SOF)

1. Test – factual inquiry into what controversy all about

2. Applications: Destruction of property = involuntary conversion; Pain & suffering = not TI; Malpractice/med./out of pocket expenses = not TI; Lost & Future wages = TI; Pun. damages = TI windfall gain under **Glenshaw**

3. **§104(a)** exclusion for damages “on account of physical injury/sickness”

a. Policy: AC – no longer have to determine whether portion of damages due to lost wages (TI), or non taxable injuries under Raytheon, VE- bunching, TPC

b. Problem – some ct.s have read as inclusionary rule so that all damages not caused by personal injury are GI, which makes the rule unconstitutional.

B. If damages compensate for losses in previous years = TI (**Sanford & Brooks**)

1. Policy: **§441(a)** taxes calculated on tax year (AC for IRS; limit suits in ct.);

Raytheon b/c damages in **Sanford** for breach of K (replacement for TI)

2. Problem – Unfair to tax damages if still results in overall net loss or break even.

3. Solution: **§172(a)** NOL carried over 20 yrs. or carried back for 2 yrs. and deduct.

a. (c) Net operating loss = excess of deductions over GI (negative profit)

b. (b)(2) Must offset gains that occur first in time (starting w/ 1st carry back yr.)

4. Tax Benefit Rules

a. Inclusionary Rule: If have a deduct. in a prior tax year that offsets income, then later recover that deduction, must include the recovery in GI (**Sanford**)

i. Policy: Error Correction

b. **§111(a)** Exclusionary rule: If have a deduction in a prior tax year but it doesn’t offset any income, then later recover that deduction, no need to include in GI

i. Policy: Prior deduction was harmless error

ii. Recovery must be for the same thing as the deduction

III. **Loan proceeds** – Not enrichment to borrower b/c loan proceeds come with offsetting unconditional obligation to repay (**Kirby Lumber, §108(d)(1)**)

A. **§61(a)(12)** D of I = GI (substance over form, enrichment, recapture)

1. Exceptions

a. Only D of I if TP received a corresponding benefit w/ liability

b. **§108(a)(1)** D of I ≠ GI (**d)(3)** if TP is insolvent at time of DI

i. (a)(3) Exclude up to amount in debt, (b) must first offset NOL

ii. Policy: Recapture rather than overall enrichment (overruled common law)

c. **§108(e)(5)** D of I for purchased prop. = reduction in purchase price if TP solvent

i. Must be bona fide dispute over value of prop; and TP still in possession (**Zarin**)

B. Claim of Right – If received funds under disputed claim w/ no restriction on use =

GI in year of receipt (**N. American Oil**)

1. **§1341** If later loses claim and repay: either deduct repayment or claim credit for erroneous incl. (use credit if rates have l)

2. Policy: **§451(a)** cash method of accounting is default (account for \$ on receipt); loan = uncondit. oblig. to repay (contingent oblig. not enough); AC policing Sol.; can’t use **§446(h)** accrual method unless prove consistent use

C. Embezzlement \$: taxed like claim of right (fact dissimilarities to loan) but repayment ≠ deduct. b/c never appears like unrestricted right to \$ (nec. under **§1341**)

D. NR loans – secured by collateral only, debtor not personally liable.

1. Treated like uncondit. loan w/ advanced D of I settlement of FMV of prop. if FMV falls below loan balance (even though also looks like condit. loan – claim of right)

2. Defaulting on collateral = sale under **§1001(a)**

a. **§7701(g)** Amount realized includes outstanding loan balance, even if loan > prop. FMV, b/c need to recapture D of I (**Tufts** FMV property received = loan bal.

i. TP gets favorable cap. gain treatment on D of I income b/c didn’t unscramble

Statutory Exclusions – Receipts that are excluded from GI

I. Certain ER provided benefits

A. **§119(a)** ER Meals and Lodging excluded if: 1) provided for convenience of ER, 2) furnished on biz. premises of ER, 3) (lodging only) Condition of EE’s employment

1. Convenience of ER = business necessity (even though **Reg. §1.119.1** interp. to mean “substantial not compensatory purpose”)

2. **119(b)(2), (3)** – ER paying EE extra then charging for the meals treated same as the meals themselves being provided

3. Justification: Forced consumption/HE (not same benefit as TP that chooses)

B. **§107** Rental value of home provided to ministers excluded if not exceed FMV

C. **§132** 8 Fringe Benefits Excluded:

1. (1) No additional cost service – limited to services of type of ER’s industry

2. (2) Qualified EE discount – for prop./service of ER’s industry; not exceed ER cost

a. (j)(1) “highly compensated employees” only exclude 1 & 2 non discriminatory

i. Justification: EE morale, Incentivize broad distribution of tax benefits

3. (3) working condition fringe – if EE would be able to deduct as **§162** business expense deduction, then can exclude here

a. See **Reg. 1.132-5** Special rule for EE product testing

4. (4) de minimis fringe – value EE is so small that accounting admin. impracticable

a. See **Reg. §1.132-6** – only look to value provided to indiv. EE, but not de minimis if benefit provided on a regular basis

5. (5) qualified transportation fringe – “commuter highway vehicle” = 6 seats (not including driver), 80% miles for commuting, ½ passengers commuters

6. (6) moving expense reimbursement, (7) retirement planning services

D. **§132(h)** – retired/disabled EEs; spouse/dependant children of EE’s treated as EEs

II. Timing Exclusions – Allow for tax deferral by putting off tax on savings (1 wealth)

A. **Annuities** – loan to ins. company and they agree to pay back in yearly installments w/ interest. Portion of each payment contains ROC (exclude) and interest (TI).

1. **§72(a)** gen’l rule – amounts received under an annuity K are included in GI.

2. **§72(b)** exclusion ratio – TP’s total investment in K divided by total amount to be received under the K (if life annuity use **Reg. §1.72-9 V**) = exclusion ratio. Apply (multiply) that ratio to each payment = amount excluded as pro rata ROC

a. (b)(3) If TP dies b/f all ROC/life expectancy → unrecovered principal deduction on last taxable year. (b)(2) If TP outlives life expectancy → all payments TI

3. **§72(e)** Deferred payment annuities (payments under annuity K that aren’t the actual annuity) = TI until all guaranteed interest paid out (**ROC last**) prevents abuse

B. **Life Insurance K** – Like annuities, whole life composed of 2 components: Term life (exclude as ROC) and savings (TI) when TP cashes in policy or lives to maturity.

1. Life ins. part **§101(a)(1)** – amounts received under life ins. K b/c death of insured are excluded from GI. Even though received “in lieu of” wage replacement.

a. But if 3d party buys and insured dies: (a)(2) – amount excluded under (a)(1) not exceed amount paid by the 3d party + subsequent premiums paid by the 3d party.

2. Savings part **§72(e)(5)(A)** – proceeds paid at maturity/surrender are included in GI, but only amounts that exceed investment in K (aggregate premiums)

a. **§101(g)(1)** Insured cashes in b/c terminally ill = treat as if paid by reason of death

3. Policy: Violates EN. Tax deferral/forgiveness on savings part; forgiveness on ins.

III. Health care costs

A. ER provided health ins.: **§106(a)** Excludes ER paying premiums for health ins.;

§105(b) Excludes health ins. reimbursements for “medical care”

B. Indiv. purchased health ins. **§213(a)** Itemized deduct. for “med. care” over 7.5% of

GI; **§104(a)(3)** Excludes health ins. reimbursements not ER provided

C. Self Ins: No premiums b/c TP pays out of pocket; **§213(a)** Itemized deduct. for “med. care” over 7.5% of GI in taxable year (probably not helpful)

D. Self employed purchased ins. **§162(i)** Excludes expenses on “med. care” for self employed; **§104(a)(3)** excludes proceeds

E. **§213(d)(1)** def. of “medical care” = (A) treatment/prevention of disease/affecting human body; (C) “qualified long term care services” (D) insurance

F. **§§106(a); (104(a)(3))** still exclude non medical care income from ER or ins.

F. Policy: Violation EN; ER’s shifting costs to EE in co-pays /deductibles. Solutions?

1. Solution to deductibles: **§223(a)** EEs contribution to **health care savings account** deductible if spent on “med. care”; **§106(d)** ER contribution excluded

2. Solution to EE co-pays: **§125** “Cafeteria plan” (written plan were EE can choose b/t cash or a fringe benefit) treats portion of EE salary withheld to pay premium same as if ER paid premium and lowered ER salary (excluded – S over F)

3. Bush’s proposal: Standard deduction for health care to let indiv. choose what kind a. Problems - But indiv. may take deduct. w/out getting ins; ERs have better

collective bargaining; healthy ppl. will opt out and drive up cost of ins.

Receipts involved in sale or disposition of property

I. Congress only has constitutional authority to tax gains upon realization of those gains (**Eisner v. Macomber**)

A. Realization event = **§1001(a)** sale or other disposition.

1. Disposition = **Macomber** something “derived from” transfer that in substance diff. from what TP already had (stock dividends not realized, codified in **§305(a)**);

Burnn Control over appreciation, can separate from risk of investment; **Cottage Savings** Material diff. in prop. exchanged (legally distinct entitlements)

2. Policy: For realization rule – ES, Liquidity, AC (valuation problems);

a. Against realization rule – HE, VE (wealthiest get tax deferral), EN

B. Calculation of realized gains/losses from disposition of property

1. **§1001(a)** Gain/Loss = Amount realized - adjusted basis

a. **§1001(b)** amount realized = cash received plus FMV of in-kind receipts

i. Value of in-kind receipts determined under Even Exchange Hypothesis = pty.s acting at arms length can assume total of things exchanged have same FMV.

II. Congress may choose not to recognize gain/loss (if also basis adj. = tax deferral)

A. **§1001(c)** gen’l recognition rule: All realized gain or loss on sale/exchange of property is recognized unless otherwise provided.

B. **§1011** gen’l basis rule: Adjusted basis = basis plus or minus adjustments

1. **§1012** Basis = cost of property including loans

2. **§1016** Adjustments = adjust basis down for previous depreciation deductions, adjust basis up for costs that were not deductible (improvements)

C. Special Non-Recognition and their corresponding Basis Rules

1. **Tenant improvements: §109** Exclude income, other than rent, derived by LL upon termination of the lease (overrules **Burnn** holding)

a. **§119** But LL does not get a basis in the improvements (tax later)

2. **Exchange of like kind property §1031(a)(1)** No recognition if:

i. Transaction is an exchange of property w/in 180 days

ii. Property given up and received held for productive use/invest.

a. **§1031(a)(2)(A)** property held for sale is not good

iii. Property exchanged is of like kind. – common usage

a. All real property in US (Negative impl. from **§1031(b)(1)**)

b. **Treas. Reg. §1.1031(a)-1(b)** – improvements are immaterial.

c. Tangible and depreciable pers. prop. – **Reg. 1.1031(a)-2(b)** Same gen’l class

d. Intangible, non-depreciable pers. prop. – **Reg. §1.1031(a)-2(c)** Same risks

b. **§1031(d)** Basis in property received = Basis in property given up – cash received + recognized gain – recovered loss. (deferral)

i. Test: Basis in prop. rec’d = RG if immediately sold at FMV

3. **Exchange of like kind property + “boot”.**

a. **§1031(b)** Gain (not loss) will be recognized up to boot FMV

b. **§1031(d)** Total basis in prop. acquired = same as like kind exch.

i. **§1031(d) 2d sentence** Basis in boot = FMV of the boot. Basis in like kind property acquired = Total basis – basis in boot.

c. **§1031(c)** If total transaction results in a loss → loss is not recognized

4. Policy: Not recognizing losses on exchanges of property (even when boot involved) = incentive for TP to sell property declining in value

5. **Involuntary Conversion** (theft, destruction, and condemnation)

a. **§1033(a)(1)** If property is involuntarily converted into property similar in use → no gain shall be recognized.

i. (b)(2) Basis of replacement prop. = basis of old prop. +/- gain/loss recognized

b. **§1033(a)(2)** If prop. involuntarily converted into money, TP has option to NR that portion reinvests in similar replacement prop.

i. Similar use = functional equivalent (CU) (TP’s intent same for both properties)

a. If only part of replacement prop. is similar use, must recog. portion of gain that went to dissimilar portion of prop.

ii. Must purchase replacement prop. w/in 2 taxable yrs. of realizing gain

iii. (b)(2) Basis in replacement = cost of replacement prop – unrecognized gain

- c. **§1033(g)** If involuntarily converted property was held for productive use in trade/business/investment and Condemned:
 - i. **§1033(a)** optional NR rule applies, use like kind standard, and gets 3 yrs. to reinvest gain
- 6. **Policy for NR rules on exch.:** AC (valuation prob); Liquidity; Capital lock-in; HE (in substance same as keeping original prop., only rat. w/ invol. conversions)
- 7. **Sale of principle residence**
 - a. **§121(a)** Exclude gain from sale/exch. of prin. place of residence
 - i. Limits – must lived there for 2 of last 5 yrs; (b) Maximum \$250K exclusion if single or \$500K exclusion if file jointly.
 - ii. No corresponding basis rule = tax forgiveness
 - b. Policy for forgiveness: Tax forgive at death anyway, so enjoy now; Capital lock

III. If disposition of property results in realized loss:

- A. **§165(a)** gen'l rule: Deduction for any loss during taxable year
 - 1. **§162(c)** Loss must be incurred in trade/biz, invest. transaction, act of God, or theft
 - 2. Limits - §§ 161, 261 deduction disallowances control
 - a. **§267(a)(1)** disallow loss incurred in transaction b/t:
 - i. **(b)(1)** family to prevent shifting loss to higher income member
 - a. **(d)** But if 'ee family member sells to 3d party for a gain → only recognize gain that exceeds the 'or family member's unreg. loss (defers the loss).
 - ii. **(b)(2)** An indiv. and a corp. which that indiv. owns more than 50%
 - a. **(c)(2)** Indiv. considered to own the stock owned family
 - b. **§1091(a)** Dissallowance for wash sales (sell for loss then and purchase same stock w/in 30 days before or after date of sale).
 - i. **(d)** Basis in new stock = basis in old stock + (purchase price of new stock – sales price of old stock) (transfers loss deduction)

B. Special Rules for Capital Gains and Losses

- 1. **§1(h)** Sets out reduced tax rates that apply to net capital gain
 - a. **§1222(11)** "net capital gain" = Gain/loss for taxable year from sale/exchange of capital assets held for more than 1 yr.
 - b. **§1222(a)** def. of "capital assets": All property held by the TP
 - i. Except: **(a)(1)** Inventory; **(a)(2)** depreciable biz. property
 - c. Policy: Taxing inflation; bunching; capital lock-in (core just)
 - 2. **§1211(b)** Only deduct cap. loss to offset cap. gains and up to \$3K in ordinary income. Cap. loss can be carried over.
 - a. Policy: TP has control over when to realize loss and gains

Disposition of property b/t ptvs w/ special relationship

I. Gifts and Bequests (G/B)

- A. Tax liability
 - 1. **§102(a)** Donee excludes FMV; **§274(b)** Donor gets no deduct. unless allowed by stat. (§170 charitable cont. only one available)
 - 2. Policy for violating windfall rule – AC (if taxed on mat. consumpt. have to audit to prevent transfer of wealth; TP not comply if both sides had tax consequences)
 - 3. Exceptions
 - a. **§102(b)(1)** Income earned on prop. given as a G/B ≠ excluded
 - b. G/B of split interest
 - i. **§102(b)(2)** Where gift itself is the income from prop. ≠ excl.
 - ii. **§273** Life tenant not get dep. deduct on prop. (even if gets life estate by settling disputed will claim) Compare **§167** purchaser of life estate gets dep. deduct.
 - 4. Basis in inter vivos gifts (gifts given while alive)
 - a. **§1015(a)** Transfer basis rule - Gets donor's basis (deferral)
 - b. **2d clause of §1015(a)** – Donee gets FMV basis if donor's basis > FMV at time of gift AND donee selling for a loss (prevents transferring loss deduct. to wealthy)
 - 5. Basis rules for split interest
 - a. **§1001(e)(1)** Life/term tenant basis = \$0 (b/c can't get income)
 - b. **Regs. §§1.1014-5, 1.1015-1(b)** Remanderman gets donor's full basis when comes into possession. If sells b/f full possession: basis = PDV of basis relative to the life/term tenant.
 - 6. Basis in bequests (inherited gifts) – outright tax forgiveness
 - a. **§1014(a)** Step up basis – 'ee gets FMV of bequest at 'or's death
 - b. Exception - **§1014(c), §691** – If receive gift of right to receive income, step up basis rule does not apply and basis is \$0
 - c. Policy of tax forgive at death: Double tax (estate tax), liquidity, capital lock-in (but no independent social incentive reasons)
 - d. **§1022** Congressional solution - takes effect in '09
 - i. Carry over basis (solves liquidity) increased by \$1.3 mil (solves capital lock-in).
- B. Determining whether the transfer is a gift or not

- 1. **Duberstein** Primary purpose test – Whether transfer primarily motivated by moral/legal oblig. Or detached generosity (CU)
- 2. Congress response:
 - a. **§274(b)** Defines "gift" as "any item excludable" under **§102**
 - i. Makes sure one side of gift will get tax (**§274(b)** donor ≠ deduct; **§162** biz. exp. deduct = donee can't claim it a gift and must include)

- ii. **§102(c)** Transferred from ER to EE ≠ gift (like **Duberstein**)
- II. **Assignment of Income**
 - A. Income from service always taxable to TP who earns it (even if K)
 - 1. Policy: Prevent tax avoid; **§102(a)** gifts taxable to donor
 - B. Income from property taxable to the TP(s) who owns the property
 - 1. Policy: **§1** use of word "of" connotes ownership (CU); state law
 - 2. Problem: "marriage bonus" disparity for TPs living in community property states
 - a. Congress resp. = Increased rate schedules for married couples
 - i. Result: "marriage penalty" if spouses earned same income but still marriage bonus if low earning spouse.
 - b. Current statutory framework (marriage bonus only for l income)
 - i. **§1(f)** Lowest tax brackets for married couples twice as wide as that of single TP; but upper brackets are not quite as wide
 - ii. **§63(e)(2)** Double standard deduction for married couples
 - c. Policy: AC diff. to trace what income came from what spouse.
 - C. Ownership unclear → look to beneficial ownership & control

III. Property Transfer in Divorce Contexts

- A. Tax Treatment of **Property Settlements** entered AFTER Marriage
 - 1. Realization event b/c transferor frees up legal liability (**Davis**)
 - 2. But **§1041(a)** Non recog. of gain/loss of prop. transfer in divorce (overrules **Farid** treating as any other sale)
 - 3. **§1041(b)(1)** Basis carry over treated same as gift (overrules **Davis** giving FMV basis b/c treated like excludable damages)
 - 4. Policy: AC (husband's weren't reporting gain; IRS prefer deferral over nothing)
 - 5. Planning: Make sure enter settlement AFTER ceremony; make sure pty w/ highest income gets assets that have loss deduction
- B. Tax Treatment of Spousal Support (i.e. **Alimony**)
 - 1. Payor = Deductible (**§215**); Payee – Must be included in GI (**§71(a)**) (overrules judicial treatment that alimony excl. by 'ee under **Raytheon**)
 - a. **§71(b)(1)** Def. of alimony = brightline, objective criteria (fixes subj. intent inquiry in **Bernatschke** required to dist. from annuity payments)
 - i. Payment in cash; Under a divorce K; 3 other technical criteria
 - b. Prob. w/ objective criteria – TP's use tax planning to get best tax outcome w/out changing substance of trans. (Congr. accepts b/c AC to big fo subj. intent inquiry)
 - 2. **§71(f)** Alimony "recapture" rule (to help fight abuse)
 - i. If alimony payments aren't at least 3 yrs, then in 3d yr. payee gets deduct. to offset prior erroneous inclusion and payor must pay in prior erroneous deduct..
- C. Tax Treatment of **Child Support**
 - 1. Looks identical to alimony payments under **§71(b)(1)** formalistic definition – but gets opposite tax treatment
 - 2. **§71(c)** – Alimony rules shall not apply to payments of child support.
 - a. Payor – Not deductible (no deduction unless express statute)
 - i. Exception - §§ **151(a), (c); 152(e)** – If child is in custody of payor parent more than ½ the year, payor can get personal exemption
 - b. Payee – Excluded (**Raytheon** replacement for tax free in kind support)
 - 3. Dist. b/t alimony and child support: **(c)(1)** Terms of divorce settlement; **(c)(2)** Payments fixed on a contingent related to a child

DEDUCTIONS (Cost of Producing Income)

- I. Deductions Generally
 - A. Purpose – come up w/ net income formula b/c tax policy based on apportion burden of supporting gov't among TP's based on resources available for consume/saving.
 - 1. Formula: 2 formulas that state same thing
 - a. Net income = gross income – expense of production
 - i. Expense of prod. = immediate cost (**§162, 212**) + depreciat'n (**§167**)
 - b. Net income = consumption +/- Δ Wealth
 - i. Consumption = never deductible per **§262**
 - ii. Positive Δ Wealth = savings just converted from cash to in-kind (capital expenditures) → never deductible per **§263**
 - iii. Neg. Δ Wealth = Consumption (never deductible per **§262**) OR True disenrichment (loss deduction per **§165**)
 - B. Value – increases as tax bracket increases
 - 1. Nontemized deduction – deductions for cost of producing income (**§162, 165, 167**) and alimony payments (**§215**) (EN for starting business)
 - 2. Itemized deductions – incentive for some consumption active. (**§213** health care)
 - a. Only helps if taken together are greater than standard deduct. under **§63(b)(2)**
 - 3. Credits – worth same to all TPs; if TP's bracket > credit rate = deduct. helps more
 - C. Deductions compete w/ specific disallowance provisions
 - 1. **§262** No deduction allowed for personal, living, or family expenditures
 - 2. **§263** No deduction allowed for expenditures to acquire or improve property (including intangible property like good will)
 - a. **§1016** but these expenses will be included in TP's basis in the property
- II. **Business and Investment Expenses** (dist. b/t biz. exp. and pers. expense)

A. **§162(a)** Deduction for "all the ordinary and necessary expenses" incurred during the year "in carrying on any trade or business."

- 1. **§212** deduction of exp. to maintain income producing prop. counterpart
- 2. This allows for an immediate deduct for cost (**§167** that is a spread)
- 3. Dist. b/t true biz. expense and personal expense (disallowed per **§262**)
 - a. "Necessary" = appropriate and helpful (leave to biz. judge of TP)
 - b. "Ordinary" = Common in business world (need **obj. standard**)
 - c. "In carrying on" any trade/biz. = expense incurred during employment and further ER's biz. interests (**Smith** – child care case below) (CU)
- B. Gen'l inquiry
- C. Is the expense for (**Welch** mode of analysis):
 - 1. **Maintaining** a trade or business/income producing property (**§162, 212**)
 - 2. **Acquire/improve** trade or biz./income producing property (**§263, §167**)
 - 3. **Personal of family benefit** (consumption) (**§262**)
 - 4. Test: If expense increases the income producing potential of the business or property = improvement = not deductible.
- D. Cost of Education – only deduct. under **§162** if maintains income skill
 - 1. But most education expense are incurred to purchase skill
 - a. Not deductible under **§162** b/c its an expense for acquiring a business
 - b. No **§167** deprec'n deduct. b/c skill (human capital) ≠ "property" (CU)
- E. Expenses for mixed motive – both business and personal
 - 1. General approach – use all or nothing primary purpose test (just like gifts w/ subjective motive inferred from objective facts)
 - a. AC calls for brightline rule based on most factually common motives
 - 2. **Cost of childcare** - Not deduct. **§162** b/c not incurred "in carrying on"
 - a. Theory – if get job after kids, not a pers. exp. but biz. expens
 - b. Policy – most common scenario is gets after job = pers. decisions
 - 3. **Commuting** – Not deduct. b/c cost of choice of where to live
 - a. Includes working while commuting b/c doesn't further biz. interest
 - b. Theory – if home fixed then commuting nec. to make income
 - c. Policy – most common scenario is can choose where to live, pers. dec.
 - 4. **Clothing** – Deduct. **§162** only if can't use clothes outside work
 - a. Theory – clothing required for work meets plain lang. of **§162**
 - i. Policy - **§262** disallowance for consumption controls over deduct.
 - 5. **Business Meals** (non traveling) – Deduct **§162** if can separate cost of meeting place (deduct from cost of meal (non-deduct. consumption)
 - a. Theory – meeting place nec. biz. exp. but meals are not
 - b. Policy – recognizes the distinction but hard for TP to split price
 - 6. **Business Travel** – Primary motive whether motivated by biz. or pers.
 - a. Theory – Biz. trip deduct. but if extend for vacation that's pers.
 - b. Meals/Lodging when traveling – Deduct **§162** unless lavish, **§274(n)** can only deduct up to 50%
 - i. Theory – Consumption costs but also duplicative forced consumption
 - ii. Policy – Recognizes mixed motive and tries to tax accordingly
 - 7. **Business Entertainment** - **§274(a)(1)** No deduct. for entertainment but **Reg. §1.274-2(d), (e)(3)** liberal exception for entertain related to biz.
 - a. Theory – entertainment core consumption but mixed motives
 - b. Policy – Regs acknowledge mixed motives
 - i. Entertainment is core consumption → not deductible per **§262**
 - ii. But also get some biz. purpose and forced consumption → that portion should be deductible under **§167**
 - 8. **Hobby Expenses** - **§183** decut. up to amt. of income hobby produces
 - a. Theory: Part consumption based and part produces income
 - b. Policy: **§183** acknowledges mixed motive and strikes compromise
- F. Attorney's fees/damages in claims relating to biz./income property
 - 1. Origin of claim test: Only deductible under **§ 162, §212** if claim arose over the business/property (not just b/c claim could affect biz./prop)
 - a. Policy: "carrying on" requirement read into **§212** just like **§162** for HE and EN b/t trade/biz. income and property income

III. Depreciation Deduction

- A. **§167(a)** Deduction for "reasonable wear and tear of property"
 - 1. Property must be: Used in trade/biz. OR For the production of income (ROC spread over useful life of the prop. rather than ROC last on sale)
 - a. Policy: Accurate measure of ANNUAL (**§441**) disenrichment for cost of producing income
 - 2. **§167** along w/ **§1001(a), 1016, 165(c)** are ways to get ROC.
- B. Mixed motive exp. – depreciable property used to build another asset
 - 1. Rule: No **§167** deduct, but "capitalize" depreciation to adjusted basis in long lived asset
 - 2. Policy: Annual accounting; disallowance prov. controls, HE; EN