

## Federal Income Taxation I Outline

- 1) Methodology
  - a) gross income
    - i) inclusions
    - ii) exclusions
    - iii) separation and divorce
    - iv) assignment of income
  - b) checklist
    - i) Has taxpayer received anything
      - (1) Has it been transferred by statute
        - (a) Assignment of income
        - (b) Divorce issues
        - (c) Kiddie tax
      - ii) What is value of property received
      - iii) Statutory exclusion
      - iv) Is there any basis
      - v) Are there any deductions?
- 2) Gross income: general rule is that "all income from whatever source derived" is income
  - a) General exclusions
    - i) Not a "mere return of capital"
    - ii) Not accompanied by a contemporaneously acknowledged obligation
      - (1) loans: since they must be paid back they are not included as income
        - (a) Deposits are considered to be loans Indianapolis Power and Light
    - iii) Any other statutory exclusion
  - b) Inclusions
    - i) Imputed income is not really income
      - (1) Bargain purchases: judicially created exception where someone gets more than they paid for. But, an employee discount of more than the allowed amount is income.
    - ii) Cash is always includible (it is easy to calculate)
    - iii) Taxes paid: Another persons' payment of taxes for a 3d person (unless it is viewed as a gift). § 1.61-14(a)
    - iv) Use of property can be considered to be income (unless an exclusion applies) Dean (using corporate yacht)
    - v) Damages
      - (1) Compensation for Personal injuries and sickness are not includible as income
        - (a) look to the complaint and see how the taxpayer tried to frame the complaint
          - (i) non-economic damages are includible
        - (b) remember, there is a basis in economic damages
        - (c) insurance payments: under § 104(a)(2) a reimbursement of a settlement from the tortfeasor is included up to the amount of any reimbursement. Any additional settlement above expenses is excluded

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

(i) example:

Year	characteristic
1	Deduct damages
2	Include reimbursement up to amount of prior deduction

- (d) insurance payments from two policies (e.g. employer's policies and employee's policies): Rev. Rul. 69-154 says that they should be apportioned between the two policies (fn. 29 p. 191). This results in an exclusion of only a portion of what is in the employer's policy.
- (e) There are restrictions under § 105(h) for discretionary benefits paid to highly compensated folks.
- (f) If a tortfeasor pays money to a victim, the source of the payment doesn't matter (annuity, selling property, etc.) Likewise, what the victim does with the settlement is treated just as if he had the money all along. (So if he puts it in an annuity, he is not taxed on the principal, but on the interest.)
- (g) If the terms of the settlement call for payment over a long time, the all of the payments are excluded.
- (2) Punitive damages are always income
- (3) If the damages account for lost profits that it must be income Raytheon, and it doesn't matter if the damages were awarded under a tort or contracts theory. But there will be a basis in that income
- vi) Structure of transaction
- (1) Barter transactions: barterers are includible in gross income Rev. Rul 79-24.
- (2) Must insure that any additions to wealth were not already purchased in the gross income of the taxpayer before as part of another transaction (e. g. when purchasing an airline ticket, the taxpayer receives a trip and frequent flyer miles).
- (a) Service says it won't tax frequent flyer miles unless it is potentially abuse situation
- vii) Time of accretion to wealth: (1) clearly realized; 2) over which the taxpayer has control)
- (1) What matter is what the property can be attributed to the taxpayer under state law. Cesarini
- (2) But illegal gains constitute gross income (even though, in theory, they need to return them)
- c) Statutory Exclusions from gross income
- i) Does not include value of income acquired by gift, devise, or inheritance (may be taxed in gift tax) § 102
- (1) Gifts:
- (a) Defining gift
- (i) *gifts are detached and disinterested generosity* Duberstein
- (ii) gifts: (carryover basis with exception) – where there is any compensation it will be treated as a sale. Farid-Es-Sulteneh

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- (iii) Employee gifts
  - 1. Reg. 1.102-1(f)(2): transfers to employee's kids that can be showed to be made not in recognition of employment are not considered to be compensation
  - 2. miscellaneous fringe benefits to employees do not count towards gross income anyway, but other a different section
- (b) types of property transferred as part of a gift
  - (i) Gifts in cash: basis is the value of the cash at the time of the gift
  - (ii) employee achievement awards are deductible up to the amount of the award
  - (iii) 7872 on below market loans (demand and gift term gift loans)
    - 1. legal fiction of 7872
      - a. the loan really does bear interest at the "applicable federal rate"
      - b. the lender transfers to the borrower amounts to fund those interest payments: **this is included as a gift (or compensation, if it is to an employee)**(on 12/31)
      - c. the borrower makes interest payments at that rate of the forgone interest payments: **this is included as a payment of interest** (on 12/31)
        - i. if the gift loan us under 100,000, the amount treated as transferred from the lender to the borrower shall not exceed the borrower's net investment income as per 163(d)(4)
        - ii. net investment income is investment income minuses expenses
        - iii. net investment income is less than 40,000 it is treated as expenses
        - iv. if borrowers net investment income (non-business profit-seeking activities) does not exceed 1,000 then no amount is deemed to be transferred
    - 2. exceptions
      - a. 10,000 unless it is attributable to purchase or maintance of income-producing property
      - b. 10,000 for corporation-shareholder or compensation related loan exception 7872(c)(3)(A)
      - c. 100,000: if the loan is under 100,000, the amount treated as retransferred by the borrower will be deemed not to exceed the borrower's net investment income for the year
        - i. (doesn't apply for tax avoidance)
        - ii. if more than one loan outstanding the net investment income will be allocated amoun such loans in purpotion to the respective amounts that will be deemed to be retransferred
        - iii. if aggregate amount of loans exceed 100,000, then no limit

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

3. characterization of income of a below market loan
    - a. Gifts:
      - i. Lender made a gift
      - ii. lender had income
      - iii. borrower had an expense
      - iv. exception: 10,000 unless it is attributable to purchase or maintenance of income-producing property
    - b. Compensation-related loans
      - i. lender paid compensation
      - ii. borrower received compensation
      - iii. exception 10,000 for corporation-shareholder or compensation related loan exception 7872(c)(3)(A)
      - iv. special rule to keep people from being chained to employers : will not be treated as a demand loan (and treated as a term loan) if its benefits are not transferable and are condition on performance. 7872(f)(5)
    - c. Corporation-to-shareholder loans: treated as dividend or return of capital (paid on last day of year)
      - i. exception 10,000 for corporation-shareholder or compensation related loan exception 7872(c)(3)(A)
    - d. Shareholder to corporation: contribution of capital
    - e. Tax avoidance: (fact-specific)
    - f. Other below market loans: (fact-specific)
    - g. Loans to qualified continuing care facilities: (fact-specific)
  4. Timing and amount of a below market loan
    - a. Demand notes (payable in full on demand):
      - i. income tax: amount of "forgone interest" is considered to be transferred annually from lender to borrower on the last day
      - ii. gift tax: Lender is treated as making a every year in the amount of interest that accrues
    - b. Term notes (everything else): **amount transferred from lender = PV OF ALL PAYMENTS – amount loaned** (this is really OID and accrues ratably)
      - i. income tax:
      - ii. gift tax: on the date that the loan is made ,the lender is treated as making a gift to the borrow of PV of all payments minus amount of loan)
      - iii. (move 7872 stuff here (check this)
- (iv) gifts of appreciated property.
1. Rule: Property acquired by gift generally takes a “transferred basis”
  2. Exception: if the donor’s adjusted basis is greater than the fair market value at the time of the gift AND the donee sells the property at would otherwise product a loss, the property’s basis is the date of gift fair market value. (§ 1015 (“except” clause

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

3. if the original basis of the gift is greater than the fmv (e. g. property has declined in value) the basis in the hands of the new owner will be its fmv for determining loss § 1015
  4. if the original basis of the gift is less than the fmv, there is a transferred basis
- (c) part-sale-part gift transferors
- (i) unadjusted basis in the hands of the transferee is MAX(amount paid by the transferee for the property, transferors adjusted basis at time of transfer + amount of increase for gift tax paid) § 1.1015-4
  - (ii) losses not recognized
  - (iii) transferor has a gain to the extent that the amount realized exceeds his adjusted basis § 1.1001-1(e)
- (2) inheritances (payment in the form of a bequest is not an inheritance Wolder)
- (a) General rule: inheritances are not includible § 102(a)
  - (b) Exception: A settlement of a dispute over a will is considered to be an inheritance Lyeth v. Hoey
- (3) employee prizes § 74 (note: if it doesn't qualify, it might qualify as a de minimis fringe benefit)
- (a) what the award can be for
    - (i) Must be for length of service or safety awards
      1. Limited to 10% of the workforce
      2. Safety awards can't be given to managers or clerical employees.
    - (ii) if it is a length of service award, must be given if the employee has been in service for 5 or more years, and must be included if they got the award in any of the prior four years
      1. if the award is made, but it must be included, it will not disqualify the later award
    - (iii) can be given to surviving spouse and still excluded, so long as there is mention of what the award was for
  - (b) How the award must be given
    - (i) Meaningful presentation (ceremony requirement)
    - (ii) Must in form of tangible personal property : No gift certificates
  - (c) What the award cannot be for
    - (i) Not a likelihood of disguised compensation
    - (ii) No *quid pro quo*
  - (4) Monetary limits
    - (i) Qualified plans v. non-qualified plans
      - (i) If it is not in a qualified plan there is a \$400 limit
      - (ii) If it is in a qualified (written plan) there is a \$1600 limit
- ii) **employee benefits** are generally excluded if they are not a form of compensation
- (1) general mode of analysis: Ways to analyze whether or not something is a gift
    - (a) is it bargained for?

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- (b) where there is a direct benefit, but not bargained for it...
- (c) general benefit?
- (d) question of how to value (is there really a willing buyer or a willing seller)
- (e) administration and record keeping problems
- (f) to who it applies
  - (i) Definition of employee
    - 1. Employee is defined as employees and their families and retired and disabled employees § 132(h)
    - 2. 132(h) includes parents of employees if their children work for airlines
  - (ii) general exclusions from nondiscrimination clause
    - 1. does not apply to athletic expenses
    - 2. working condition fringe benefits (e. g. you can give higher paid employees nice free stuff if it is part of their job, but there are restrictions about giving them expensive cars)
  - (iii) discrimination based on number of years an employee has been there is a form of discrimination
  - (iv) anything in favor of highly compensated employees is per se discrimination
- (2) no additional cost services
  - (a) must be offered to all employees 1.132-2(a)(4)
  - (b) may includes reciprocal agreements with other companies or affiliates of airlines
  - (c) employees of subsidiary companies need not be offered the service in the parent company, but employees of the parent company MAY be offered the discount in the subsidiary company
    - (i) check 132(j)(5)
- (3) “qualified employee discounts”
  - (a) check 132(j)(2)
  - (b) Qualified employee discounts 132(a)(2)
    - 1. requirements
      - a. Must be in same line of business
      - b. Unlike with services, these discounts can be given in the form of a rebate
      - c. Includes insurance policies (legislative history)
      - d. Non-discrimination provisions 132(j)(2)
      - e. fatal exclusions
      - f. Does not apply to real or personal property held for investment
      - g. Does not include loans to employees of financial institutions
    - 2. goods
      - a. up to the gross profit percentage of the employer § 132
      - b. aggregate sales price reduced by cost / aggregate sales price
      - c. where aggregate sales price is all property in the employer's

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- line of business, not just the discounted sales item
- 3. services
  - a. may be up to 20% of what price is offered to consumers
- 4. Employee is defined as employees and their families and retired and disabled employees § 132
  - (ii) Non-discrimination provisions apply
- (4) De minimis fringe benefit
  - (a) Eating facilities: must be non-discriminatory
  - (b) All other de minimis fringe benefits may discriminate between workers. 1.132-6(f)
- (5) Employee eating facilities 132(e)(2)
  - (a) Non-discrimination clause. Note: highly compensated employees will have high gross income, but the lesser ones will not 1.132-8(a)(2)
- (6) Qualified retirement and planning services 132(a)(7)
  - (a) Non-discrimination clause. Note: if the employer screws this up, highly compensated employees will have high gross income, but the lesser ones will not 1.132-8(a)(2) – 1.132-1(e)(5)
- (7) Athletic facilities 132(j)(4)
  - (a) **there is no non-discrimination clause** 1.132-1(e)(5)
  - (b) Must be on premises
  - (c) Must be operated by employer
- (8) No additional cost services
  - (a) definition of qualified services
    - (i) Must be services
    - (ii) Must be offered for sale to customers
    - (iii) Must be in same line of work, but people who work for the parent company can be given access to the child companies... but sibling companies cannot be given access to other sibling companies
  - (b) Definition of "no additional cost":
    - (i) To determine if there is a substantial additional cost the service takes into account the amount of revenue lost
    - (ii) Other times it applies
    - (iii) When there is a reciprocal agreement with a similar company 132(i)
    - (iv) To affiliates of airlines 132(j)(5)
    - (v) Does not apply if there is a cash rebate program (but regulations seem to say that this is allowable)
  - (c) If it fails this test it still might qualify as an employee discount
- (9) Working condition fringe benefits 132(a)(3)
  - (a) Includes
    - (i) Things that would have been deductible by the employee as a business expense if they had paid for it
    - (ii) Things that would have been deductible by reason of a depreciation deduction by the employer
  - (b) Companies may discriminate on who they give this too (unless it is eating)

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

- (c) Examples
  - (i) Company car to do company things 132(j)(3)
    - 1. note: there are restrictions on security items in 1.132(6)(e)(2)
    - 2. includes demonstration autos
  - (ii) educational benefits § 132(j)(8)
- (10) de minimis fringe benefits
  - (a) things normally included with work
    - (i) Hatt: if something is the custom, and it aids with the job, then it can be considered to be a fringe (e. g. lodging)
  - (b) traditional retirement gifts presented after lengthy service
  - (c) meals that are due to overtime and occasional will not be included 1.132-(6)(e)(2)
    - (i) meals must be
      - 1. on premises (non-discrimination clause)
      - 2. for convenience of employer (will look to whether it is customary. Hatt)
- (11) qualified transportation fringe benefits – note, under 132(f)(7) if something qualifies as a transportation fringe before imposition of dollar limits, it may not qualify as a non-transportation fringe benefit
  - (a) on a commuter highway vehicle
  - (b) transit pass/token/etc.
    - (i) can be reimbursement
    - (ii) applies to reimbursements
    - (iii) limited to \$100/month (adjusted for inflation)
  - (c) qualified parking limited to \$175/month (adjusted for inflation)
  - (d) wider definition of employer 1.132-9(b) Q&A 5
- (12) moving expenses 132(g) that are reimbursed (note there is another section § 217 wherein one can deduct self-paid moving expenses)
  - (a) qualified means that it was not deducted by the employee
- iii) Scholarships and tuition assistance: see chart in n. <sup>1</sup>

<sup>1</sup>Paid educational expenses

Program requirement	§ 127 (educational assistance program)	§ 117 (qualified scholarships)
Definition of employee	Employees and self-employed people	Employee and their family, retired employees, etc. (under 132(h))
Barter issues		So grants from present or former employees are considered compensation, not an award
		Grants for specific teaching and research do not count.
Formality	Must tell employees about it	Athletic scholarships are only okay if there is no requirement to be on the team
		Requirement that it be part of a scholarship or fellowship grant
Degree candidate requirement	No	Yes (must be a degree candidate)

- iv) prizes for being a good person (Prizes made for doing something really good (religious, charitable, etc) are not included as income due to § 74(b))
- (1) Recipient selected without any action on his part to enter contest
  - (2) Not required to render substantial services
    - (a) Arguably an acceptance speech okay
    - (2) Must be immediately (before there is control over it) given to a government or charitable agency: This designation can be made before or after they are aware of the award – up to 45 days after the award is granted.
- v) Annuities
- (1) General rule: can exclude **investment / expected return** § 71(b)(3)
    - (a) Estate will get a deduction for early death in last taxable year § 71(b)(3)
    - (b) People who die later will have to pay a tax on the full amount § 71(b)(2)
  - vi) Life insurance
    - (1) Rule: the "face amount" is generally excludible (amount paid by reason of the insured's dead)
      - (a) If they receive it before they die, it must be included 101(a)
        - (i) Obviously, the person has a basis in it
        - (b) Policies that are transferred to people, are received with a carryover basis 101(a)(2)

Level of study	Graduate and undergraduate study now available	Must be below the graduate level, unless the person is a graduate assistant
Maximum limits	5,250 (payments above will be included as income)	
Non-discrimination requirement	Yes (unless evidence of good faith collective bargaining agreement). Cannot be used for the top 5% shareholders	Yes
Exchange requirement	Can't offer people a choice between education and something else	N/a
Extraneous allowed	For books	For books Like no additional cost services, this can be made to the student, and to reciprocal institutions
<b>Extraneous expenses disallowed</b>	<ul style="list-style-type: none"> <li>• For things that will be retained by employer</li> <li>• Things might be considered to be a game of hobby</li> <li>• Travel as education</li> </ul>	<ul style="list-style-type: none"> <li>• Cannot be used for lodging</li> <li>• Travel as education</li> </ul>

5  
7  
9  
11  
13  
15  
17  
19  
21  
23  
25  
27  
30  
32  
34  
36  
38  
40  
42  
44  
46  
48  
50  
52  
54

- (i) Exceptions for ill people: 101(g)
  - 1. Terminally ill: They can get the money tax free, if they are going to die in 24 months
  - 2. Chronically ill: for 12 of the past months, can't perform 2 important tasks
    - a. Limited to \$175/day, and reduced by any reimbursements from medical insurance proceeds
- (2) Elections by a beneficiary to leave a policy with the company
  - (a) If they elect to only receive the interest, it is included 101(d)
    - (i) Amounts that are received are received as interest. However, any amount that was initially a payment will be excluded to the amount that it was prorated
    - (b) If they elect to only receive benefits as an annuity
      - (i) Treated as other annuity: exclusion of investment/expected return
  - (3) Transfers of policies
    - (a) If a policy is transferred for consideration during the life, whoever benefits must include it as income 101(a)(2)
      - (i) This means that a settlement provided must realize gain
      - (ii) Whoever takes the policy has a basis in it
    - (b) Exceptions, The following people need not include an insurance policy
      - (i) A third transferee, who acquires it from the original transferee with a transferred basis need not include it 101(a)(2)(A)
      - (ii) Transfer was to the insured
      - (iii) Transfer was to a partner of the insured
      - (iv) Or a partnership or corporation which the insured had an interest 101(a)(2)(B)
- vii) Tort-type injuries: tort-type damages and settlements 104(a)(2)
  - (a) Can exclude damages for physical sicknesses
    - (i) Medical care or related to personal injury (committee report)
  - (b) Emotional distress can be excluded if it is based on a physical injury (e. g. Emotional distress is not a physical injury)
  - (c) Punitive generally not included, unless they are punitive in wrongful death actions in states without a survivorship statute
  - (d) Allocation, since, in settlements there will be allocation between physical personal injury claims and compensatory damages and punitive
    - (i) Look to taxpayers complaint
    - (ii) The parties must be somewhat advisory in their motivations to allocate
  - (e) It matters not where the source of a settlement comes from, so if the Defendant buys the Plaintiff an annuity it is not valued as an annuity, but as a tort settlement
- vi) When employers pay for medical expenses
  - (1) 106: employer's contributions to health plans to pay compensation excluded
  - (2) 104(a)(1): benefits paid based on workers compensation statutes, but it must be job related, and not a non-occupational benefit
    - (a) can't exclude amounts in excess of workers comp 1.104-1(b)

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- (b) does not apply to nonoccupational injuries 1.104-1(b)
  - (i) can only be for things that are related to the course of employment 104(a)(1)
- (c) 104(a)(3): employee-funded plans are excluded, even if the injury is not job related
  - (i) however, this includes all benefits, even if the amount paid exceeds the injury
- (3) amounts that employees pay the employee for the medical care (and their families) are excluded
  - (a) can deduct medical expense coverage but not permanent injury or medical expense 1.213-1(e)(4)
  - (b) all employee-funded benefits from employers are fully excluded no matter what type of plan 104(a)(3)
    - (i) there is a presumption that all benefits are allocated to accident and health benefits, unless the plan is worded in a contrary way 1.72-15(c)(2)
- (4) amounts paid by employers
  - (a) employers can deduct
    - (i) **joint contribution** excludible percentage is pro-rated to the employee 1.105-1(d)
  - (b) employees can exclude § 106(a)
  - (c) employer-funded benefits included by employees 105(a) unless they are used for medical care, and permanent injury that is not related to a period of absence 105(c)
- (5) disability pensions of armed forces and government excluded 104(a)(5)
  - (a) 105(c) health and accident insurance is excluded, if the amount is calculated with regard to the nature of the injury and not to the period he was absent from work
    - (i) this section is usually preempted, except when dealing with nonoccupational injuries and spouse injuries
  - (b) prior year exceptions in 104-105: reimbursements for previous taxable years medical expenses that were deducted under § 213 are INCLUDED
- vii) sale of residence § 121
  - (1) may exclude up to 250k in gain (500k for a married couple) § 121
    - (a) must be a two-year gap between each sale of houses § 121
  - (2) land that surrounds house is also excluded. § 121
- 3) assignment of income issues
  - a) statutory anti-assignment provisions
    - i) Kiddie tax: kids under 14 get taxed on their unearned income at their parent's rate
      - (1) But, amounts earned by children (even though they could be included under state law as parent's property) will be taxed as theirs under Sec. 73
  - b) Property v. services: Self-created property is viewed as a transfer of property rather than the services
    - i) services

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- (1) Guiding principle:
  - (a) principal: the more specialized the person, the less likely it is to be assignable
  - (b) one service is rendered it is too late to reassign it
  - (c) Gianni exception: if you assign the income before it is earned, they are no longer the taxpayer
    - (i) Two “Ginnannini” criteria 1) disclaimer prior to earning income 2) no control over who receives the income
- (2) The person who earns it, is, in general the person who is taxed on it
  - (a) Lucas v. Earle: older case holds that even if a document is executed assigning income, it will be attributed to the person who owns it (Assignment of unearned wages is ineffective to transfer income, no matter what state contract law says. Lucas v Earle)
    - (i) Personal service income cannot be shifted except by performance of gratuitous services
  - (b) Look to original disposition of property
    - (i) However, under state law, if the earnings originally vest in both people than they will stay there Poe v. Seaborne (splitting through operation of law)
    - (ii) Ginannini: Determining factor is who is controlling the disposition
      - 1. Two “Ginnannini” criteria 1) disclaimer prior to earning income 2) no control over who receives the income
    - (iii) 66-167: Waiver of statutory fees (executor of will) reduces income
    - (iv) 74-581: assignment by contract (law school criminal law clinic) will actually be excluded from income, though this case makes little sense (except the IRS found it in its heart to issue an unprovoked ruling saying that payment of attorneys fees to law school clinic is good. *Whatever*)
    - (v) to charity, the IRS has ruled that one could have a 170 deduction and then taxed on honorarium
- ii) property: general rule: includible as income
  - (1) "fruit-tree" doctrine: he who owns the corpus will be taxed, even if he gives the income away (Helvering v. Horst) (who controls the property most important to tax ownership) – factors are risk of loss, whether it looks like a conditional assignment, and how the appreciation is handled (possible conflict): probably not as applicable now as it used to be
    - (a) Bonds are considered to be two different economic obligations 1) a right to receive the principle back, and a right to receive income from them. Any transfer of the either of the obligations should be analyzed as an economic gain.<sup>2</sup>

<sup>2</sup> Helvering v. Horst: The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

- (b) Blair: assigned income of bonds is actually an (vertical) assignment of income<sup>3</sup>, which shifts it to the donee
- (c) When transferring the interests there must actually be some substance (e. g. conveyance for value, so, in general, gratuitous assignments of income from bonds does not result in a an assignment for tax purposes)
  - (i) Must inquire as to whether the benefits and burdens of ownership actually passed
  - (ii) Substance of a gift or other transaction: there must be some substance to the transaction (from Helvering v. Horst)
    - 1. Strahanan: so long a transaction has some substance to it, it will be recognized as an actual shifting of the property which occurs at the moment of the transaction, rather than numerous gifts of income from the property
      - a. Government was trying to point out that the income stream was predictable so it looked like a loan
    - 2. Under the step transaction doctrine (Court Holding), a conveyance of property away from its holder (by gift) was a way to reduce income will be ignored.
    - 3. Susie Salvatore: ("a sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title"). This is the "who sold it" doctrine.
    - 4. Cambell v. Prothro: Where the holder has no risk of loss (because he has something of an undivided, and guaranteed interst) the donee has not actually made a gift
- (d) Exception for payment of royalties – even though there is a component of personal services in the payment of royalties, the tax court has held that this is assignable
- (2) division of income and ownership interests: if the owners of the property transfers the property to two or more persons (dividing up all of the interests) then those people may successfully only be taxed on the income or corpus that they own
- 4) alimony (true alimony is not included in gross income, however, there are provisions for recapture of what might actually be a disguised property settlement)
  - a) Determine when an indirect payment constitutes alimony
    - i) Question is what rights and legal interests are implicated by the payments
      - (1) A payment that is made by the payor spouse to maintain property used by the payee spouse is not an indirect alimony payment
        - (a) Includes premiums on life insurance, mortgage properties
      - (2) Payments in satisfaction of a legal obligation that the payor spouse has no legal interst in are considered to be alimony

---

others which constituted an economic gain to him.

<sup>3</sup> Blair: Person who is to receive income of trust as owner of beneficial interest must pay income tax thereon, and where income has been validly assigned, without reservation, under law governing trust, assignee thus becomes "beneficiary" and is entitled to rights and remedies accordingly

5  
7  
9  
11  
13  
15  
17  
19  
21  
23  
25  
27  
30  
32  
34  
36  
38  
40  
42  
44  
46  
48  
50  
52  
54

- ii) These payments should be viewed as increasing basis in the property, if they are capital expenditures.
- b) Differentiate between **alimony** or **separate maintenance** payments
  - i) To qualify as either **alimony** or **separate maintenance** payment must meet six criteria
    - (1) Must be paid under a divorce or separation instrument
      - (a) Can be divorced, separated by decree, married but have a written separation agreement, married but have a support decree
    - (2) Instrument does not designate it as a non-alimony payment
      - (a) If the instrument designates it as non-alimony, this gives the receiving couple the power to allow the receiving couple to get the benefit of preferential tax treatment
    - (3) Anti-sham: parties are not members of the same household when the payment is made (if it is made pursuant to a divorce or legal separation instrument)
    - (4) There is no post-death liability to receiving spouse
      - (a) If there is some provisions, where at one spouse's death, a payment to a third party is made, these payments can't be treated as alimony<sup>4</sup>
    - (5) payment is **not** for **child support** (not taxable, not deductible)
      - (a) regulations say that if payments change because of something involving the children (e.g. number of children) it is inferable that the payments are for child support
    - (6) payment is in **cash**
  - c) Determine what is a **Property settlements** (treated as a gift, not taxable, and not deductible) – in addition to specific property settlements, recaptured alimony (due to frontloading) is treated as a property settlement
    - i) No gain or loss. Transferee assumes the transferor's (exact) basis. (must be within a year and incident to divorce)
      - (1) Actual transfer must be with 6 years after the marriage ceases
      - (2) No gain or loss. Transferee assumes the transferor's (exact) basis. (must be within a year and incident to divorce)
      - (3) Actual transfer must be with 6 years after the marriage ceases
    - ii) recapture of alimony that converts it into property settlements steps: determine what portion of a front-loaded alimony payment is subject to 71(f)'s alimony recapture provision (when a large payment is made in the 1<sup>st</sup>, or 2d year in relation to year 3)
      - (1) note: this applies to the first three years of actual alimony (so if there was either no alimony in the first year, or there was deemed to be no alimony in the 1<sup>st</sup> year, the recapture formulas begin with the 2d year)
      - (2) steps
        - (a) determine if exception applies
          - (i) if spouse remarries or dies
          - (ii) if payee spouse will receive fixed schedule of income from

<sup>4</sup> **71(b)(1)(D)** there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

- business or property
- (iii) if spouse is to receive from compensation for business or self employment
- (b) first, determine excess payment for the **second year in which the alimony was made.**
  - (i) Excess payments is alimony payments in second year minus the sum of alimony payments in 3d year and 15,000<sup>5</sup>
  - (ii)  $excess_{year2} = year2 - (year3 + 15,000)$
- (c) Second, Determine excess payments for first year payments were made
  - (i) Excess payments (1<sup>st</sup>) is alimony payments made in first year less the sum of 15,000 plus average alimony payment made in second (after above computation) and third years
  - (ii)  $excess_{year1} = payments_{year1} - \left( \frac{[payments_{year2} - excess_{year2}] - payments_{year3}}{2} \right) + 15,000$
- (d) third, in the third year the payor spouse includes as gross income  $\sum excess_{year1} + excess_{year2}$ , the payor spouse includes this amount in gross income, and the payee spouse takes a deduction

5) Rules about basis

- a) In general: basis is cost of property
  - i) Basis is reduced for depreciation deductions taken
    - (1) (must allocate which part of the property the depreciation deduction was taken against, since a house on land constitutes a depreciation deduction only to the house)]
  - ii) special basis rules
    - (1) property **converted from personal property to income producing property** is subject to the basis reduction rules in 1.165-9(b) (if the property is sold at a loss, its basis is the lesser of the fmv at the time of the

<sup>5</sup> 71(f)(4) EXCESS PAYMENTS FOR 2ND POST-SEPARATION YEAR.--For purposes of this subsection, the amount of the excess payments for the 2nd post-separation year is the excess (if any) of—

71(f)(4)(A) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 2nd post-separation year, over

71(f)(4)(B) the sum of--

71(f)(4)(B)(i) the amount of the alimony or separate maintenance payments paid by the payor spouse during the 3rd post-separation year, plus

71(f)(4)(B)(ii) \$15,000.

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

- conversion or the adjusted basis as per 1.1011-1)
- (2) commissions are added to basis, and are generally not considered to be expenses
  - (3) stocks: 1.1012-1(c)(1): if taxpayer can trace which stock he purchased when, the basis shall be the basis of the first stock purchased
  - (4) gifts: (carryover basis with exception) – where there is any compensation it will be treated as a sale. Farid-Es-Sulteneh
    - (a) if the original basis of the gift is greater than the fmv (e. g. property has declined in value) the basis in the hands of the new owner will be its fmv for determining loss § 1015
    - (b) if the original basis of the gift is less than the fmv, there is a transferred basis
    - (c) part-sale-part gift transferors
      - (i) unadjusted basis in the hands of the transferee is MAX(amount paid by the transferee for the property, transferors adjusted basis at time of transfer + amount of increase for gift tax paid) § 1.1015-4
      - (ii) losses not recognized
      - (iii) transferor has a gain to the extent that the amount realized exceeds his adjusted basis § 1.1001-1(e)
  - (5) transfers incident to divorce
  - b) adjustments downward in basis
    - i) depreciation deductions taken
  - c) adjustments upward in basis
    - i) taxes paid
    - ii) improvements to property
  - 6) Deductions: taxable income = gross income minus deductions and credits allowed by the IRC § 162(a)
    - a) Ordinary and necessary business expenses (general rule: there will be a deduction **for salaries, traveling expenses when away from home in pursuit of a trade or business provided it meets four categories 1) reasonable 2) necessary 3) expenditure 4) incurred as a result of a trade or business**)
      - i) Requirements for **ordinary**
        - (1) Welsh v. Helvering: paying off someone's debt to make him not look bad is not ordinary and necessary
        - (2) Conti: immediate need for goodwill can be considered to be ordinary and necessary
        - (3) No deduction if they could have been compensated for it by employer, but chose not to because of personal convenience. Heidt
      - ii) Requirements for **necessary**
        - (1) (educational expenses are always necessary, if they are a requirement to keep current credentials)
      - iii) What is an expenditure (as opposed to a capital improvement)
        - (1) Indopco: expenses incurred in a merger procedure "future benefits" and therefore had to be capitalized (even though it was difficult to figure out its useful life)
          - (a) Indopco-style assets may only be recoverable when the business is

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- sold
- (2) Lincoln Savings: test surrounds whether or not something is a "distinct asset" or not
  - (3) Limitations on business expenses
    - (a) § 274: a lot of travel an business expenses are limited under
    - (b) § 162: ordinary and necessary business expenses includible (unless they can be properly added to the basis)
      - (i) § 1.162-4 no deduction for repairs that do not prolong life

If the activity is not engaged in for profit, then § 183 applies. Can still deduct things that are deductible nevertheless, everything else is only deductible to

- 1. Norwest (asbestos case): repairs subject to a general plan of improvement are capital expenses and not really repairs
- 2. (Stairway analogy): something becomes a capital improvement if one has to rebuild it to increase the value of the house

(ii) see n.<sup>6</sup> for repair and removal of contaminants

iv) requirements to be **"carrying on" a trade or business** (because no deductions under this category are allowed for activities not engaged in for profit) (this applies to individuals as well as S-corporations, trusts and estates).

(1) Defining "activity:" look to § 1.183-2(d)<sup>7</sup>

<sup>6</sup>**Deductibility of removal of contaminants**

Type of action	deductibility
<b>§ 198(c) qualified site</b>	Can elect to deduct
<b>If owner had knowledge</b>	Not an expense 1.162-4
<b>Owner built the building</b>	Split: 1) repair (expense); 2) continuing to build the building
<b>Acquired the building without knowledge</b>	Can be an expense because it is restoring the building to the status it was in before
<b>Remodeling</b>	capital expense

<sup>7</sup> (d) *Activity defined --(1) Ascertainment of activity.* In order to determine whether, and to what extent, section 183 and the regulations thereunder apply, the activity or activities of the taxpayer must be ascertained. For instance, where the taxpayer is engaged in several undertakings, each of these may be a separate activity, or several undertakings may constitute one activity.

In ascertaining the activity or activities of the taxpayer, all the facts and circumstances of the case must be taken into account. Generally, the most significant facts and circumstances in making this determination are the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings. **Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities.** The taxpayer's characterization will not be accepted, however, **when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case. If the taxpayer engages in two or more separate activities, deductions and income from each separate activity are not aggregated either in determining whether a particular activity is engaged in for profit or in applying section 183.** Where land is purchased or held primarily with the intent to profit from increase in its value, and the taxpayer also engages in farming on such land, the farming and the holding of the land will ordinarily be considered a single activity only if the farming activity reduces the net cost of carrying the land for its appreciation in value. Thus, the farming and holding of the land will be considered a single activity only if the income derived from farming exceeds the deductions attributable to the farming activity which are not directly attributable to the holding of the land (that is, deductions other than those directly attributable to the holding of the land such as

5  
7  
9  
11  
13  
15  
17  
19  
21  
23  
25  
27  
30  
32  
34  
36  
38  
40  
42  
44  
46  
48  
50  
52  
54

- (2) presumption: there is a presumption that the activity was engaged in for profit if the gross income for 3 of the past 5 years exceeds the deductions attributable to the activity § 183(d)
  - (a) 183(e) provides a means to elect to change the presumption
  - (b) § 1.183-1(d) provides means to tell if something really is engaged in as part of a trade or business
- (3) result of being involved in a business not for profit
- (4) investigation of an active trade or business: Morton Frank
  - (a) job search expenditures are usually not deductible until one is actually in business
  - (b) usually investigating a new trade or business is not deductible, but must be capitalized (but there is a special election for start-ups)
    - (i) **special election** for start up expenditures... allows taxpayer to elect to amortize over a period of 60 months 195(c)(1)(A) for 1) investigating 2) creating an active trade or business 3) activities engaged in profit beforehand
    - (ii) can deduct the remainder under 212 if they bail out
  - (c) note: if the venture is abandoned, can take deductions after a "meeting of the minds" Dominie
- (5) educational expenses: must be improvement of skills, not changing jobs **or** meet requirements of employer
- (6) employee job-finding expenses
  - (a) never in business before (whether or not successful in finding a job): Rev. Rul 75-120.
    - (i) **exception:** a contingent employment agency fee is deductible because the expenses were not due or payable Hundley
  - (b) in business before: deductible
  - (c) if it is a different trade or business, it is not deductible, unless it is a commission, due later
- (7) meals (note: meals can also be de minimus fringes)
  - (a) meal expenses are only ½ deductible, since the taxpayer has to eat at home as well.
    - (i) exceptions:
      1. if meal is included in price of ticket it may be 100% deducted
      2. if federal law requires a meal to be provide it is deducted
      3. de minimis fringe meals
- (8) traveling expenses
  - (a) (see inset)

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

interest on a mortgage secured by the land, annual property taxes attributable to the land and improvements, and depreciation of improvements to the land).

52

54

- (b) general requirements
  - (i) meals and lodging cannot be excessive
    - 1. cruise ship limits
      - a. must be a § 274(m) meeting on the held on the cruise ship
      - b. taxpayer must report it
      - c. ship must be registered in the US
      - d. all of the ports are in the US or possessions
    - 2. using cruise ships to travel
      - a. travel (not expenses on cruise ship) limited to two times the per diem US limit
      - b. never can call a cruise ship education
- (c) dealing with mixed business/personal trips
  - (i) expenses at the destination that are properly allocable to business are considered business expenses
  - (ii) travel expenses to and from the location are deductible if the treated is related PRIMARILY to the taxpayer's trade or business (question of fact)
    - 1. convention rules
      - a. may be ordinary and necessary depending on circumstances
        - i. 274(h): meeting outside North America are presumed not deductible, deductible unless the taxpayer can show that it is reasonable based on: primary purpose of the activity, the purpose of the sponsoring organization, the residences of the members of the sponsoring organizations the residences of the members of the sponsoring organizations, other relevant factors presented by the taxpayer
- (d) defining where one's home is for purposes of this section
  - (i) Flowers: a personal choice to live very far away from work is not deductible
  - (ii) Rosenspan: A taxpayer must have some home to be able to take advantage of the deductions<sup>8</sup>
    - 1. "to be away form home, you need a home" and if you don't have a home to be away from, you can't be away from home

<sup>8</sup> Whether or not driving is deductible?

Deductible	<b>Not-deductible</b>
<b>Home to temporary location (e. g. for hearing) for temporary location is deductible if one also has a regular place of business (no if no regular place of business)</b>	<b>Driving to job</b> <b>Driving to second job</b>

- Rosenspan
- a. earlier rule was that it should only be based on a marginal cost
  2. US v. Corell: don't get to deduct traveling expenses unless you are away from home overnight
  - (iii) § 162(a): one year test for permanency: if under a year deductible
    1. judged based on initial expectations, until the date that their reasonable expectations change
  - (e) defining where one's business is (person was allowed to have two homes): Andrews (two business locations): Guiding policy in determining where a home is, should be that it should be near the taxpayers "major place of duty" (factors: amount of time, how much activity, and how much income is being earned at each location. Tax court decided that he had two homes.
  - (f) Carrying on business 162(a)
    - (i) Deduction for Traveling away from home in pursuit of business
      1. defining home: tax court and some courts of appeals find that a home for the purpose of this act the place of business, others say it is the tax home
      2. Traveling means 1.162-2(a)
        - a. 1.162-2(a) Traveling expenses include: 1) transportation (different than "travel" which is the all three) 2) meals, 3) lodging
          - i. Hatzis: a business home requires an actual business (not being a student)
          - ii. "why isn't he living somewhere where he isn't making money... and if he made that choice because of a person choice, than it is not a business expenses."
          - iii. foreign travel regulations include allocation rules. § 274, § 162-2(a), § 274m3, § 1.274-4(d)(2)(v)
        - b. no deduction for commuting expenses 1.162(2)
      3. meals
        - a. Big reduction for meals and entertainment 274(n) -- by 50%
          - i. Meals: deductible up to 50% by 274, unless 1) business entertainment or 2) not away from home overnight (or requiring rest)
        - b. No deduction for meals, and meals incurred not when traveling away from home 1.262-1(k)(5)
      4. lodging No deduction for lodging when you are not traveling, except if it is in relation to moving expenses 1.262-1(k)(3)
  - v) deduction allowed for payment of **reasonable salaries** § 162(a)
    - (1) requirements
      - (a) must be rendered
      - (b) must be purely for services
        - (i) might be dividend

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- (ii) compensation for something they did
- (c) must be reasonable
  - (i) defining "reasonable salary"
    - 1. Minority view: Factors
      - a. Type and extent of services rendered
      - b. Scarcity of qualified employees
      - c. Qualifies and prior earnings capacity of the employee
      - d. The contributions of the employee to the business venture
      - e. The net earnings of the employer
      - f. The prevailing compensation paid to employees with comparable jobs (in and out of corporation\_
      - g. The peculiar characteristics of the employer's business
    - 2. 6<sup>th</sup> Cir: Critiques: Exacto Spring: Tax court used a 7 prong test which took into account the nature of the work. Judge Posner (6<sup>th</sup> Cir.): Test is wrong because it doesn't say how the factors should be weighed, and it doesn't bear a relationship to the very things that it is trying to prevent (e. g. dividends, gifts); and allows the tax court to second-guess business decisions. **Instead**, proper test is the "indirect market test" which is a contraction view in which corporations are viewed as a contract between the investors and management, therefore one can simply evaluate the rate of return to the investors based on the salary paid. If it is high, it is difficult to question.
      - a. Prof: Posner gets it wrong because he seems to forget that even though the profits of the salaries go up, profits and taxes may go up.
    - 3. 9<sup>th</sup> cir: if the salary wasn't really the result of a "free bargain" (e.g. dominated shareholders) then it is not deductible.
  - Harolds
  - (ii) When "reasonable salaries" are based on compensation, reasonableness is judged at the time of the making of the agreement<sup>9</sup>. Will look to whether or not there was "domination" by the highly compensated employee. 1.162-7
- (d) bonuses 1.162-9
  - (i) must be made in good faith
  - (ii) must be for additional services rendered
  - (iii) aggregate of salary and bonuses must be reasonable
- (2) Even if the salary is reasonable from a common law point of view, it must not fall under the § 162(m) limitations on "excessive employee remuneration" when dealing with public companies
  - (a) Requirements to excessively compensate the CEO and top 4 employees of a public company

<sup>9</sup> Harolds: Where there is a salary plus a percentage of the profits (contingent compensation), but the agreement originates because there is a "domination" by the employee being paid of the partners who make it, the standard for reasonable compensation rests on the substance of the payment and not on whether or not there was a defect in the procedure. Judge base on the time of agreement

5
7
9
11
13
15
17
19
21
23
25
27
30
32
34
36
38
40
42
44
46
48
50
52
54

- (i) substantive: can highly compensate people if their compensation package is
  1. commissions
  2. performance goals
- (ii) formal
  1. must be determined by committee of board of directors composed of outside directors
  2. shareholders must be informed before payment
  3. committee must certify that goals were satisfied
- (b) exception: unwritten binding contracts before 2/17 can be excessive
- (c) effect:
  - (i) no deduction will be allowed to the extent that the compensation exceeds \$1m safe harbor in § 162(1)(m)(F)
  - (ii) the 1m safe harbor is reduced if it is a golden parachute payment under 280G
    1. definition
      - a. nature: excess golden parachute payments:
        - i. payment
        - ii. contingent on a change in control of the company (presumed to be contingent if the agreement is made within 1 year of the exchange or an amendment is made within 1 year) (burden is clear and convincing evidence)
        - iii. change of ownership or control of the corporation 280G (b)(2)(A)
        - iv. to "disqualified individual" (employee, independent contractor, and is 1) highly compensate (highest paid 1% or if less, the highest paid 250 employees)
      - b. amount: aggregate exceeds 3 times the base amount
        - i. base amount is "annualized individual compensation" (average individual's compensation) for the base period (five most recent taxable years) or
        - ii. the individual compensation **does not include** 1) reasonable compensation for personal services rendered before the date of the change (excess parachute payments will be offset against this amount) 2)
    2. exceptions
      - a. does not include: small business corporation
      - b. does not include payments if the corporation is not on an established securities market and the shareholder requirements were met
- b) deductions for profit-making activities that are not in the course of a trade or business
  - i) individual moving expenses are deductible under § 217
    - (1) distance requirements
      - (a) deduction is allowed if the distance between the taxpayer's residence

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- and new place of work is at least 50 miles farther than from the older residence (so if someone lived 10 miles away from work, the new residence must be 60 miles away).
- (i) distance requirement does not apply if a retiring American taxpayer is returning to the US § 217(h)(1)
  - (b) people who are entering the work for the first time, the new residence must be 50 miles from the former residence
- (2) time requirements
- (a) must have been employed for 39 weeks of the 12 month period commencing in his arrival (waived if taxpayer dies or becomes disabled, or fired)
  - (b) time requirement does not apply if a retiring American taxpayer is returning to the US § 217(h)(1)
    - (i) employees and self-employed individuals are treated the same
- (3) moving expenses eligible for deduction: see n. <sup>10</sup>
- (a) must recapture any additional reimbursement that employer paid employee to move.
- (4) timing of deduction for moving expenses .
- (a) may deduct for earlier year, if at the time of filing it is possible that the taxpayer may still satisfy the timing requirement – amending a return is also possible. Meadows
- ii) preliminary question in is whether or not the property is "held for the production of income"
- (1) it need not actually put up for rent YET
  - (2) must fit into one of these three categories:
    - (a) 212 expenses for production of income (defending title, tax, etc)
    - (b) § 167deduction for depreciation
  - (3) remember: there must be actual income for the deductions to apply
    - (a) however, interest expenses can always be deductible
- iii) § 212: whatever is expended in the production or collection of income is deductible – including stuff for defense and management and conservation of property. **But unlike other provisions, these expenses must be incurred in the current taxable year**

<sup>10</sup>

Deductible § 217	Not deductible
Expenses of individuals traveling with taxpayer	Not-in-transit storage charges (unless international
Moving household goods and personal affects	Moving a yacht
Moving pets	More than one trip
Expenses of traveling	Meals
Lodging while traveling	Unreasonable expenses
Not everyone in the party need travel at the same time	Payment of reduction in market value of house by employer (compensation) <u>Keener</u>
Transit expenses for international travel	

5  
7  
9  
11  
13  
15  
17  
19  
21  
23  
25  
27  
30  
32  
34  
36  
38  
40  
42  
44  
46  
48  
50  
52  
54

(1) **212's boxes into which expenses that are deductible in the current year must fall**

- (a) expenses paid or incurred for the production of income
  - (i) can't be inherently personal in nature
    - 1. Higgins: taxpayer claimed that everything he did involving investing in stocks was a trade or business. Tax court said that things really could be apportioned.
  - (ii) Conventions are considered not to be personal in nature
  - (iii) Commissions are not expenses, but are added to basis
    - 1. deductions are against ordinary income, whereas a reduction in basis results in a difference in capital gain Spreckles
    - 2. Spreckles indicates that if the commission is really a disguised compensation for analysis then it can be deducted as an expense
- (b) for "ordinary and necessary" management of property (which really means "proximately related") and tax advice related to therein.
  - (i) defending title is management (but defending against a lawsuit which may result in attachment of property is not defending title Bowers v. Lumpkin)
    - 1. must look to "origin of the claim"
      - a. divorce issues:
        - i. expenses are not deductible unless they can be allocated to tax advice (courts differ on the degree of substantiation v. Cohanization allowed)
        - ii. however, expenses incurred in the collection of alimony are allowable Jane U. Elliot
  - (ii) courts use whether or no the expenses involved are "proximately related": so, a proxy fight is proximately related: Surasky IRS will not acquiesce § 212(1),(2)
    - 1. caselaw indicates that one needs to own a lot of stock for a proxy battle or shareholder travel expenses to be ordinary
    - 2. going to investment seminar is right out. No deduction. Don't even think about it. 274(h)(7)
    - 3. expenses incurred if people who were investigating business opportunities later bail are deductible.
  - (iii) maintenance of rental property deductible (look to taxpayer's intent by looking to how long the stuff was held as a personal residence – placing it immediately up for sale is an indication that taxpayer does not intend to use it as a personal residence) – if the property is used as a personal home then it is not used in a trade or business, and no deductions for its maintenance are allowed
    - 1. limits in the case property that has declared in value: 1.165-9(b)(2): if the fair market value of the property is less than the taxpayer's basis at the date of conversion, the fair market value of the property is deemed to be the adjusted basis of the property for determining loss

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

2. if the property is held to be sold, but while it is being sold it is put on for rent, it is held for the production of income.
  - Horrmann
  - a. still can take depreciation deductions
  - b. this is disallowed if they live in the house for more than 14 days (or 10% of the days it was rented at fmV) per year  
280A(d)(1) no deduction can be allowed in the year of conversion
3. if the property is not being used as a residence, but it is being held for an anticipated sale, expenses may be deductible Lowry
  - a. still can take depreciation deductions
  - b. this is disallowed if they live in the house for more than 14 days (or 10% of the days it was rented at fmV) per year  
280A(d)(1) no deduction can be allowed in the year of conversion
4. when property that is held for the production of income (based on intent test) is sold
5. note: if a portion of the property is allocated to land, a depreciation deduction is obviously not allowed
- (iv) conversions of property from business to personal use
  1. Determine what the portion of the basis allocated to the property is *160*
    - a. deduct from that basis any amount that was taken as a depreciation deduction *150*
      - i. 1.165-9(a) make sure that the property is not used for more than 14 days of personal use (280A) (a loss sustained on sale of residential property purchase or converted by the taxpayer for use as his personal residence is not deductible)
  2. special rules for property converted from personal use to business use
    - a. 1.165-9(b) if the property is sold at a loss, its basis is the lesser of the fmV at the time of the conversion or the adjusted basis as per 1.1011-1
  3. see if the § 121 exception applies for people who lived in the house for 5 years. This exception for the sale of a residence excludes from gross income the income attributable to the sale of a residence.
    - a. requirements
      - i. must have been owned for five years or more by the taxpayer
      - ii. must have been occupied for 2 years
    - b. gain can't be more than 250,000 (500,000 for spouses)  
spouse only has to have occupied, not owned it.
- (v) Home offices: can deduct allocable portions of the dwelling used as a home office if 1) they see customers, 2) it is the principal

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54

- place of business, 3) or it is a separate structure
- (c) for dealing with tax matters (see divorce section): in general, simply must allocated expenses
- iv) deductions not limited to profit-seeking activities
  - (1) general rule is that a deduction is allowed for **interest paid** – but there are a number of restrictions against individuals 163(h)(2)(A)
    - (a) categories of interest
      - (i) **trade or business interest**: always deductible (but not allowed for the "trade or business of performing services as an employee) 163(h)(2)(B)
      - (ii) **investment interest**: considered a separate "basket" of interest: It may be carried forward. 163(h)(2)(B)
        - 1. corporations are not limited to the amount of the investment income, but individuals are
      - (iii) interest in connection with a passive activity: allowed, but subject to limits of the passive activity rules 163(h)(2)(C)
      - (iv) "qualified residence interest": 163(h)(2)(D)
        - 1. qualified residence is defined as
          - a. up two qualified residences per taxpayer
        - 2. two types of qualified residence interest
          - a. acquisition indebtedness:
            - i. incurred in either acquiring OR substantially improving taxpayer's residence.
            - ii. Debt limited to 1m
            - iii. Refinancing of acquisition indebtedness counts as a form of acquisition indebtedness
          - b. home equity indebtedness:
            - i. all other types of loans secured by a qualified residence
            - ii. limits: MIN ((fair market value of qualified residence minus acquisition indebtedness), 100,000) 163(h)(3)(c)
            - iii. can be used for anything
      - (v) personal interest: 163(h) says individuals can't deduct their credit cards
      - (vi) interest on education loans: § 221 (amount and phase out ratios)
        - 1. overall limits 2,500 for 2001 and on (see limits in § 221(b))
        - 2. then reduce this amount (2,500) by the taxpayer "modified agi" over 40k-15k
  - (2) see section on below market loans in gifts

1

3

5

7

9

11

13

15

17

19

21

23

25

27

30

32

34

36

38

40

42

44

46

48

50

52

54