# Taxation classnotes, Fall 2004. Professor J. Miller.

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**Monday, August 23**

***Introduction to the course***

Recommended class-preparation process

1. Read the code and the regulations—"cold."
2. Read the text selections.
3. Look at the code and the regs. again.
4. Do the assigned problems—writing them out fully as needed, and noting authority for each answer.
5. If time allows, go over the problems with others.
6. Annotate the code and the regs., adding cross-references where applicable. **(N.b. that you can bring in your code supplement—with annotations on existing pages—to the exam.)**

Topical / chronological roadmap to the course

1. First, throughout the course we'll be dealing with the concept of *income*.
   - E.g., what abou frequent flyer miles? Should you be taxed:
     - When they're added to your FF account?
     - When you redeem them for a ticket?
     - When you finish using that ticket?

2. Exclusions (from what's income; e.g., gifts).

3. Deductions

4. Timing (i.e., of income and deductions)

5. Character of income
   - E.g., capital gains, which are taxed at a different rate than other kinds of income.

6. Identity of the taxpayer

7. Deferral and nonrecognition of income

8. Special topics: real estate transactions, educational expenses, charitable giving, tax consequences of litigation, and divorce.

Taxation and tax policy

What is tax about? Miller says it's about:

1. Money
2. Language (i.e., of the IRC)

- Tax policy
    1. Equity
        - Horizontal equity: people with the same income should pay the same amount in tax.
        - Vertical equity: people with different incomes should pay differenent amouns in tax.
            - Progressive taxation: the rate goes up as income goes up. This is based on a general assumption—the "declining marginal utility of money." This assumption is widely debated.
    2. Efficiency
        - Cost of collection
        - Economic neutrality: the tax system should be structured to allow people to do business without regard to its tax consequences. Our system is *not* very neutral.
    3. Simplicity (there is very little of this in our system)

<u>The legislative process for tax statutes</u>

1. Usually, tax bills are drafted by the Treasury Department
2. Tax bills are constitutionally required to be introduced in the House (though sometimes they go through the Senate at the same time).
    1. Committee (which will issue a report, which is valuable for judicial interpretation)
    2. Floor
    3. Conference committee (which will also issue a valuable report)
    4. Final ratification

- Besides the code itself, there are:
    - Regulations
    - Revenue rulings
    - Revenue procedures
    - Cases
        - Tax Court (where you don't have to pay the tax before complaining, but you don't get a jury) (appeals from here are made to the regional circuit court)
        - Court of Claims (appeals from here are made to the Fed. Cir.)
        - District Court (appeals from here are made to the regional circuit court)

- N.b., the tables in the beginning of the casebook (e.g., p. lxix, which has a table of Treasury Dep't regulations)

**<u>Tuesday, August 24</u>**

***Gross income***

- "Gross income" is used in § 61, but "income" itself is never defined in the IRC. Essentially, they're the same thing.
  - N.b.:
    - §§ 71–86: inclusion provisions
    - §§ 101–137: exclusion provisions

- *Cesarini* (p49) (cash treasure trove inside old piano)
  - The court finds Reg. 1.61-14 ("Miscellaneous items of gross income") to be on point.
  - But the taxpayer also agrues about the timing of his income—the court has to look to Ohio property law in order to determine *when* taxpayer got possession of the money.
  - N.b., Reg. 1.61-1(a) ("Gross income::General definition"): when you acquire something of value—even if not case—it's income.
  - What if taxpayer here had found a diamond ring inside the piano instead? Same result—because there's a *realization event* in the finding. (But *isn't* there a difference? The cash provides the taxpayer with a way to actually pay the tax, whereas the ring does not. This is a *liquidity* problem.)

- *Old Colony Trust* (p54) (company resolves to pay president's taxes)
  - The company's payment of the president's taxes was a form of compensation. So, if someone pays your debt, it's the same as if they paid you directly. And so it's income.
    - (But note the Zeno's paradox here—a progression of tax liabilities that must be summed.)

- *Glenshaw Glass* (p56) (punitive damages)
  - Punitive damages are income.
  - The court develops a standard that has lasted:
    1. Undeniable accessions to wealth,
    2. clearly realized,
    3. over which the taxpayer has complete dominion.

- *Charley* (p60)
  - Here, the court applies *Glenshaw Glass*, and says the frequent flyer miles trick taxpayer tried didn't work. He had income.
    - The court considers the trick in two different ways (see ¶¶2-3p62).

    - (N.b., that the IRS has never tried to directly tax frequent flyer miles. See 2002-18 IRB 10 (IRS won't treat FF miles as income unless they're converted to cash).)

- *James v. U.S.* (p63, in text): unlawful gains are taxable.

Local review
    - *Cesarini*: IRC definition of gross income is intended to be as broad as the constitution allows.
    - No receipt by the taxpayer is necessary before there can be income.
    - *Glenshaw*'s lasting standard
    - Illegal income is taxable (*James*)
    - § 61 list isn't all-inclusive (*Glenshaw*)

***Imputed income***

- *Independent Life Ins.* (p66)
    - Occupying your own home can be though of as income—you're relieved from the burden of paying rent. But, the court says no—it's not going to allow imputed income to be taxed.
        - (See 58 Pol. Sci. Q. 514 for more on the imputed income concept.)
- *Rev. Rul. 79-24* (p66)
    - What if you just perform a service for yourself? (I.e., isn't that, in effect, what is happening in the facts of this Rev. Rul.?)
    - Itc., unlike in *Independent Life Ins.*, the imputed income is taxable.

## Thursday, August 26

***Gifts, bequests, etc.***

- § 102(a): what's excluded?
    - Gifts
    - Bequests
    - Devises
    - Inheritances

So, the question becomes—what exactly are those things?

N.b. § 102(b): income from a § 102(a) gift is *not* excluded. (E.g., grandma gives you a rental unit. You aren't taxed on the value of the unit, but you are taxed on the rent payments you receive.) (Also, § 102(b)(2) makes taxable gifts of pure income.)

What's the policy behind § 102(a)? Miller doesn't know, but suggests there are lots of possibilities.

- *Duberstein* (p71)
    - Note how the court, in ¶0p75, calls for an "objective inquiry" into the transferor's intent. Aren't intent inquiries always somewhat subjective, though? Hmm...

- § 102(c): an effort to create a bright-line test for employers' and employees' gifts. See, too, Reg. 1.102-1(f).

- *Lyeth* (p83): was a settlement of a will contest an "inheritance" under § 102(a)?
    - State law will not control in IRC interpretation unless an express intent of the IRC to let it control.
    - The court ends up with a kind of "but for" test—if the taxpayer wasn't an heir, he wouldn't have been settling the will contest and getting some money. This is the *origin of claim* doctrine. (Consider how, if the taxpayer had litigated the will to the bitter end, rather than settled—then he would obviously be an heir. So, the holding itc. is preferring settlements over litigation.)

## Monday, August 30

### *Fringe benefits*

- The treatment of fringe benefits is *entirely* statutory nowadays. I.e., there is no fringe benefit common law anymore. So, every fringe benefit is taxable unless it's specifically excluded (see Regs. 1.61-21(a)(2), (d)(1), and (d)(2)).

- We will cover four § 132 fringe benefits:
    1. No-additional-cost services
    2. Qualified employee discounts
    3. Working condition fringes
    4. De minimis fringes

    - <u>No-additional-cost services</u>
        - Whats a NAC service?
            - A service in the same line of business (that the employee works in).
            - A service regularly provided by the employer.
            - A service provided at no substantial additional cost.

    - <u>Qualified employee discounts</u>
        - The item must be sold/provided by the employer

        - The item must be offered for sale in the same line of business (that the employee works in)
        - Ceilings for exclusion of employee discounts:
            - Services: 20%.
            - Property: gross profit percentage formula:
                - ((aggregate sales) – (COGS)) / (aggregate sales)

    - <u>Working condition fringes</u>
        - An item which, if the employee paid for it, could be deducted under either § 162 or § 167.

    - <u>De minimis fringes</u>
        - Things that just aren't worth keeping track of.

- Now, why do we even allow any exclusions for fringe benefits?
    - Consider two employers:
        - A, who pays out $100K in wages, all in taxable dollars.
        - B, who pays out $80K in taxable dollars, $20K in fringe benefits.

        So, if the tax is 20% for both:

        - A gets $80K after taxes.
        - B gets $84K after taxes.

    So, fringe benefits are subsidies to employers (or, at least they can be viewed this way).
        - However, since the government's need for money doesn't change as more fringe benefits are offered, the tax rates may go up to compensate for this subsidy.
        - Also note that in a progressive tax structure, tax subsidies are more valuable the more you make. This means that the wealthiest get the "biggest" subsidies.

**<u>Tuesday, August 31</u>**

***Gain***

- § 1001(a)
    - Gain realized = amount realized – adjusted basis
        - Amount realized = money received + FMV or property received.
        - Adjusted basis = cost, with adjustments
            - Adjustments? See § 1016 (e.g., you buy a home for $100K, then improve the roof for $10K. Your adjusted basis is $110K.)

- Note that not every gain that is *realized* is necessarily *recognized* (i.e., reported and taxable. However, § 1001(c) sets up the presumption that a gain realized is a gain to be recognized.

- N.b., loss realized? LR = AB – AR. That is, we always need a positive number.

- *Philly Park*
    - This is a property swap: T gives the city property A in exchange from the city's property B.
        - The question is, should the basis for T be the value of A or the value of B? (However, n.b, that in most cases, A's value will be the same as B's value.)
        - The court itc. picks B. (!) Why does this make sense? Because there's a problem if you don't do it this way—*distortion*.
            - E.g., say you've got a painting with FMV of $10K, which an employer gives to his employee at a discount for $9K. The employee pays the employer with a boat with FMV of $9K.
                - If the employee's basis is only $9K, then the employee's gain is $1K if he turns around and sells the painting for $10K—and that elimiinates the benefit of his employee discount exclusion.
                - Likewise, if the employer's basis in the boat is $10K, and he sells it for $9K, he has a $1K loss, distorting his $1K deduction for the employee discount.

- § 1015: property acquired by gift
    - § 1015 says that a donee takes the basis his donor had.
        - However, for determining a *loss* the donee's basis cannot exceed FMV on the date of the gift. This is a device to prevent taxpayers from transferring losses amongst themselves.
        - § 1015 is like § 1019, in that it *preserves* a gain.
    - *Taft* (p122): holding that § 1015(a) is constitutional.
    - Note the tension between § 1015(a) (gifts taxed at time of sale, effectively) and § 102(a) (gifts are not income).

**<u>Thursday, September 2</u>**

- N.b., how § 1015(a) makes it so that a donee doesn't get to realize any loss that occurred in the donor's hands (although he does have to realize any gain that occurred in the donor's hands).

- § 1041: transfers between spouses

**<u>Tuesday, September 7</u>**

- § 1014: property acquired from a decedent
  - Here, the basis is stepped up (or down), to the date of death FMV.
    - Is this taxpayer-favorable? You bet it is. This is a reason why many people hold on to property until the bitter end.
      - And so note that this is an advantage primarily to the wealthy, who can afford to hold on to their property.
    - Why do we have this provision at all though? It probably arises from administrative concerns—it was created when basis record-keeping was difficult.
  - § 1014(b)(1) explains what *is* property acquired from a decedent.
    - § 1014(b)(6): surviving spouse's share of community property is property acquired from a decedent. (!!) Note how the decedent never owned this property. (!!).
      - This means that, under the same set of facts, you can reach different results in different states.
        - E.g., (and this is *always* on the exam): H and W with $500K with a $200K adjusted basis. W dies, leaving her half to H.
          - In a community property state, what is H's basis in *his* half? $250K (§ 1014(b)(6)). What is H's basis in W's half? $250K (§ 1014(a)(1), (b)(1)).
          - What happens in a separate property state? H's aggregate basis in all the property is $350K, so H has a *$150K gain* inherent in the property when he takes it.
  - N.b., § 1020: which will appear in 2010, replacing § 1014. § 1020 institutes a carryover basis for property acquired from a decedent.
    - But, then § 1020 will automatically repeal in 2011, and § 1014 will come back.

***Amount realized***

- § 1001(b)
  - *International Freighting Corp.*: recall *Philly Amusement*. Here, we figure the value of the services T receives as what T paid as a bonus for those services.

**<u>Thursday, September 9</u>**

- *Crane*
  - Here, the widow's debt = the property's value. So, her net worth is $0, wrt. this property.
    - She keeps paying interest on the debt.
    - Then she sells it, subject to the debt, for $3K cash and reports a $1250 taxable gain ($3K sale price – $500 selling expenses = $2500 capital gain, of which half is taxable, so $1250).
    - The IRS says:
      - She realized $255K relief from the mortgage + $2500 sale price (after subtracting selling expenses), so $257500.
      - Her adjusted basis in the *land*, which is nondepreciable, is $35K; her adjusted basis in the *building*, which is depreciable, is $179K.
      - So, $255 AR – ($35K + $179K) AB = $23500 gain realized.
    - Whether the IRS is right depends on what "property" means in § 1014(a).
      - The widow argues that she inherited "property." But, if she did, she had $0 AB in it and so should not have taken any depreciation deductions.
      - The court says "property" in § 1014(a) means the physical thing itself—*not* any attached debt.
        - If that's so, then why is the debt part of the widow's AR? I mean, it's a nonrecourse mortgage after all—the widow can point to this as distinguishing her from *Old Colony*.
          - The court says no—the widow couldn't have realized *any* sale price at all if the buyer hadn't assumed the mortgage.
          - The court also rationalizes its holding on the grounds that if the widow's AB is $224K and her AR only $3K, she'd have a $221K *loss*! That would be a windfall.

N.b. the "boomerang effect" here—the government won the case, but the case has created a whole slew of tax shelters.

So, *any* time (recourse *or* nonrecourse mortgages, generally) you transfer property subject to a mortgage, the release from the mortgage is part of the transferor's AR.

- N.b., that *Tufts* says that this rule applies even if the mortgage

        debt is *greater than* the property's FMV.
    - N.b., also, what is the *Crane* purchaser's AB? Recall *Philly Amusement*—it's the FMV of the property received.

**<u>Friday, September 10</u>**

***Life insurance proceeds and annuities***

<u>Life insurance proceeds</u>

- Life insurance is generally excluded from gross income, under § 101(a). But § 101(a) basically covers *only* the date-of-death lump-sum payment.
    - What's the policy justification for this?
        - Sympathy for the bereaved. (?)
        - Analagous to § 1014 (devises and bequests).

        But, n.b., how life insurance is basically a substitute for income (i.e., the breadwinner's).

- However, the life insurance exclusion doesn't apply in some situations:
    - When you take the surrender value before your death.
    - When a third party collects on your policy.
- If you take proates over time after the holder's death, you prorate your taxable income evenly across those years.
    - But, if you receive just the income off the policy, that is *fully* taxable.
- N.b., also that there are accelerate death benefits applicable when either:
    - Terminal illness
    - Chronic illness

    In those cases, you can collect on your life insurance before you die.

<u>Annuities</u>

Note how with life insurance, everything's the same not matter when you die in relation to your life expectancy. But, with annuities, you get a deduction of unrecovered principle if you die before your expectancy, and you are fully taxed on payments received after your expectancy.

***Discharge of indebtedness***

- *Kirby Lumber* (p165)
    - The court says that reduction of indebtedness is an accession to wealth and so it's income.

        - So, if you're able to satisfy a debt for less than you owe, you have income in the amount of the difference.

- See §§ 108 and 1017: what happens to an insolvent debtor relieved of his debt? These §§ allow him to *not* report income for that relief. But that's in exchange for *reducing his basis* in certain assets.

**<u>Monday, September 13</u>**

***Indentifying the taxpayer***

Who is the taxpayer? And how can one taxpayer assign his income to another?

- This is a game. Two issues cause it:
    1. Progressive tax scheme (which we'll discuss now).
    2. Characterization (which we'll discuss later).

- *Lucas v. Earl* (p244)
    - The *act of earning* the income determines who gets taxed. To use the metaphor —if you are the tree, then the fruit is taxed to you.
- N.b., *Poe*, 282 U.S. 101: following soon after *Lucas* and concerning community property states. Same issue as in *Lucas*, but the court comes to the opposite result. Why? Because the *law* dictates who actually earns the income in a community property state.
    - This has very significant planning consequences in the context of divorce.
        - E.g., H and W. H makes $100K a year, W makes $20K a year.
            - Now, in Idaho, separation does not sever the community.
            - So, say H and W separate on 2/1/1, then divorce on 2/1/2, and then W buys a car for $10K. At the end of year one, H files a $60K tax return. But W files a $20K tax return. The IRS can come after W for the tax on $40K. (And she just spent $10K to buy a car. Yikes!)
        - But see § 66.
        - Also see 43 S.W. L. J. for an article by Miller about this.

- *Horst* (p255): a coupon bond.
- *Blair* (p259): a trust.
    - Blair is a life tenant who decides to give pieces of his life estate to his children.
    - The court says Blair's assignments are succesful—they effectively transfered tax liability to the transferees.
        - How is this different than *Horst*? Itc., for one thing, Blair is *only* a life tenant. I.e., he's not the tree—he just gets some fruit.

So, if you own *only* an income stream, you can transfer the tax liability. (...or, is this *really* what *Blair* says?)

- *Stranahan* (p261): tax deduction.
- *Susie Salvatore* (p264): how does this work—well, she owned the tree at the time of realization, the court is saying.

<u>Income-producing entities</u>

- Corporations, and their shareholders.
- Partnerships (and LLCs and S-corps.), and their partners.
- Trusts, and their beneficiaries.

All three of these calculate their taxes just like individuals: GI – deductions = taxable income. The only difference is: who gets taxed?

So, let's say we have an entity with $100K income, distributed.

- Corporation:
  - The corp. is taxed on $100K (entity level (EL).
  - The shareholders are taxed on $100K (owner level (OL)).
- Partnership:
  - The partnership is not taxed (EL).
  - The partners are taxed on $100K, across the distributions, in proportion (OL).
- Trust:
  - The trust is not taxed (EL).
  - The beneficiaries are taxed on $100K, across the distributions, in proportion (OL).

Now, what if we don't have any distributions?

- Corporation:
  - The corp. is taxed on $100K.
  - The shareholders are not taxed.
- Partnership:
  - The partnership is not taxed.
  - The partners are taxed on $100K. It doesn't matter that there's no distributions.
- Trust:
  - The trust is taxed on $100K.
  - The beneficiaries are not taxed.

And what if *half* is distributed?

- Corporation:
  - The corp. is taxed on $50K.
  - The shareholders are taxed on $50K.

- Partnership:
    - The partnership is not taxed.
    - The partners are taxed on $100K.
- Trust:
    - The trust is taxed on $50K.
    - The beneficiaries are taxed on $50K.

So, what do we have?

- Corporations are a purely taxable entities.
- Partnerships are pure tax conduits.
- Trusts are variable tax entities.

N.b., though, *grantor trusts* (e.g., revocable trusts) (see §§ 671–678), which have pass-through taxation.

***Business deductions***

- Expenses (§ 162) versus capital expenditures (*not* § 162)
    - Outcome? Expenses are deducted now, capital expenditures are deducted over time.
    - Why distinguish these? The *matching principle* from accounting.

- *Welch* (p316)
    - (The court here basically sees T as trying to acquire goodwill—a capex).
    - But, the court's analysis of "ordinary" is important.
    - N.b., "life in all its fullness must supply the answer" to these questions. So—this area is *infinitely variable*.
        - That's a reason why congress has tried to limit § 162 in specific areas.

- N.b., the distinction between repairs (expenses) and improvements (capital expenditures). See Reg. 1.162-4.

**<u>Monday, September 20</u>**

- § 162
    - *Morton Frank* (p337)
        - The court says to T—you were *looking* for a business, so you weren't carrying one on.
            - This has been modified by statute: see § 195 (startup expenses can be amortized and deducted over a five-year period (if the business is actually started and carried on)).

- N.b., *Hundley* (p342, in text): an example of something that does not run afoul of the *Morton Frank* rule.
- N.b., Rev. Rul. 75-120: you can't deduct expenses incurred in finding your *first* job. But you *can* deduct expenses incurred finding your second job. However, there has to be substantial continuity in your employment (i.e., you can't sit around for three years).

<u>Traveling expenses</u>

- § 162(a)(2)
  - N.b., how the wealthier you are, the easier it is to exploit this provision (see, e.g., *Andrews* (p368)).
  - Note also, § 262—you can't deduct your personal expenses.
    - Where's the line? § 274 tries to draw part of it. See, especially, § 274(n)(1) (only 50% of meals are deductible).
      - (Why allow meal deductions at all? It's not like there duplicate expenses? Well, maybe because meals on business are more expensive than the ones you'd have at home.)
  - *Rosenspan* (p360)
    - The court doesn't accept the IRS's position that "home" means place of business. Instead, the court says "home" means place or residence. And that, therefore, the taxpayer itc. has no "home."
      - Is this right? Well, T has no duplicate expenses; so, maybe.
      - See 143 F.3d 497 for an Idaho case on this issue. (See esp. the dissent there.)
  - *Flowers* (p363, in text)
    - A three factor test for traveling expenses:
      1. Reasonable and necessary?
      2. Incurred while away from home?
      3. Incurred in pursuit of business?

      (So, this means that commuting expenses are *not* deductible.)
  - *Andrews* (p368)
    - The court finds duplicate expenses here, and so says it has to determine which place is T's "major post of duty."

  N.b., that the IRS has issued a number of rulings about how to determine where someone's tax home is. It depends on three main factors:
    - Amount of income in each place.
    - Whether your family is there.
    - The length of time you spend there.

SCOTUS hasn't resolved this tax home question. But note how the result comes out the same under both tests ("major post of duty" and IRS three-factor), most of the time.

- *Correll*: the "sleep or rest" rule.
  - Note that this does *not* prohibit deduction of transportation expnses that are business-related. That is, they *are* prohibited under § 162(a)(2), but under the "ordinary and necessary" language in the § 162(a) lead-in.

- N.b., what if the employer is reimbursing the employee? See Reg. 1.162-17(b): the IRS realizes that this is a wash and allows the taxpayer to treat it as such.

**<u>Thursday, September 23</u>**

- Another thing about *Andrews*: when the lower court determines which place is T's "major post of duty," are T's expenses deductible *only* while he's there, or for the whole year?
  - *Andrews* doesn't really say—but Miller thinks that the implication is that he can deduct for the whole year.

<u>Education expenses</u>

- There is no *specific* deduction for education expenses set up by § 162.
  - There is a *limitation* on such deductions set up by *Morton Frank*'s "carrying on" requirement.
- *Hill* (p385): T had a legal obligation to pursue this education, although she could have chosen other ways of pursuing it.
- *Coughlin* (p389): even though T had no legal obligation to pursue this education, it's still "maintaining or improving" his job skills.
  - But is this a capital expenditure? No, the court says—tax law is "evanescent"; it changes to frequently.
- Regs. 1.162-4(a)(1) and (2): which codify, basically, *Hill* and *Coughlin*.
  - However, there are limitations: see Regs. 1.162-5(b)(2) and (3).

**<u>Monday, September 27</u>**

***Depreciation***

<u>§§ 167 and 168</u>: the key operative depreciation provisions.

- § 167(a) limits depreciation deductions to:

        - Property used in a trade or business
        - Property held for the production of income.

        So, there's no depreciation for property held for personal use.
    - To depreciate something, it has to have a *determinable* useful life. So, e.g., there's no depreciation deduction allowed on land.
    - ACRS (§ 168):
        - Salvage value is assumed to zero, for tax purposes (§ 168(b)(4)).
        - Your basis is your limit for depreciation deductions.
            - And basis is reduced with each depreciation deduction taken (§ 1016(a)(2)).
        - ACRS deductions are artificially large, compared with economic reality. So, you might very well end up with a gain on depreciated land when you sell it. (And that's why we have § 1245—to deal with the gain that's a product of depreciation deductions taken.)
    - Methods of depreciation: we'll study two of these:
        1. Straight-line depreciation.
        2. Double-declining balance depreciation:
            - With this, you take the straight-line percentage and double it. Then apply that percentage to the new adjusted basis each year.
                - Note that you never get to zero this way. So, when straight-line depreciation would give a larger deduction than the DDB percentage does, you switch to straight-line—using, as useful life, the *remaining* useful life.
    - The half-year convention—it applies in:
        1. The year of acquisition.
        2. The year of disposition.

        And note that with real property, there's the mid-*month* convention.

<u>Bonus depreciation deductions</u> (§§ 168(k) and 179)

- § 168(k): this is a temporary provision, passed in the wake of 9/11 to stimulate the economy. It's scheduled to go away in 2005.
    - It applies to most depreciable *personal* property. It doesn't apply to real property.
    - You can elect out of it. (Why would you do that? You'd do it if you didn't have enough income to absorb the extra deduction.)
    - § 168(k) deductions reduce basis, just like normal.
- § 179: this is a permanent provision; but it's purpose is also to stimulate the economy. It allows qualified property to be treated as an expense—not affecting a capital account.
    - Qualified § 179 property: any § 1245 property (tangible, personal property) that's used in a trade or business.
    - The amount of § 179 allowance is reduced dollar-for-dollar for every dollar over $400K that you spend on qualified property in the year.

Legislative history shows that § 179 should be applied first, then § 168(k), then regular depreciation.

Note that § 1016(a)(2) tells us that you *must* take depreciation deductions. (Or, actually, you could not take the deductions, but you'd still have to reduce your basis by the amount of deduction you could have taken.)

- Intangibles: §§ 167 and 168 apply primarily to tangible property. Intangible property isn't depreciated—it's <u>amortized</u>.
  - For a long time, things like goodwill were *not* amortizable. But the, § 197 was passed, allowing amortization for things like goodwill.

**<u>Tuesday, September 28</u>**

- Recovery period:
  - § 168(e)(1): the "class life" gives you a "classification."
  - § 168(c): the classification tells you your recovery period.

  To determine the "class life," you've got to do some other stuff. But, for our purposes, the class life will always be given.

- Note that the half-year convention is not used if the anti-loading provision (§ 168(d)(3), Rev. Proc. 87-57) kicks in.

<u>Special rules for realty</u>

- Always use the straight-line method (§ 168(b)(3)).
- There are two possible recovery periods:
  1. Residential property: 27.5 years.
  2. Nonresidential property: 39 years.

  And you use the mid-month convention (§ 168(d)(2), (4)).

  - What is "residential" real estate, here? Something with 80%+ of dwelling units (§ 168(e)(2)(A)).
    - What's a "dwelling unit" then? § 168(e)(2)(A)(ii)(I) tells us. E.g., a hotel is *not* one.
  - What is "nonresidential" real estate? § 168(e)(2)(B) tell us (referring to § 1250 property). Basically, it's real property that's depreciable but not residential.

## Wednesday, September 29

### *More deductions*

§ 212 expenses: the analog to § 162 for investment.

- *Higgins* (p444): itc. is in the book just to show how § 212 came to be.
- Typical § 212 expenses:
    - Expenses for investment advice (but *not* commissions or broker fees, though).
    - Office expenses for an office maintained for maintaining your investments.
    - Maintenance of investment realty (e.g., a rental property). But there's no deduction for capital expenditures on such property. (Also, your own home can not be investment realty (Reg. 1.212-1(h)).)
- Broker's fees: the courts have said that this is not an expense—it's a cost of obatining the stock, and so it's a capital expenditure.
    - With fees paid to sell, the fee just reduces the amount realized—it's not an expense.

§§ 163 and 212: interest.

- §§ 163 allows deduction of interest, generally.
- § 212 prohibits the deduction of personal and family expenses.
- So, personal interest is generally not deductible (e.g., personal credit card debt, interest on money borrowed to buy a car).
    - But, under § 163(h)(2)(D), interest on a home mortgage *is* deductible.
        - There's a $1M cap. (Note that that's a pretty high cap. So it's the people with the largest mortgages who benefit the most from this deduction (and the people with the largest mortgages are usually the wealthiest among those who have mortgages).)
            - (Also note that you have to be a homeowner to get this deduction in the first place—so the poorest people, who don't have homes, don't get any of this tax subsidy. *And*, the tax rates are progressive, so this deduction is worth more to you the higher your tax bracket.)

§ 164: taxes.

- *Cramer* (p504):
    - Property #1: the seller keeps title. The buyer is supposed to pay the taxes, but the seller ends up paying them. Then the seller repossesses, and then sells to another buyer in mid-year, but pays the full year of taxes.
    - Property #2: the seller pays taxes for her mother's home.
    - Property #3: the seller buys a home and the taxes on it are paid by the escrow (this is straightforward—it's deductible).

The court says on property #2 that seller didn't have title, so the taxes weren't her obligation, so she gets no deduction. Reg. 1.164-1(a).

On property #1, it says that seller can deduct all the taxes paid while she was the record owner. But she only gets a prorated amount of deduction in the year of sale. § 164(d)(1). So note that it doesn't matter here who actually *paid* the taxes.

Note § 165, which allows deduction of losses—mainly wrt. property losses due to casualty.

- The loss is measured by your basis.
- Generally, losses on personal-use property are *not* deductible.

<u>§ 465</u>: an important one of many restrictions on deductions.

## <u>Thursday, September 30</u>

### ***Restrictions on deductions***

<u>§ 465</u>: "Deductions limited to amount at risk."

- The portion of a loss not deductible is carried forward to the next year (§ 465(a)(2)). This carryover is indefinite, even though that's not explicit here.
- There are two ways you can raise your at-risk amount:
    1. Generate income in the business.
    2. Contribute assets to the business.
- Your at-risk amount could fall *below* zero (§ 465(e)). E.g., if your bank allows you to convert a recourse to a non-recourse debt. That's called a "flip-flop." § 465(e) requires that the negative at-risk amount be immediately included in income—but you also get a deduction for that amount carried forward.

<u>§ 183</u>: hobby losses.

- This provision is directed at people like the gentleman farmer. If an activity doesn't turn a profit at least some of the time (3 out of 5 years), it's considered a hobby loss and you can only deduct an amount up to the income it generated.

### ***Passive activity losses***

<u>§ 469</u>: passive losses.

- What is a "passive activity"? What is an "activity," even?
    - It depends on "material participation." § 469(h)(1) defines "material participation."
        - There are some bright line rules on "material participation":

            - If your spouse materially participates in something, you do too.
            - A limited partner is presumed to *not* MP.
            - Generally, rental activities are inherently passive (§ 469 (c)(2)); except, e.g., realty rental (§ 469(c)(7)).
- So, what does § 469 really do?
    - What *is* a passive loss? It's a net (aggregate) loss of all your passive activities for the year.
    - Denied loss carries forward, indefinitely (like in § 465).
    - Losses can also be <u>released</u>, e.g. at sale. Then the lass can be applied to *all* of your income.

**<u>Monday, October 4</u>**

- Again, what is a "passive activity"? § 469(c)(1). Tells us.
    - What is an "activity"? Reg. 1.469-4(c)(1) tells us. Note how the broad/narrow interpretation of "activity" can cut both ways (taxpayer or service) depending on the situation.
    - What does it mean to "materially participate"? § 469(h)(1) and Reg. 1.469-5T tell us.
        - Note that § 469(h)(2) says that limited partners are automically *not* MP.
- So, then what is a passive activity loss?
    - For one thing, it's an aggregate. E.g.:

        $10K passive activity gain
        $4K passive activity loss
        $3K passive activity loss
        ---
        $3K passive activity gain

    - Passive activity losses aren't deductible against active income. But they can be carried forward (§ 469(b)).
- Disposition loss release: § 469(g)(1)(A).
    - If you have a passive activity loss at disposition, you:
        1. Offset the gain on the sale with the PAL.
        2. Offset other PAGs.
        3. Offset active income.
- Note that portfolio income is treated as active income (§ 469(e)).
- Special rules for rental realty activity:
    - § 469(i):
        - There's a $25K limit.
            - If you have more than $100K AGI, your limit goes down by $1 for every $2 of AGI over $100K.

    - You don't have to MP—just "actively participate" as defined in § 469(i).
    - So, this covers mom-and-pop, lower income lessors.
    - Note, however, that limited partners are still not getting any of this.
    - Also, you have to own more than 10% of the realty.
- Loss release:
  - What if you sell to a related party? § 469(g)(1)(B) tells us that the loss is not released until the related party transfers to some *un*related party.
  - What if you *give* to a related party? § 469(j)(6) tells us that the basis is stepped-up by the amount of PAL—but only up to the FMV, for loss purposes (there's no limit on the step-up for gain purposes).
- Installment sale of an activity: § 469(g)(3) tells us that the loss is released over time (see § 453 for more on installment sales).
- What happens if a taxpayer dies with suspended PALs? § 469(g)(2) tells us that losses that exceed the stepped-up death basis (§ 1014) are deductible on the decedent's final return.

**<u>Tuesday, October 5</u>**

[Skipped class.]

**<u>Thursday, October 6</u>**

Calculating tax liability:

1. GI
2. Take § 62 deductions to arrive at AGI.
3. Compare itemized deduction amount versus standard deduction. Take the larger of the two.
4. Take personal exemptions to arrive at TI.

***Personal deductions***

<u>§ 217</u>: moving expenses.

- Meals during moving are not deductible.
- There are two requirements:
  1. Distance
  2. Time: after you take the new job, you have to stay there for 39 weeks in one year.
- Reimbursal: if you don't take this deduction, you don't have to report the moving expenses reimbursal—you can treat it as a wash.

§ 213: medical expenses.

- § 213(a) imposes a 7.5% requirement, which puts a real crimp on this deduction. It means this deduction is only going to come into play if you have extraordinary medical expenses.
- *Gerard* (p552): note how the problem itc. arises partially because of § 263 (no deductions for capital expenditures).

Personal exemptions

- §§ 151 (authorizes the personal exemption) and 152 (describes who you take a personal exemption for).
- There are basically two requirements:
  1. Relationship
     - It's, by and large, got to be a family relationship (§ 152(a)(1)–(8)). But there's (a)(9), too.
     - § 152(b)(2) says adopted and foster children are treated as blood children.
  2. Support
     - § 152(a): you have to provide at least 1/2 support, generally.
     - The dependent must have a GI ≤ $2K, generally.
       - Unless the dependent is a child under 19 (§ 151(c)(1)(A)).
       - Or unless the dependent is a full time student under 24 (§ 151(c)(1)(B)).

**Monday, October 11**

- N.b. § 152(b)(5) "violation of local law" clause. This comes into play with polygamous relationships, illegal aliens, and maybe some relationships in anti-sodomy law states.

The standard deduction: recall that to take the standard deduction, you must decide *not* to itemize.

***Accounting methods***

- Cash (Regs. 1.451-1(a) (income) and 1.461-1(a) (deductions)).
- Accrual

The accounting matching principle is key, here.

- *Kahler* (p587): in part announcing the doctrine of cash equivalence—when there's little risk of noncollection, and instrument will be considered to be its equivalent in cash when it's received.

        - E.g., compare a personal check from Bill Gates (cash-equivalent) with an IOU from Miller (not cash-equivalent—use for tax purposes the FMV at the time as the current income. And then when the IOU is paid, that's a second instance of income.)
        - N.b. credit card payments are cash-equivalent (Rev. Rul. 78-38).

**Tuesday, October 12**

(N.b. *Cohan*, 39 F.3d 540.)

- Cash accounting, again:
    - N.b. *Williams* (p588): a note does *not* generate a current deduction.
    - *Hornung* (p595)
        - Why did the IRS want this to be 1962 income? Because of SoL problems. If it was 1961 income, Hornung may not have had to pay it.
        - The court says T did *not* have constructive receipt in 1961. So, what do we need for constructive receipt?
            1. Property set aside for you.
            2. And you have a way to take control of it.

            This is now described in Reg. 1.451-2(a).
        - Why do we have the constructive receipt doctrine? To prevent taxpayers from manipulating the system.
        - N.b. postdated checks—the question here is whether it's a cash equivalent, only. It's *not* a constructive receipt question.
        - N.b. on legal fictions in tax law, see 68 (or maybe 68) Colo. L. Rev. for article by Miller.
        - Note that there's no "constructive payment" doctrine.
    - *Boylston* (p599)
        - Prepaid insurance must be prorated across the time period.
        - N.b. 616 F.2d 429.
        - N.b. § 461(g)(1) and (2): the taxpayer must use the accrual method for interest deductions (except for the § 461(g)(2) exception for mortgage points).

- Accrual accounting
    - N.b. the § 166 bad debt deduction—you acquire a basid through income recognition. See *Spring City Foundry* (p613).

**Thursday, October 14**

Cash accounting, see Reg. 1.446-1(c)(1)(i).

- Accrual accounting, again:
    - Reg. 1.446-1(c)(1)(ii).
    - Income accrues when either:
        - All events occur that fix your right to that income, and the amount if reasonably ascertainable; OR
        - You have actual receipt of the money.

        Whichever is *sooner*.
    - Deductions occur when both:
        - All events occur fixing the liability and the amount is reasonably ascertainable; AND
        - There's been economic performance (§ 462(h)(1) and (2)).
    - *New Capital Hotel* (p617)
        - Advance rent is income *now*—even though this isn't consistent with the conventional accrual method. The court justifies this departure by distinguishing advance rent from a security deposit and deferring judgment to the commissioner.
    - *Artnell* (p619)
        - Miller can't reconcile this with *New Capital Hotel*. Itc. (and *Tampa Bay*, p627 in text) may just be aberrations for those special facts.
    - N.b. *N.A. Consolidated* (p614 at pp616-17): claim of right judgment.
    - Tax benefit rule—e.g., the bad debt deduction.

***Capital gains***

<u>§ 1(h)</u>

- Basically, this sets up 5 main capital gains rates. The ones we're mostly concerned with are:
    - 15% rate—the general rate.
    - 25% rate—the § 1250 rate.
    - 28% rate—the collectibles rate.
- § 1222
    - What is a capital gain/loss?
        - It involves the sale or exchange of a capital asset. (And § 61(a)(3) tells us that this is income).
        - Recall—what's a gain/loss? § 1001 tells us that GR = AR – AB, and LR = AB – AR.
            - For AR, see § 1001(b).
            - For AB, see § 1012.

            And note other applicable sections: §§ 1015 (gift), 1014 (inheritance), 1016(a)(2) (depreciation), and 1016(a)(1) (improvements).
    - What is it about capital losses that makes them inferior to ordinary

losses? Well, you can only deduct $3K of capital losses from ordinary income in a given year (if you're an individual) (§ 1211(b)(1)).

- What is a capital asset?
  - § 1221 tells us that it's *all* property *except*:
    - (1) inventory;
    - (2) trade or business property that is either depreciable or is realty (but note that under § 1231 this property can get capital gains treatment sometimes);
    - (3)(A) copyrights held by the creator;
    - (4) accounts receivable.
- Why should capital gains be taxed at a lesser rate?
  - To give an incentive to invest (this is trickle-down theory).
  - (Appreciation may simply reflect inflation—but this is true of everything, really.)
  - Probably the strongest argument is that capital gain is a often a result of multiple-year investment.

**<u>Monday, October 18</u>**

N.b. the § 1(i) 10% tax bracket for some ordinary income.

- The capital gains netting process
  - § 1222(5)–(8).
  - § 1222(9)–(11):
    - (9): CGNI is the net of *all* CGs and CLs, iff there's gain.
    - (10): NCL is the net of all CGs and CLs over $3K, iff there's loss.

      So, e.g.:

      $10K CG
      $15K CL

      ---

      $2K NCL

      The significance of NCL is that it's carried forward.
    - (11): NCG = NLTCG – NSTCL
      - Note how this *excludes* NSTCG.
      - Also, you must have NCG to even get *into* § 1(h) (see § 1 (h)(1)). So, NSTCG is taxed under the regular rates.
- So, to get CG treatment, we have to have:
  1. A sale or exchange
  2. of a capital asset
  3. helf for more than one year.

- Some other important things:
  - § 165
    - (f): CLs allowed.
    - (c): *but*, no deduction for personal losses (unless provided for by § 165(c)(3)).
  - It doeesn't matter what category of gain you carry forward—it's all applied to the highest rates first.
- Capital losses:
  - § 1211(b): you can deduct all your CLs up to you CG amount, plus up to $3K, against ordinary income.
  - § 1212(b)(2): use NSTCL against ordinary income (up to $3K) *first*. And note how this section works—it creates $3K of constructive STCG.

**<u>Tuesday, October 19</u>**

  - Why are capital losses limited? Because you can time them.
- "Capital asset"
  - § 1223
    - (2) you can tack a prior holder's holding period onto your own in certain circumstances—viz., if the prior holder had the same basis you do. So:
      - When you get a § 1015 gift.
      - When you get a § 1041 spousal transfer.
    - (11): you can tack when you get an inheritance (but this usually doesn't matter because you get the step-up basis).
    - (1): you can tack with swaps (i.e., § 1031 like-kind exchanges).
  - Rev. Rul. 66-7 (p712)
    - The holding period begins the day *after* the date of acquisition.
    - *But*, the date of sale *is* included in the holding period.
    - To calculate if you've held something for a year—you have to hold the property *one day beyond* its birthday to have held it more than one year.
  - Rev. Rul. 66-97 (p713): the trade date is treated as the date of sale. The settlement date is *not* used.

**<u>Thursday, October 21</u>**

  - Holding periods are *always* on the essay part of the exam.
  - N.b. § 1223.

***§ 1231 recharacterization***

- This, too, will always be on the final exam—both on the essay and multiple choice portions.
- § 1231 was enacted in the WWII period in order to encourage transfer or used equipment, so as to maximize efficiency.
- § 1231 only concerns two main kinds of property:
    1. Sale/trade of property used in a trade or business.
    2. Casualty or condemnation of:
        - Trade or business property
        - Capital assets

    What is "trade or business property" here (see § 1221(a)(2))?
        - Property used in a trade or business that is depreciable and held for more than one year.
        - Real property used in a trade or business and held for more than one year.
            - Note how land could be:
                - Inventory (*Mauldin* and *Malat*)
                - A capital assest (§ 1221)
                - § 1231 property
- How does § 1231 work?
    1. Identify if it's a § 1231 gain/loss.
        - § 1231(a)(3)(A)
        - § 1231(b)(1)
    2. Do the casualty sub-hotchpot: § 1231(a)(4)(C)
        - This does *not* include condemnations.
        - Net these amounts:
            - If there's a net loss, all of these gains and losses are ordinary.
            - If there's a net gain, the throw all of it into the main hotchpot.
        - (Why include involuntary conversion of capital assets in § 1231? So that you can get capital gains treatment for them, even though they're not sales or exchanges.)
    3. Do the main hotchpot:
        - Net all gains/losses
            - If there's a net gain, everything gets capital gain treatment—everything's LTCG, included in the general capital gains netting process.
            - If there's a net loss, everything is an ordinary loss and so can be deducted against ordinary income.
    4. Do recapture:
        - Look back to the previous 5 years, and if you've had § 1231 ordinary loss treatment and you have § 1231 gain this year, then this year's gain is treated as ordinary to the extent of those previous § 1231 losses.

## Monday, October 25

With property transactions, first do the § 1001 analysis. Only if there are gains to be recognized must you worry about characterization.

- The § 1231 method, again:
  1. Gains/losses within § 1231?
  2. Sub-hotchpot
  3. Main hotchpot
  4. Recapture lookback

  - *Williams v. McGowan* (p748): this is a sale of an unincorporated business:
    - AR must be allocated *per each asset*. Then whatever's left AR goes to goodwill.
    - Then, characterize, by the nature of each individual underlying asset.

### *Depreciation recapture*

§ 1245: disposition of certain depreciable property.

- (First, n.b. § 1239: a loophole closer—this section overrules § 1231 when the § 1231 transactions are between related parties.)
- § 1245 is almost guaranteed to be on the final.
- What does § 1245 do?
  - §§ 167 and 168 generate ordinary deductions for depreciation.
  - Without § 1245, the sale of depreciated property would generate a § 1231 gain/loss. And if it's gain, it would be capital.
  - So, you're getting ordinary deductions for depreciation, but because the depreciation is faster than real life, you're getting capital gain due to the depreciation. That's too good a deal, congress thought.
  - To solve this, then, we've got § 1245.
- How does § 1245 work?
  - (a)(1): take the lesser of:
    - recomputed basis – AB; OR
      - Recomputed basis, § 1245(a)(2) tells us, is the present AB + all depreciation that's already been allowed (including any § 179 bonus depreciation (§ 1245(a)(2)(C)) and any § 168(k) bonus depreciation).
    - AR – AB
  - N.b. § 64, which operates to keep § 1245 out of § 1231.
  - Also note § 1245(d), which says that § 1245 overrides *everything else*

*in the IRC*. (!!!)

**Tuesday, October 26**

- Exceptions to § 1245: § 1245(b) (these are needed since § 1245(d) makes § 1245 override everything else in the code):
  - Gifts: if you give something, you have no gain/loss. (But note that this is just a deferral, really, since the transferee must realize a gain under § 1245).
  - Bequests
  - § 1245(b)(3), which applies primarily to the formation of partnerships and corporations.
  - Like-kind exchanges.
- Rev. Rul. 69-487 (p765): conversion from business to personal use does not trigger § 1245 recapture.
- What *is* § 1245 property?
  - Basically, it's tangible personal property that's subject to depreciation.

§ 1250, which is like § 1245.

- § 1250 only recaptures gain from depreciation in excess of straight-line depreciation. So, it will only apply to real property acquired before 1986 (when you could depreciate realty faster than straight-line).
- § 1250 is interesting because it interacts with § 1(h): § 1(h) creates a special 25% bracket for unrecaptured § 1250 gain (§ 1(h)(6) and (1)(d)).

**Monday, November 1**

***Installment sales***

§ 453

- Taxpayers love this section, because it allows them to defer recognition of income.
- The installment method overrules both the cash and accrual methods when it applies.
- When do we have an installment sale?
  - When there's at least one payment to be made beyond the current year (§ 453(b)(1)).
  - *But*, you can't use the installment method for:
    - inventory
    - "dealer dispositions"
- If we have an installment sale, what do we do?

- The tax liabilities are prorated:

  (gross profit / total K price) x payment amt. = gain on the year

  What's "gross profit"? See Regs. 15a.453-2(b) and 1.453-4(c).
  Gross profit = selling price – AB
    - What's "selling price"? Everything you get, less any interest. (Note that selling price ≠ total K price, always; because total K price = selling price – any qualifying indebtedness.)
      - (What's "qualifying indebtedness"? See *Crane*.)

  What's "payment"? See Reg. 1.453-4(c). The assumption of a mortgage in year is *not* payment, for the purposes of determining the gross profit ratio, to the extent that it exceeds AB.
- Also n.b. §§ 453(i) and 453B.

**<u>Tuesday, November 2</u>**

- Recall that the gain for the year on an installment sale = (GP / TKP) x payment amount.
- § 453(i): depreciation recapture must be realized immediately, though.
- Reg. 1.453-4(c): the amount of mortgage assumption, up to AB, is *not* treated as a payment.
- The open transaction doctrine:
  - *Burnet v. Logan* (p838): itc., there's an installment sale, but you can't tell how much or when the payments will be. The court allows you to recover your basis before you have to begin using the installment method.

***Taxpayer classification***

Why do we have a marriage-based tax system? Mainly because of *Poe v. Seaborn*, which concerns community proprerty states, and adopts the half-and-half rule.
- N.b. 49 Villanova L. Rev. 261 (2004).

- Surviving spouse (§ 2(a)):
  - a widow/widower
  - not a status in the year of death (because you can file a joint return in the year of the spouse's death)
  - haven't remarried
  - provide > 1/2 the cost of maintaining the home
- Head of household (§ 2(b)):

        - not married
        - have a child living in the home
        - provide > 1/2 the cost of maintaining the home

**<u>Thursday, November 4</u>**

- Note the difference between § 1(a) and the tables on pp921-23. Why can't you just use § 1(a) to calculate tax liability?
    - § 1(f) indexes the tables to inflation.
    - § 1(i) creates a 10% bracket.
- N.b. § 1(g): the kiddie tax: children under 14 with unearned income—their income is taxed at the parents' top tax rate.

***Credits***

- Credits reduce tax liability dollar for dollar (whereas deductions reduce tax liability only by the top marginal rate times the deduction amount).
- Important credits for our purposes:
    - § 24: dependent children.
    - § 31: withholding.
    - § 32: earned income credit.

**<u>Monday, November 8</u>**

***Like-kind exchanges***

- § 1031 is a nonrecognition provision (like, recall, § 1041 spousal transfer).
    - The tax policy for § 1031 is that congress doesn't think the taxpayer has cashed in his chips, really, and so shouldn't be taxed.
    - (Whereas the tax policy for § 1041 is to ease the marriage to divorce transition.)
- With § 1031, as usual, keep §§ 1245 and 1250 in mind. These sections have provisions accommodating § 1031 (§§ 1245(b)(4) and 1250(d)(4)).
- What character of property does § 1031 deal with?
    - Mainly, it will be §§ 1221 and 1222 capital gain, § 1231 property, and § 1245 property.
- What's "like kind"?
    - Real estate is always like kind with other real estate. *Crichton*; Reg. 1.1031(a)-1(b).
    - Generally, it has to be "similar in nature or character." Reg. 1.1031(a)-1(b).

    Note "three cornered exchanges":

1. You find a buyer for your property.
2. You persuade the buyer to buy the property you want.
3. You swap with the buyer.

- Exceptions to § 1031 nonrecognition:
    - § 1031(a)(2): the main ones are:
        - Inventory
        - Stocks and bonds and other marketable securities
- Note the § 1031(a)(3) timing requirements.
- Boot:
    - § 1031(b)
        - Partial LKEs must recognize the *lesser* of:
            - Gain realized
            - FMV of the non-LK property (the "boot")

            Why do we have boot, by the way? Because it's not likely that two properties will have exactly equal values.
- § 1031(c): in some cases, you don't recognize loss. E.g., no loss recognition as to LK property, generally, but you do recognize loss in boot.
- § 1031(d) basis adjustment: the basis in the new property is the same as the basis of the old property. Also:
    - Subtract any cash received
    - Add any gain recognized (§ 1031(b)).
        - Why? Because recognizing that gain and increasing the basis keeps you from being taxed on that gain again.
    - Add any cash paid (Reg. 1.1031(d)-1(a)).

    (Note that your new and old bases are *aggregates* of all the bases of all the assets received.)

    Now, from the new basis, subtract FMV of any boot.

    So:

    Old basis
    – gain received
    + gain recognized
    + cash paid
    -- loss recognized
    
    ---
    New basis
    -- FMV of boot
    
    ---
    New basis for the LK property

- What about mortgages? They're treated as cash payments. § 1031(d) tells us this (and that's an application of *Crane*).

- What's the holding period in the new property? § 1223(1) tells us that we tack the old property's holding period to the new property.

**<u>Tuesday, November 9</u>**

- Liabilities and LKEs, again: liabilities are treated as boot, throughout all § 1031 calculations. And they offset each other (Reg. 1.1031(d)-2). *But*, the receipt of cash can *not* offset any received liability.
- Three-cornered exchanges: see Rev. Rul. 77-297. And note the constructive receipt problem here (Reg. 1.1031(k)-1(f)(2) and (3)).
- When multiple properties are exchanged, allocate the basis proportionately. See Rev. Rul. 68-36.
    - E.g., if you give A with basis 100 for B and C with bases 100 and 50, respectively, then 2/3 of the basis (67) is allocated to B and 1/3 (33) to C.

**<u>Tuesday, November 16</u>**

***Sales of residences***

- § 121: this excludes from income any gain from the sale of your principal residence.
    - Requirements:
        - The two year rule (§ 121(a)). But this has some exceptions in (c)(2).
    - Election out (§ 121(f)). Why would you elect out? E.g., if there's not much gain and you have another residence that might qualify within the next two years.
    - You can apply this provision to any dwelling—like a boat, or a trailer. Reg. 1.121-1(c).
- § 163(h): this is a very large tax subsidy for rich homeowners.
    - (h)(1) says there's no deduction for personal interest, normally. But (h)(2)(D) has an exception for mortgage interest:
        1. Acquisition indebtedness: that incurred to acquire or improve a qualified resident ($1M limit on this indebtedness).
        2. Equity indebtedness: any other indebtedness secured by the home ($100K limit on this indebtedness, plus an FMV – acquisition indebtedness limit).
    - You have to live in the home only for some nominal amount of time each year —so you can take this deduction for your summer home, even, e.g.

**<u>Wednesday, November 17</u>**

- Mortgage points

- § 461(g)(2) allows a current deduction of points (if they would otherwise be deductible under § 163). This is an exception to § 461(g)(1), which says that interest is usually deductible *only* when it accrues.
- What are "points"? One point is 1% of the amount borrowed. Some number of points are usually payable as a fee at the front-end of the loan.
- Note that points are only deductible if actually paid, rather than simply withheld. See *Cathcart* (p603). Yes—this is form over substance.
- N.b. Rev. Rul. 87-22 (p604).

***Tax consequences of litigation***

- The tax treatment of damages is a mixture of caselaw (common law) and statutory provisions.
  - Common law rules:
    - The general principle is the "in lieu of" test—if you would have paid taxes on it, then the damages are taxed.
    - Punitive damages are gross income. *Glenshaw Glass*.
    - So, what do you do if your tenant burns down your apartment building? You treat it as a sale/exchange: GR = AR – AB.

**<u>Thursday, November 18</u>**

  - Statutory rules
    - § 104(a)(2)
      - "Physical" injuries only are excludable. See Reg. 1.104-1(c).
      - It doesn't matter if it was a suit or a settlement.
      - Generally, punitives are *not* excludable. And exception is § 104 (c)(1) and (2), allowing punitives to be excluded if they're part or certain wrongful death awards.

      Why do we have this provision?
        - The taxpayer has suffered enough, maybe.
        - Because it's hard to treat personal injury as a property transaction (what's your basis in your arm, e.g.?).

      - To determine whether it's excludable, you don't use the "in lieu of" test. You use the "nature of the injury" test. However, the caselaw sometimes conflates or confuses these two tests.
- Settlements
  - "Structured settlements" (as opposed to lump sum settlements).
    - Rev. Rul. 79-313 (p192): even though the income looks like interest here, all of the settlement is excludable because the interest wasn't stated and because there's no right to accelerate the payments.

    - Note that even here, you *could* artificially accelerate the payments by selling the settlement to a third party—this wouldn't change your tax consequences. It would still be excludable.
    - N.b. Rev. Rul. 65-29 (interest on a lump sum settlement *is* taxes).
- Attorney's fees.

**<u>Monday, November 29</u>**

***Divorce***

§§ 71, 215, and 1041 are the sections we'll be looking at wrt. divorce.

<u>Alimony</u>:

- Gross income to the payee (§ 71(a)).
- A deduction for the payor (§ 215(a)): the deduction is equal—specifically and expressly—to the payee's income from alimony (§ 215(b)).

But what *is* alimony, as far as the IRC is concerned?

- § 71(b):
    - It must be cash (or a check or a money order—but this is *not* as broad as all cash equivalents. E.g., a note would not work.).
    - It must be a payment made pursuant to divorce or a separation instrument.
    - The separation instrument can't say that it's *not* alimony—that is, the parties can determine between themselves what the tax treatment of any payments under the instrument will be.
    - *If* the payment is made pursuant to a *decree*, the parties can live in the same household. (This means that if the instrument is *not* a court-ordered decree, the parties *could* live in the same household. Also, if the instrument is a temporary support order, the parties could live in the same household. It's just that it can't be a decree.)
    - The liability must terminate at the death of the payee.
- Note § 71(f): a loophole closer—it prevents frontloading of alimony (it doesn't prevent, though, rearloading of it).
- Indirect alimony payments *are* alimony (because of the § 71(b)(1)(A) "*or* on behalf of" language).

<u>Spousal transfers</u>:

- § 1041: the transferee *always* (as in, *always*) takes the transferor's basis. (Which, that's unlike § 1015, where there are special rules if the transferor is holding a loss.)

Child support: this is *not* income to the payee (§ 71(c)).

**Tuesday, November 30**

- Indirect alimony payments, n.b.

Child support:
- § 71(c)(2): child support portions of an alimony payment will be inferred.
- § 71(c)(3): if there's a shortfall in payments, then alimony gets "paid," for tax purposes, first—so, you've got to pay your child support if you want to get your alimony deduction.

Alimony trusts: § 682 allows for an alimony trust, where the income is taxable to the *payee*, and the payor gets a deduction. (This is an exception to the usual trust taxation rules, found in §§ 671 to 679, where the grantor is taxed.)

§ 212 in divorce: (business-expense-like deductions for personal investment expenses)
- (Recall *Higgins*, the pre-§ 212 case.)
- (And recall § 262, which says you don't get a deduction for personal or family expenses.)
- *Fleischmen* (p456): the court employs the origin of claim doctrine to prevent T from using § 212(2) for expenses in protecting his property in a divorce action.
  - Note, however, *Wild*, where T was permitted to take § 212(1) deductions for expenses in pursuing alimony payments.