Taxation problems, Fall 2004. Professor J. Miller.

Page 65: income

1. Would the results to the taxpayers in *Cesarini* be different if instead of finding $4,467 in old currency in the piano they found that the piano was worth $500K?

   Then, it would *not* be treated as income in the current year. Distinguish this conceptually from finding cash because here, all they've got is a piano—before, and after, the discovery. Or, another way to think of it is that they didn't have something *severable* that they didn't have before. "One is entitled to make a good bargain."

2. W attends the opening of a new store. Everybody there gets a free raffle ticket for a watch worth $200. Disregarding § 74, must W include anything in GI if she wins the watch?

   This is income. Apply the *Glenshaw* "undeniable accession to wealth, clearly realized, over which T has complete dominion" test. (It's not a gift, by the way, because there's no donative intent.)

5. O agrees to rent T her lake house for the summer for $4K.

   a. How much income does O realize if she agrees to charge only $1K if T makes $3K worth of improvements?

      $4K (§ 109).

   b. Is there a difference to O if T effects the same improvements but does everything himself at a cost of only $500?

      $4K: measure income by the value of what's received, not its cost.

   c. Are there any tax consequenes to T in (b)?

      $2500 GI, because the reduction in rent was compensation for services rendered.

Page 68: imputed income

1. V grows vegetables in her garden. Does V have GI when:

   a. V harvests her crop?

      No—it's imputed income of the kind that won't be taxed (*Helvering*).

   b. V and her family consume $100 worth of vegetables?

      Nope—still in the nontaxed imputed income realm (*Helvering*).

   c. V sells vegetables for $100?

      This is a realization event that makes the $100 income under the *Glenshaw Glass* test.

   d. V exchanges $100 worth of vegetables with C for $100 worth of tuna that C caught?

      This is barter, governed by Reg. 1.61-4(c) and RR 79-24.

Page 101: fringe benefits

1. To what extent of these fringe benefits excluded from GI?

   a. Employee of a national hotel chain stays in one of the chain's hotels in another town rent-free while on vacation. The hotel has several empty rooms.

No additional cost fringe benefit—excludable under § 132(a)(1).

b. Same, but the desk clerk bounces a paying gues so Employee can stay rent free.

E can probably exclude up to 20%, treating it as an employee discount (§ 132(a)(2)). (See Reg. 1.132-2(a)(2)&(5).)

c. Same, but E pays the bill and receives a cash rebate from the hotel chain.

Excludable under Reg. 1.132-2(a)(3) (NAC fringe exclusion applies whether there's an amount paid or a cash rebate).

d. Same, but E's spouse and dependent children, travelling with*out* E, use the room on their vacation.

Excludable because E's spouse and dependent children are constructive employees under § 132(h) (which only applies, though, to NAC and discount fringe exclusions).

e. Same, but E stays in a rival chain's hotel under a written reciprocal agreement under which employee's pay 50% of the normal rent.

Excludable because written reciprocal agreements count under § 132(i).

f. Same, but E is an officer in the hotel chain and rent-free use is only for officers —all other employees pay 60% of the normal rent.

This is *not* excludable, because fringes for highly-compensated employees are only excludable if they are provided to all employees on *substantially the same terms*, under § 132(j)(1).

g. Same, but the hotel chain is owned by a conglomerate that also owns a shipping line, and E works for the shipping line.

Not excludable, because this would be a NAC fringe, and NAC fringes have to be part of the "ordinary course of the line of business of the employer *in which the employee is performing services*," says § 132(b)(1).

h. Same as (g), but E is comptroller of the conglomerate.

E can probably exclude this, because Reg. 1.132-4(a)(1)(iv) says that an employee who performs substantial services that benefit more than one line of business is treated as performing substantial services in all those lines.

i. E sells insurance and his employe insurance company allows him 20% off a $1K policy.

Fully excludable as a qualified employee discount for services (§ 132(c)(1)(B)).

j. E is a salesman in a home appliance store. Last year the store had $1M sales and $600K COGS. E buys a $2K VCR for $1K.

Excludable as a qualified employee discount for property, § 132(c)(1)(A). The allows exclusion is up to the "gross profit percentage," which is (Sales – COGS) / Sales). So, here GPP = ($1M – $600K) / $1M = 40%. So, E can exclude a 40% discount, which is $800. He *got* a $1K discount, which means he has to include $200.

k. E attends a business convention in another town, and his employer picks up his costs.

Excludable as a working condition fringe (§ 132(d)).

l. E works at a bar that gives him cocktails at the end of each week's work.
Excludable as a de minimis fringe, probably (unless it was a *lot* of alcohol) (§ 132(e)).

m. E gets a case of scotch each Christmas from his employer.
This might be excludable as a de minimis fringe—but Reg. 1.132-6(e)(1) says expressly that holiday gifts are de minimis (only, it seems) if they have a low fair market value. So, it will depend on the FMV of the case of scotch.

<u>Page 121: gains from property</u>

1. O purchases some land for $10K and later sells it for $16K.
   a. What's O's gain on the sale?
   GR = AR – AB (§ 1001(a)). So, GR = $16K – $10K = $6K.
   b. What difference if O purchased the land by paying $1K for an option to purchase the land for $9K and exercising the option?
   The option is property itself, but the exercise of the option isn't a realization event. So, AB0 = $1K, then adjusted upwards (§ 1016) for AB1 = $10K. So GR = $6K, still.
   c. What if, under (b), O never acquired the land and instead sold the option for $1500?
   Then GR = $1500 – $1K = $500.
   d. What if, under (a), O purchased the land with $2K cash from his funds and $8K from a recourse mortgage? Would it make a difference if it was a nonrecourse mortgage?
   Same result—$6K gain. Recourse/nonrecourse doesn't make a difference. Because basis = cost (§ 1012).
   e. What if O purchased the land for $10K, spent $2K clearing the land, then sold it for $18K?
   The $2K expenditure is added to basis under § 1016(a)(1). So GR = $18K – $12K = $6K.
   f. What if in (d) O had previously rented the land to L for five years, $1K per year cash rent, and had let L spend $2K to clear the property (assuming O excluded the $2K expenditures under § 109 (GI doesn't include income besides rent that's derived from improvements made by the lessee)?
   § 1019 says *don't* adjust basis for § 109 excluded improvements. So, O's basis stays the same—$10K.
   h. What if O is a salesperson in an art gallery and O purchases a $10K painting but is only required to pay $9K, because of a 10% discount (excludable under § 132(a)(2) as a qualified employee discount fringe benefit), then sells the painting for $16K?
   Philadelphia Amusement tells us that O's basis is the FMV of the property received. So, his basis is $10K, and thus GR = $16K – $10K = $6K.

<u>Page 128: gifts</u>

1. Donor gave Donee property under circumstances requiring no gift tax payment. What

gain/loss to Donee in a subsequent sale if:

a. The property had cost Donor \$20K, had a \$30K FMV at time of gift, and Donee sold it for:

1. \$35K?

   Donee has a \$20K basis in the property, since Donor's basis is < FMV (§ 1015(a)). So GR = \$35K – \$20K = \$15K.

2. \$15K?

   LR = \$20K – \$15K = \$5K.

3. \$25K?

   GR = \$25K – \$20K = \$5K.

b. The property had cost Donor \$30K, had a \$20K FMV at time of gift, and Donee sold it for:

1. \$35K?

   Donee has a basis of \$30K for purposes of calculating gain, and a basis of \$20K for purposes of calculating loss. Here, there's a gain, so GR = \$35K – \$30K = \$5K.

2. \$15K?

   Here, there's a loss, so LR = \$20K – \$15K = \$5K.

3. \$24K?

   Look at this: if we use the gain-purposes basis of \$30K, GR = \$24K – \$30K = (\$6K). Gain can't be negative, so no gain. But if we use the loss-purposes basis of \$20K, we have LR = \$20K – \$24K = (\$4K). So no loss, either. Reg. 1.1015-1(a)(2) verifies such a result.

2. F had some land he purchased for \$120K that had increased to \$180K. H transferred it to D for \$120K cash in a transaction identified as part gift and part sale. No gift tax was paid.

   a. What gain to F and what basis to D under Regs. 1.1001-1(e) and 1.1015-4?

      Reg. 1.1001-1(e) says that with a sale-gift the transferor's gain = AR – AB, if any. There is no loss, though. Period. Reg. 1.1015-4 says that the transferee's basis is whichever is greater between (a) the amount he paid and (b) the transferor's AB at time of transfer. So, here, F has no gain (\$120K – \$120K = \$0); D's basis is \$120K (because \$120K = \$120K).

   b. What if the transaction was viewed as a pure sale of two-thirds and a pure gift of the other third?

      Then, we follow the regular rules (§ 1015) wrt. each part, separately. So, F got \$120K AR for the two-thirds, which would have AB = \$80K (and no gain/loss on the gift, because of § 1015). That's GR = \$40K for F. D's basis in the two-thirds is what she paid (§ 1012), which was \$120K, and her basis in the other third is her transferor's basis, which was \$40K.

<u>Page 130: spousal transfers</u>

1. A purchased some land ten years ago for \$4K, cash. It appreciated to \$7K, when A sold it to his wife S for \$7K (it's FMV).

   a. What tax consequences to A?

A recognizes no gain, says § 1041(a)(1).

b. What is S's basis in the property?

Same as A's: $4K (§ 1041(b)(2)).

c. What gain to S if she immediately resells the property?

GR = $7K – $4K = $3K (§ 1001(a)).

d. What results for (a), (b), and (c) if the property had declined to $3K and A sold it to S for $3K?

A doesn't recognize any loss (§ 1041(a)(1)), and S's basis is the same as A's (§ 1041(b)(2)). Now, wrt. what happens if S immediately resells, this is where § 1041 is different than § 1015—§ 1041 doesn't do the bifurcated gain-purposes/loss-purposes basis thing that § 1015 does. So S, if she immediately resells, has LR = $4K – $3K = $1K.

<u>Page 153: amount realized</u>

1. M purchases a parcel of land from S for $100K. M borrows $80K from Bank and pays it and $20K cash to S, giving Bank a nonrecourse mortgage on the land. The land is the security for the mortgage, which bears an adequate interest rate.

a. What is M's cost basis in the land?

$100K (§ 1012).

b. Two years later, the land has appreciated to $300K and M has paid only the interest on the $80K mortgage. M takes out a second nonrecourse mortgage of $100K, with an adequate interest rate, again using the land as security. Does M have income when she borrows the $100K?

No—there hasn't been a realization event (e.g., a "sale or other disposition of property" (§ 1001(b)).

c. What is M's basis in the land if the $100K of mortgage proceeds are used to improve the land?

Basis is adjusted upwards by the capex, § 1016(a)(1) says. So AB = $100K (original) + $100K (capex) = $200K.

d. What is M's basis in the land if the $100K is used to purchase stock and bonds worth $100K?

That investment isn't chargeable to the capital account of the land (§ 1016 (a)(1)), so M's basis in the land isn't adjusted. M has an AB in the land of $100K, and an AB in the stocks and bonds of $100K total.

e. What if under (d) the principal of the two mortgages is still $180K and the land is still worth $300K, and M sells the property subject to both mortgages to P for $120K cash? And what is P's cost basis in the land?

M has an AR = $300K (= $180K debt assumption + $120K cash) (*Crane*). So GR = $300K – $100K = $200K. P's basis is $300K (§ 1012 and *Philadelphia Amusement*).

f. What if under (d) M instead gives the land subject to the mortgages, and still worth $300K, to her son? And what is her son's basis in the land?

Son "pays" $180K for the land, by assuming the mortgage. So M's GR = $180K – $100K = $80K. Son is getting a sale-gift, and so under Reg. 1.1015-4 his basis is the greater of (a) what he paid ($180K) and (b) his transferor's basis ($100K). So the son's basis is $180K.

g. What if under (f) M gave the land to her spouse rather than he son? What's the spouse's basis? And what's the spouse's basis once he pays off the $180K of mortgages?

M doesn't recognize any gain, because this is a § 1041 spousal transfer. S takes M's basis (§ 1041(b)(2)) of $100K. S's basis doesn't change when he pays the mortgages off—those are simply his debts, following the transfer.

h. What if under (d), the land declines from $300K to $180K and M transfers a quitclaim deed on the land to the bank?

M has an AR of $180K, and an AB of $100K. Go, M's GR = $180K – $100K = $80K (§ 1001(a)).

i. What if under (h), the land had declined to $170K at the time of the quitclaim transfer?

M still realizes $180K. So M's GR is still $80K.

2. N purchased three acres of land, each worth $10K, for $30K. N sold one of them in Y1 for $14K and a second in Y2 for $16K. The total AR for N is $30K, which isn't in excess of his purchase price. Does N have any gain or loss?

Reg. 1.61-6(a) says that when a part of a larger property is sold, the basis of the entire property has to be equitably apportioned, with GR/LR calculated per each part. So, here with acre one, N has AB = $10K and AR of $14K, thus GR = $4K. With acre two, N has AB = $10K and AR of $16K, thus GR = $6K. For a toal GR over the two years of $10K.

Page 158: life insurance income

1. N died in the current year with an insurance policy that would pay B $100K, under several alternatives:

a. What if B just takes the $100K in cash?

Under § 101(a), this lump sum payment on occasion of death of the insured is excludable.

b. What if B instead leaves all the proceeds with the company and they pay her $10K interest this year?

Interest payments like this are fully taxable, says § 101(c).

c. What if B is N's daughter and the company pays her $12K in the current year, and that she'll get such payments for her life, and she has a 25-year life expectancy?

With $100K for the company to pay out, and over 25 years, B gets a prorated $100K / 25 = $4K exclusion every year, under § 101(d)(1). So, this year, with a $12K payment, B gets to exclude the $4K but is taxed on the remaining $8K.

d. What if in (c), B lives beyond her 25-year life expectancy and receives $12K in the 26th year?

She continues to get the exclusion, says Reg. 1.101-4(c) (doesn't matter if the beneficiary lives beyond his life expectancy).

Page 163: annuities income

1. In the current year, T buys a single life annuity with no refund feature for $48K. Under it, T gets $3K per year for life. T has a 24-year life expectancy.
   a. To what extent is T taxable on the $3K received the first year?
      T gets to exclude a portion of the payment propotionate to his "exclusion ratio" under § 72(b)(1). Exclusion ratio = investment / expected return. T invested $48K, and expects to get $3K for 24 years, or $72K. So his exclusion ratio is $48K / $72K = 2/3. So, this year, T gets to exclude 2/3 of $3K, or $2K, and is taxed on the remaining $1K.
   b. If the law remains the same while T is alive, how will he be taxed on the $3K receiving in the 30th year of payments?
      T's exclusion is limited to his investment, says § 72(b)(2). So, he's taxed on the full $3K once, in his 24th year, he's excluded all that he invested.
   c. If T dies after nine years of payments, will T or his estate be allowed a deduction?
      § 72(b)(3)(A) tells us that he will—he gets a deduction in the amount of his unrecovered investment (which is defined in § 72(b)(4)). So, after nine years, T would have recovered $27K, and so get a deduction for $48K – $27K = $21K.

<u>Page 180: discharge of indebtedness income</u>

1. P borrowed $10K from R several years ago. What are P's tax consequences if he pays off whole debt with:
   a. A settlement of $7K cash?
      Kirby Lumber says that discharge of indebtedness satisfies the *Glenshaw* "undeniable accession to wealth, clearly realized, over which T has complete dominion" test, and § 61(a)(12) codifies that result (discharge from indebtedness is expressly included in GI; see also § 108) and so P has $10K in GI.
   b. A painting with a basis and FMV of $8K.
      Under §61(a)(12), P has $8K AR on the painting with $8K AB, so no gain/loss on the painting, but $2K of § 61(a)(12) discharge of indebtedness, which is included in GI.
   c. A painting with FMV = $8K and AB = $5K.
      On the painting, P has GR = $8K – $5K = $3K. Then, he has $2K of DOD income.
   d. Services, of remodeling R's office, worth $10K.
      P has $10K of earned income (but this isn't DOD income, n.b.).
   e. Services worth $8K.
      $8K earned income, $2K DOD income.
   f. Same as (a), but P's employer makes the $7K payment, renouncing any claim to repayment by P.
      P has $7K of income from his employer (*Old Colony Trust*) and $3K of DOD income.
2. M purchases a parcel of land held for investment from S for $100K with $20K of his cash and $80K from a recourse mortgage. M is personally liable and the land is

security. When the land appreciates to $300K, M borrows another $100K with a recourse mortgage using the land as security. M uses the $100K to buy stocks and bonds. Several years later when the principal on the mortgages is still $180K, the land declines to $170K. M transfers the land to the bank and bank discharges all of M's indebtedness.

a. What are M's tax consequences?

Reg. 1.1001-2(a) says that AR includes the amount of discharged liabilities, *except* in the case of a recourse mortgage. So, M's AR = $170K, and thus his GR = $170K – $100K = $70K. And he has $10K in DOD income.

b. What if the liabilities had been nonrecourse liabilities?

Then everything goes into AR. So AR = $180K and thus GR = $180K – $100K = $80K.

<u>Page 254: assignment of income from services</u>

1. E has a salaried position under which she earns $80K every year.

a. Who's taxed if E, at the beginning of the year, directs that $20K of her salary be paid to her parents?

E, says *Lucas*. (The parents take the $20K as a gift, under § 102(a).)

d. Who's taxed if E, in her corporate role, gives a series of lectures at a business school and pursuant to her employment contract turns over her $1K honorariumm to her employer?

E is fulfilling a service, and so her employer is taxed on the $1K (see RR 74-581).

<u>Page 274: assignment of income from property</u>

1. F owns a coupon bond that he bought several years ago for $8K. It has a $10K face amount, to be paid off in 2010. The current FMV of it is $9K. It pays 8% interest, semi-annually on April 1 and October 1 (i.e., $400 each payment). What are the tax consequences to F and D in these situations:

a. On April 2 of the current year, F assigns D all the interest coupons?

F is taxed on all the coupons, on April 2, because he still owns the income-producing property (*Horst*).

b. On April 2, F gives D the bond with the right to all the interest coupons?

F is taxed on $400 for the April 1 coupon. D takes F's basis, and is taxed this year on all future coupon payments and the principal when she realizes it.

c. On April 2, F gives D a half interest in the bond and the right to all the interest coupons.

F is taxed on half the fruit and half the tree (even though he doesn't have a right to the coupon payments). D, just the same—taxed on half the fruit and half the tree.

d. F owns an income interest in a trust which owns the bonds. On April 2, F gives his income interest, and the right to the future coupons, to D.

Under *Blair*, this is a successful income assignment. D is taxed on all the income.

e. On December 31, F gives D the bond with the right to all the interest coupons.

F has has income for the interest that has accrued to him since October 1—half of the total. So, with the April 1 coupon redemption, F is taxed on three months and D is taxed on three months. That is, half and half.

f. On December 31, F sells D the right to the two succeeding interest coupons for $600, their FMV at time of sale.

This is like *Stranahan*—as long as the transaction is not a sham, it it valid as an assignment. F is taxed on $400 interest plus $600 on the sale in Y1. D takes the coupons with a $300 basis in each one (§ 1012 cost basis), and so as she redeems each one she'll have $400 AR – $300 AB = $100 OI.

<u>Page 319: deductions "ordinary and necessary" trade or business expenses</u>

1. T is a businessman and local politician who is also an officer-director of a S&L that he founded. When the S&L began to go under, in part because of his own mismanagement, he donated about $500K to help bail it out. Is the payment deductible under § 162?

   As in *Welch*, a court would probably defer to T's judgment as to whether this was "necessary." The question is whether it's "ordinary"? *Welch* would tend to suggest that it's not ordinary, and that it's a capital expenditure for development of reputation and goodwill. But, *Welch* can be distinguished from these facts on the ground that the T in *Welch* was paying post-bankruptcy debts of his company, whereas this here is a bailout. The court in the case from which these facts were taken, *Conti*, allowed the deduction, citing that it was T's own mismanagement that caused to S&L to begin going under.

<u>Page 377: deductions for travel expenses</u>

1. C owns a home in Suburb of City and drives to work in City every day. He eats lunch in City restaurants.

   a. Can C deduct his costs of transport or meals?

   No, he can't, says Reg. 1.162-2(e) (commuters' fares not business expenses) and Reg. 1.262-1(b)(5) (costs or commuting to place of business are personal expenses).

   b. What if C is an attorney and has to travel between his office and the City courthouse to file papers and try cases. Can he deduct any of his costs of transport and meals?

   He can deduct his transportation expenses under § 162(a)(2), because he's going from one work location to another (see RR 99-7). But he can't deduct his meals expenses assuming those meals are solo, non-business meals.

   c. C resides and works in City, but occasionally has to fly to Other City on business. He eats lunch there and returns home later that day. Can he deduct any of his costs?

   He can deduct the transport under § 162(a)(2), but not his meals, because of the *Correll* "sleep or rest" (aka "overnight") rule.

2. T lives with her husband and children in City and works there.
    a. If her employer sends her to Metro on business for two days and a night each week, and if T isn't reimbursed for her expenses, can she deduct?
        She can deduct her transportation costs using § 162(a)(2); and she satisfies the "sleep or rest" rule and so can deduct her meals and lodging costs, too. But under § 274(n)(1)(A), she can only deduct 50% of those meals costs.
    b. What if she works three days and two nights in Metro and maintains an apartment there?
        Then, first we have to determine where her tax home is. To do that we must pick whether to employ the *Andrews* "major post of duty" test or the IRS's three-factor test ((a) amount of income in each place, (b) whether T's family is there, (c) length of time T spends there). Whichever is T's tax home, she can deduct her transport expenses to and from the other home, her lodging expenses at the other home, and 50% of her meals at her other home.
    c. T and her husband own a home in City and H works there. T works in Metro, maintaining and apartment there, and travels to City every weekend to visit H and family. What can she deduct?
        Under the *Flowers* personal choice theory, T can't deduct anything—it's her personal choice to maintain a home in Metro.
3. B is a pro football play for City's team. He and his wife own a home in Metro where they reside during the 7-month offseason.
    a. If B's only income source is his team salary, can he deduct any of his City living expenses that he incurs during the football season?
        No—for alternative reasons. If City is his tax home, then he can't deduct his City expenses because he's not leaving home for business. If Metro is his tax home, the the *Flowers* personal choice doctrine kicks in to prevent a deduction.
    b. Any difference if during the offseason B worked as an insurance salesman in Metro?
        Then, B might can get some deductions. Determine where his tax home is using the *Andrews* or IRS test, and go from there.
4. T works for Employer in City where T and his family live.
    a. E has trouble in Branch City office in another state, and asks T to supervise that office for nine months. T's family stays in City and he rents an apartment in Branch City. Are T's expenses there deductible?
        Yes—this is under an exception to *Flowers* that permits deduction for expenses of temporary, definite relocations of less than one year.
    b. What if the time period is expected to be nine months but after eight is extended to fifteen?
        Then the exception applies up until the extension—T can deduct for eight months. See RR 93-86.
    c. What if T and his family lived in a furnished apartment in City and gave the apartment up and moved to Branch City, to a furnished apartment, for the nine months.

He might not can deduct anything, because there's no duplication of expenses. However, the duplication idea comes from the caselaw, not from the statute, so there's room to argue on this one.

<u>Page 392: deductions for educational expenses</u>

1. A, B, C, and D were college roommates who went on to be a doctor, a dentist, a CPA, and a lawyer, respectively. This year, after some time as a surgeon, A, who often gave medical testimony in malpractice suits, decided to go to law school in order to better understand this aspect of her medical practice. B enrolled in postgraduate study of orthodontics, intending to restrict her dental practice to that specialty. C enrolled part time in law school (with prospects of attaining a degree) to better perform her accounting duties in overlap areas. D took a leave from her firm to enroll in an LLM in taxation, intending to practice exlusively in tax. Who's incurring deductible education expenses?

    Reg. 1.162-5(a) sets out a threshold test for deductibility of education expenses: the expenses must either be to (a) maintain or improve skills required in T's employment/trade/business or (b) meet his employer's or the law's express requirements imposed as a condition of retention. But, even if the threshold is met, Reg. 1.162-5(b) has two disallowance provisions: expenses are not deductible if they (a) are for education required of T to meet the minimum educational requirements for qualification in his employement/trade/business or (b) will lead to qualifying T in a new trade/business.

    So, A, by going to law school, will qualify for another trade/business—her expenses aren't deductible. B doesn't get caught up in either of the disallowance provisions, and satisfies the "maintain or improe skills" prong of the threshold test—deductible. C, like A, will qualify for a new trade/business—(probably) not deductible. D, like C, is improving skills—(probably) deductible.

2. Assume D's expenses above are deductible. If she's a practitioner in Seattle who travels to Gainesvill for a year to participate in an LLM program there, what expenses, in addition to tuition and books, can she deduct?

    Reg. 1.162-5(e) says that her travel, meals, and lodging are deductible (meals only 50%, says § 274(n)); except, the portions of her expenses for personal activities are not deductible. (And, if the purpose of the trip is primarily personal, none of the meals, lodging, and travel is deductible.)

<u>Page 439: depreciation deductions for trade or business property</u>

1. On January 2 of this year D buys new equipment for use in her business for $300K. The purchase is made from an unrelated person. The equipment has a 6-year class life and is 5-year property under § 168(c). D plans to use it for seven years, and expects it to have a $30K salvage value after that time. D is a calendar year taxpayer and uses the equipment only in her business.

    a. D elects under § 168(b)(5) to use the straight-line method and elects out of § 168(k).

        The straight-line method is spelled out in Reg. 1.167(b)-1. Salvage value is zero (§ 168(b)(4)). So, for each full year, she gets $300K / 5 = $60K depreciation deduction. But in the first and last years, she must use the applicable convention, which here is the half-year convention (§ 168(d)(1), (4)(A)). So, the first year's deduction is $60K / 2 = $30K. In years two, three, four, and five, she deducts $60K. And in year six she deducts $30K again, taking her AB to zero.

b. D uses ACRS but elects out of § 168(k).

Her method under ACRS is the default ACRS method, 200% DDB (§ 168 (b)(1)(A)). DDB is spelled out in Reg. 1.167(b)-2. To use it, first figure the SL rate, which here—for five-year property—is 20%. Take 200% of that, so our DDB rate is 40%. Also, in year one, the applicable convention is the half-year convention (§ 168(d)(1)). Finally, you must switch from DDB to SL when the SL method, calculated using the remaining useful life, gives a bigger deduction than the DDB. So:

Y1: Half: $300K * 40% = $120K; $120K / 2 = $60K deduction.
AB = $300K – $60K = $240K. (4.5 years remain.)
Y2: $240K * 40% = $96K. (SL would be 22.2%.)
AB = $240K – $96K = $144K. (3.5 years remain.)
Y3: $144K * 40% = $57,600. (SL would be 28.6%.)
AB = $144K – $57,600 = $86,400. (2.5 years remain.)
Y4: $86,400 * 40% = $34,560. (SL would be 40%.)
AB = $86,400 – $34,560 = $51,840. (1.5 years remain.)
Y5: Switch to SL: $51,840 * 66.7% = $34,560.
AB = $51,840 – $34,560 = $17,280. (0.5 years left.)
Y6: Half: $34,560 / 2 = $17,280.
AB = $17,280 – $17,280 = $0.

c. What if, under (b), D disposes of the eqipment on December 1 of year five?

Then, we apply the half-year convention in Y5, the year of disposition (§ 168(d)(4)(A)). So, everything's the same through Y4, and then:

Y5: Switch to SL; Half: $34,560 / 2 = $17,280.
AB = $51,840 – $17,280 = $34,560.

d. What if D doesn't elect out of § 168(k)?

Then she gets her bonus deduction. Assuming this is 50% bonus property (§ 168(k)(4)(B)), she gets an additional 50% deduction in the first year (§ 168(k)(1)(A), (4)(A)(i)). Legislative history tells us that § 168(k) should be applied *before* calculating regular depreciation. So:

Y1: §168(k) bonus: $300K * 50% = $150K.
AB = $300K – $150K = $150K.
Regular; Half: $150K * 40% = $60K; $60K / 2 = $30K.
AB = $150K – $30K = $120K.

(Total of $180K deductions.) (4.5 years remain.)
Y2: $120K * 40% = $48K. (SL would be 22.2%.)
AB = $120K – $48K = $72K. (3.5 years remain.)
Y3: $72K * 40% = $28,800. (SL would be 28.6%.)
AB = $72K – $28,800 = $43,200. (2.5 years remain.)
Y4: $43,200 * 40% = $17,280. (SL would be 40%.)
AB = $43,200 – $17,280. (1.5 years remain.)
Y5: Switch to SL: $17,280 * 66.7% = $11,520.
AB = $17,280 – $11,520 = $5,760. (0.5 years remain.)
Y6: Half: $11,520 / 2 = $5,760.
AB = $5,760 – $5,760 = $0.

e. What if D uses § 179, too?
First of all, we need to know if this equipment if § 179 property (§ 179(d)(1)). Also, we'd need to know the income D has from her business this year, to know if her § 179 deductions will be limited under the § 179(b)(3) income cap (§ 179 deductions can't exceed the amount of trade-or-business TI). Assuming her § 179 deductions will fit underneath her income, though:

Legislative history says apply § 179 first, then § 168(k), then do regular depreciation:

Y1: § 179 bonus: (§ 179(b)(2) does not act to reduce D's § 179 deduction because the equipment cost her less than $400K.) She gets the full $100K bonus (§ 179(b)(1)).
AB = $300K – $100K = $200K.
§ 168(k) bonus: $200K * 50% = $100K.
AB = $200K – $100K = $100K.
Regular; Half: $100K * 40% = $40K; $40K / 2 = $20K.
AB = $100K – $20K = $80K. (4.5 left.)
Y2: $80K * 40% = $32K.
AB = $80K – $32K = $48K. (3.5 left.)
Y3: $48K * 40% = $19,200.
AB = $48K – $19,200 = $28,800. (2.5 left.)
Y4: $28,800 * 40% = $11,520.
AB = $28,800 – $11,520 = $17,280. (1.5 left.)
Y5: Switch to SL: $17,280 * 66.7% = $11,520.
AB = $17,280 – $11,520 = $5,760.
Y6: Half: $11,520 / 2 = $5,760.
AB = $5,760 – $5,760 = $0.

<u>Page 443: depreciation deductions for real estate</u>

1. This year, D buys a piece of new improved real property for $130K, $100K of which is for the building and $30K for the land. D immediately rents to others.

a. The building is an apartment building.

This would be residential rental property, under § 168(e)(2)(A). So the recovery period is 27.5 years. The SL method applies (§ 168(b)(3)(B)). (And the mid-month convention, § 168(d)(2)(B).) The land part isn't depreciable, because land doesn't have a determinable useful life (Reg. 1.167(a)-2). So, D gets $100K * 3.64% = $3636.36 deduction in Y2.

b. The building is an office building.

This is nonresidential real property (§ 168(e)(2)(B), and so has a 39 year recovery period (§ 168(c)). So, D gets $100K * 2.56% = $2564.10 deduction in Y2.

c. The buildings in (a) and (b) are used—not new. They were purchased from D's sister who originally purchased them in 1982.

The "related person" "anti-churning" rules do not apply to residential rental or nonresidential real property (§ 168(f)(5)(B)(i)), so the result is the same.

d. What if D elects the alternative depreciation system?

This system is spelled out in § 168(g). Under § 168(g)(2)(C)(iii), the recovery period is 40 years, the SL method, and the mid-month convention. So, D gets $100K * 2.5% = $2500 deduction in Y2.

<u>Page 464: deductions for personal investment activities</u>

1. S buys 100 shs. of Sound Company for $3K, paying a $50 broker commission. Fourteen mos. later, she sells for $4K, paying a $60 broker commission.

a. Can she treat the $110 in commissions as § 212 expenses?

No. The purchase commission is considered a capex, part of the shs. basis: AB = $3K + $50 = $3,050. The sale commission just offsets the AR: AR = $4K – $60 = $3,940. (Reg. 1.263(a)(2)(e).)

b. What if, under (a), S sells the shares for $2500 paying a $45 commission?

AR = $2500 – $45 = $2455. LR = $3K AB – $2455 = $545. And S can deduct this loss under § 165(a) & (c)(2).

c. S owned only 0.1% of Sound Company's stock but, eager as she was, incurred $500 of transportation, meals, and lodging expenses to travel 1K miles to NYC to the annual SH mtg. Can she deduct these costs under §212(2)?

The question is whether these are "ordinary and necessary" expenses. They probably aren't, because of her tiny ownership interest.

d. What if, under (c), S owned 10% of the SC stock?

Now, these expenses are looking more "ordinary and necessary."

<u>Page 507: deductions for taxes</u>

1. Which of these taxes is deductible under § 164?

a. State sales tax imposed at a single rate on sellers, but required to be separately stated and paid by purchasers to sellers, applicable to retail sales of any property besides food, clothing, and medicine.

This closest match for this is § 164(a)(2): personal property taxes. But these aren't them—§164(b)(1) says they must be imposed on an annual basis.

b. A state real property tax of $1K that A became liable for as owner of Blackacre on January 1, but which B agreed to pay half of when he acquired it from A on July 1.

§ 164(d)(1) tells us to apportion the deduction between A and B—A gets half, B gets half.

c. State income tax.

Deductible under § 165(a)(3).

d. Federal income tax.

§ 275(a)(1) expressly disallows deductions for payment of federal income taxes.

e. A state gasoline tax imposed on customers.

This is just like (a)—it doesn't meet the requirements for personal property taxes under § 164(b)(1).

3. Son, still in college, owns a bunch of securities. Father, when paying his own intangibles tax to his state, pays his son's intangibles tax.

a. Can F deduct the tax paid?

No, says *Cramer* and Reg. 1.164-1(a) ("taxes are deductible only by the person upon whom they are imposed").

b. Can S deduct it?

Yes, by the same rules.

Page 515: amount-at-risk restrictions

1. To what extent does § 465 limit T's loss deductions, generate recapture income out of previously allows loss deductions, or allow the use of a loss carryover:

a. T bought a farm for $50K cash and his personal note for $400K secured by a mortgage. In the first two years he put in an additional $50K each year, cash and personal loans, for feed, fertilizer, and other supplies. Things didn't go well. In Y1 he lost $80K, and $80K again in Y2. No principal was paid on the liability in either year.

T has $50K + $400K + $50K + $50K = $550K at risk. In Y1, he can report the entire $80K loss, and his at-risk amount is reduced to $470K. In Y2, he can again report his entire $80K loss, reducing his at-risk amount to $390K (§ 465(b)(5)).

b. What if, under (a), the farm was acquired for $50K cash and $400K nonrecourse financing.

T then has only $50K + $50K + $50K = $150K at risk. In Y1, he can report the entire $80K loss, and his at-risk amount is reduced to $70K. In Y2, he can only report $70K loss, reducing his at-risk amount to $0, and has $10K of loss to carryover.

d. What if, under (b), T pays off $10K of the nonrecourse loan in Y2?

Then, in Y2 he increases his at-risk amount to $80K and can report the entire $80K loss, reducing his at-risk amount to $0.

e. What if, under (b), the farms breaks even in Y3 and T pays off $10K of the nonrecourse loan in Y3?

T carries over $10K in disallowed loss from Y2, which he now can apply to the $10K at-risk amount he gets from paying off the loan. So, he reports $10K in loss and reduces his at-risk amount to $0.

<u>Page 535: passive activity losses</u>

1. L earns $200K of TI from her practice this year.
    a. L also has $10K of dividends and interest this year. She invests as an LP in a partnership that films and distributes movies. Her share of the partnership's movie losses for the year is $50K.
        The $50K loss is a passive activity loss. This loss is not deductible, but it offsets passive activity gains. Except that it can't offset the $10K dividends and interest gain, because of the no-offset-of-portfolio income provisions, §469(e)(1). So, L has $210 TI and a $50K PAL carryover.
    b. What if, under (a), L also has a $30K gain from her LP investment in a windmill power tax shelter?
        Then, the $50K loss offsets that gain, leaving her with $20K PAL carryover (and the $210K TI).
    c. What if, under (a), the partnership makes a $90K gain in the succeeding year?
        Then, that $90K gain is offset by the $50K PAL carried over from the year before (§ 469(b)), for only $40K gain from that activity.
    d. What if, under (a), L sells her movie LP interest at the beginning of the succeeding year, at a gain.
        Then her PALs ($50K, here) a released, says § 469(g)(1), ofsetting first the gain from the sale, the gain from other passive activities, and finally everything else in OI.
    e. What if, under (a), L's LP interest is in rental real estate rather than in a movie.
        Because she's still an LP, the result is the same—she doesn't qualify for the special rental realty rules (§ 469(i)(6)(C)).
    f. What if, under (e), L owns a 20% *general* partnership interest in rental real estate, in which she actively participates in the management decisions.
        Then L *does* qualify for the special rental realty rules (§ 469(c)(7) and (i)), but her TI totally depletes her $25K cap on this (§ 469(i)(2)), which is reduced by 50% of the amount of AGI over $100K (§ 469(i)(3)(A)). L has $200K AGI, which means a $50K reduction, taking the cap to $0.
    g. What if, under (f), L's AGI for the year is $120K?
        Then, she doesn't totally reduce her realty rules cap. She reduces it by $10K only, to $15K. So, she's allowed $15K non-PAL loss on rental realty activities.
2. Answer these questions:
    a. This year G buys a grocery store and spends 35 hours a week operating it to the exclusion of all other business and investment activities. G's loss from the store is $50K. How much is deductible?
        All of it—G meets the "material participation" tests (specifically, he spends more than 500 hours a year on this activity, which satisfied Reg. 1.469-5T(a)(1)).

b. What if, under (a), G is only irregularly involved, but makes significant management decisions.

Then G probably doesn't meet any of the 1.469-5T(a) tests. His best bet would be 1.469-5T(a)(7), "substantial, continuous, regular" involvement, but even there, G has to be involved for more than 100 hours in the year (1.469-5T(b)(2)(iii)).

c. What if, under (a), G buys the grocery store and hires a manager who has carte blanche power to make all business decisions.

Then G definitely can't satisy any of the 1.469-5T(a) tests. This is a passive activity.

d. What if G, upset with the $50K loss in (c), fires the manager at the end of the year and in the next year, manage the store on a full-time basis and makes a $60K profit that year?

Then, the activity goes from being passive to being active, but the suspended losses from when the activity was passive (here, $50K) may still be used to offset gain from the activity, even now that it's active. So, the $60K active gain is offset by the $50K prior PAL, for a $10K gain.

4. J owns and runs a catering business which is profitable in Town X. She opens a new catering business in Town Y which is basically run by her staff there, although J makes management decisions. J also has a LP interest in a real estate partnership that currently generates losses and expects to do so for the next few years. J wants advice about how to treat her Town Y catering business.

The question is whether to try and call it a separate "activity" from the Town X business or not. If she calls it separate, it would be passive and any gains from it would absorb losses from the LP. It she expects to have losses from the Town Y business, though, she may want to call the Town X and Town Y businesses the same "activity" (Reg. 1.469-4(c)(1)) so that her Town Y (active) losses can offset her Town X income.

<u>Page 546: above- versus below-the-line deductions</u>

1. Assume the following expenses are properly deductible. Does the deduction fall under § 62, or only under § 63?

a. E, a policeman, purchases a new uniform at his own expense.

§ 63—§ 62(a)(1) doesn't allow ATL deductions of employee's TB expenses.

b. E, a salesman, pays the cost of entertaining purchasers in social circumstances that are directly related to her TB, and isn't reimbursed by her employer.

Likewise, § 63, because § 62(a)(1) doesn't allow ATL deductions of employee's TB expenses.

c. What if, under (b), employer reimburses E for the exact cost incurred?

1. How should E treat the expenses and reimbursement?

Basically, as a wash, says Reg. 1.162-17(b)(1).

2. What if the amount paid as reimbursement exceeds E's actual expenses?

Then E must include the excess as income, says Reg. 1.162-17(b)(2).

3. What if actual expenses exceed her reimbursement?
Then E might be able to get an ATL deduction, says Reg. 1.162-17 (b)(3).

d. What if, under (b), the *employer*, an individual, entertained the purchasers.
This is ATL, under § 62(a)(1).

e. E, as his own expense, pays $500 tuition for a refresher course to bring himself up to dae on current techniques related to his employment.
BTL, if these are § 162 deductions (because of the § 62(a)(1) no-employee-ATL-deductions clause). ATL, though, if these are § 62(a)(18) / § 222 deductions.

f. E makes payments for medical expenses and charitable contributions and for taxes on her residence and interest on a note secured by a mortgage on the residence.
BTL, because there's nothing in § 62 permitting these to be ATL.

g. What if, under (f), the taxes and interest relate to a residence that E rents to T.
Then they're ATL, because of § 62(a)(4) (deductions attributable to rents).

h. E has a loss on the sale of stock he held for investment.
ATL, under § 62(a)(3) (deduction for loss from sale/exchange of property).

l. S pays ex-spouse $6K in alimony.
ATL, under § 62(a)(10) (alimony deductions).

m. E incurs properly deductible moving expenses.
ATL, under § 62(a)(15) (moving expenses deductions).

<u>Page 562: medical expenses deductions</u>

1. H, divorced, who received neither alimony nor other support payments from her former husband, fully supported her daughter who had no income, lived with H and was a dependent of H under § 152. This year, H installed a central AC for $4100, which a doctor said was an basic requirement for D's respiratory problems. After installation, H's home increased in value by $2100. Other medical expenses during the year by H and D consisted of meds, $320, and doctor's bills, $400. Late in the year, H also paid $300 in health insurance premiums but received no reimbursements under the policy this year.
   a. If H's AGI is $12K, what is her medical expense deduction?
      Gerard says that for the air conditioning system, she's entitled for a deduction equal to the AC's cost less any value added to the home because of it (because of § 263(a)(1) (no deduction for capexs)). So, that's $4100 – $2100 = $2K. The other expenses are deductible as well, and they add up to $320 + $400 + $300 = $1020. So, altogether, her medical expenses are $3020. Now, however, § 213(a) allows a deduction only to the extent that medical expenses exceed 7.5% of AGI. For H, that's 7.5% * $12K = $900. So, H can deduct $3020 – $900 = $2120.

<u>Page 568: dependency exemptions</u>

2. Is T entitled to a dependency exemption for X? (Assume that it's 1989; that T was married but filed separately; that T furnished over half the support for the person; that

the person earned less than $2K GI and did not live with T.)

a. X was T's wife's brother.

X is a brother-in-law is a dependent under § 152(a)(8). So T can take the exemption per § 151(c)(1).

b. What if, under (a):

1. T's wife died the year before?

Reg. 1.152-2(d) allows the exemption—X is still a brother-in-law.

2. T and wife were divorced the year before.

Steele v. Suwalski allowed the exemption.

c. X was T's wife's deceased sister's husband.

X isn't a brother-in-law. See RR 71-72.

d. What if, under (c), X lived with T for the entire year.

Probably, T can take the exemption, per § 152(a)(9) (dependent status for people not otherwise dependents but whose principal place of abode is T's home and are members of T's household). (N.b., however, § 152(b)(5), which says X would not be a member of T's household if the relationship between T and X is a violation of local law.)

e. X is T's son who is 19 this year and who earned $2K from summer jobs during the year, but who's a full-time college student, except in the summer.

T gets the exemption, not because X is a dependent under § 152, but rather directly under § 151(c)(1)(B) (exemption for a child of taxpayer who's a student not yet 24 ("student" defined at § 152(c)(4))).

<u>Page 579: taxable income</u>

1. T, single, has $20K AGI this year, a single personal exemption, and some itemized deductions: $1K interest; $500 taxes; $1500 unreimbursed employee travel expenses; $200 tax preparation fees; $300 bar association dues.

a. What's T's TI?

No above-the-line deductions, because T is an employee (§ 62(a)(1)).

Below the line:

Standard deduction: $3K

Itemized deductions:

Not subject to the § 67(a) 2% floor:

$1K interest (§ 67(b)(1))

$500 taxes (§ 67(b)(2))

$1500

Subject to the § 67(a) 2% floor:

$1500 travel

$200 tax prep.

$300 bar dues

$2K

So the floor is $2K * 2% = $400.

$2K – $400 = $1600

So, total IDs = $1500 + $1600 = $3100

$3100 > $3K, so T will elect to itemize (§ 63(e)).

For a total TI of $20K AGI – $3100 ID – $2K PI = $14,900.

b. What if, under (a), T's 65th birthday is January 1 of next year?

Reg. 1.151-1(c)(2) says that, for the purposes of determining your age for the old-age bonus standard deduction (§ 63(f)), your age is as of the day *before* your birthday. So, T gets his old-age deduction beginning this year! This adds $750 (§ 63(f)(3)) to his standard deduction, making it $3750. That's greater than his itemized deductions of $3100, so T will elect to take his standard deduction.

c. What if, under (a), T is a married couple filing jointly?

Then, they get the standard deduction amount (§ 63(c)(2)(D)) times the applicable percentage (§ 63(c)(2)(A)(i)), which is 200% (§ 63(c)(7)). So, $6K (which they'll take, since it's greater than $3100).

d. What if, under (c), T's deductible interest is $4K?

That raises T's IDs to $6100, so they'll elect (§ 63(e)) to take their IDs rather than their SD.

<u>Page 611: cash method accounting</u>

1. L lends money at a legal interest rate to D. D has to pay $5K interest each year, and the loan extends over five years. The interest is deductible to D under § 163. D has to pay each year's interest on December 31. Both L and D are calendar year, cash method taxpayers.

a. D mails a check for $5K to L on December 31 of Y1. It's delivered to L on January 2 of Y2.

D has a deduction in Y1 (mailbox rule is used for deductions, say RR 54-465). L has income in Y2 (Reg. 1.446-1(c)(1)(i) (income taxed in the year received, for cash method)).

b. D mails the check on December 30 or Y1. It's delivered to L on December 31 of Y1, but after the banks are closed.

D deducts in Y1 (mailbox rule). L has income in Y1 (Reg. 1.451-2 (constructive receipt)).

c. D pays all five years' interest to L in cash on December 31 of Y1.

D must amortize this prepaid interest across the five years, says § 461(g)(1). L has all this income in Y1, under the claim of right doctrine (expressed in *North American Consolidated*).

d. What if, under (c), D prepays because L makes it a condition of extending D another loan?

Probably the same result, but D has an argument that this prepayment is like points, which are exempted (§ 461(g)(2)) from the § 461(g)(1) amortizing of prepaid interest rule.

e. D pays Y1's $5K of interest in cash on January 2 of Y2 and, as agreed, pays Y2's interest on December 31 of Y2.

D takes both deductions in Y2 (§ 461(g)(1) only applies to accelerated payments—not late ones), and L has all income in Y2.

f. L asks D to pay Y1's interest on January 2 of Y2.

D takes the deduction, and L has income, in Y2.

g. D gives L a promissory note on December 31 of Y1, agreeing to pay Y1's interest plus $50 on January 30 of Y2. D pays off the note on January 30 of Y2.

The promissory not is *not* a cash equivalent. So D takes the deduction, and L has income, in Y2.

Page 639: accrual method accounting

1. L renders services to C that are deductible to C under § 162. L sends C a bill for $1K on December 24 of Y1 and C pays the bill on January 5 of Y2. What if L and C are both calendar year, accrual method taxpayers?

   L performed the services and earned the fees in Y1—that's when he has his income. D made the actual payment in Y2, and so doesn't get the deduction until then.

Page 689: capital gains

1. T, single, has a $50K salary this year. T also has the following captial asset transactions: $15K gain on a "collectible" held two years; $20K gain on stock held for 15 months.

   a. What's T's net capital gain?

      NCG = NLTCG – NSTCL

      NLTCG = LTCG – LTCL = $15K + $20K = $35K

      NSTCL = STCL – STCG = 0

      NCG = $35K – $0 = $35K.

   b. At what rate will the components of T's NCG be taxed?

      The $15K collectible gain is taxed at 28% (§ 1(h)(4)). The $20K stock gain is taxed at 15% (§ 1(h)(1)(C)).

   c. Assuming there's a flat 30% tax on OI, and disregarding any deductions, what's T's TL this year?

      $50K * 30% = $15K on OI

      $15K * 28% = $4,200 on collectibles gain

      $20K * 15% = $3K on stock gain

      $22,200 total TL

Page 694: capital loss carryover

1. The figure for TI below is a single taxpayer's TI for each of two years without regard to his capital gains and losses. In computing GI, no gains will be included since capital losses exceed CGs, and so the § 1211(b) excess amount will be a reduction.

TI	LTCG	LTCL	STCG	STCL
$10K	$2K	$6K	$2,600	$1K
$10K	$2K	$10K	$2K	$4K

For each year, separately, without regard to computations for other years, determing the amount of T's CL that's allowed as a deduction from OI under § 1211(b)(1) or (2) and the amount and character of his CL carryover.

Year A:
- All gains = $2K + $2600 = $4600
- All losses = $6K + $1K = $7K
- Losses less gains = $7K – $4600 = $2400 (< $3K)
- Sum allowed under § 1211(b):
  - $4,600 (gains) + $2400 = $7K
- So, all losses are deductible (NCL = $0 (§ 1222(10)).

Year B:
- All gains = $2K + $2K = $4K
- All losses = $10K + $4K = $14K
- Losses less gains = $14K – $4K = $10K (> $3K)
- Sum allowed under § 1211(b):
  - $4K (gains) + $3K = $7K
- So, NCL = $14K (all losses) – $7K (§ 1211(b) amount) = $7K.
- Character of carryover:
  - NSTCL = $2K; NLTCG = $0;
    - So, $2K STCL carried over (§ 1212(b)(1)(A)
  - NLTCL = $8K;
    - NSTCG = $0 (reality) + § 1212(b)(2) amount
      - §1212(b)(2) amount:
        - (b)(2)(A)(i) amount = $3K
        - (b)(2)(A)(ii) amount = ATI
          - ATI = $3K + X
        - So, the (b)(2)(A)(i) amount is the lesser.
    - So, NSTCG = $0 + $3K = $3K

    And, so NLTCL – NSTCG = $8K – $3K = $5K
    Thus, $5K LTCL carried over (§ 1212(b)(1)(B)).

<u>Page 717: holding period</u>

1. T, a cash method, calendar year taxpayer, engaged in the following transactions in shares of stock.
   a. T bought 100 shs. on January 15 of Y1 at $50/sh. T sold them on January 16 of Y2 at $60/sh.
      The holding period begins to run on the day *following* the date of acquisition (RR 66-7). With debentures, stocks, and securities, specifically, the holding period *excludes* the trade date on which they were acquired, and *includes* the trade date on which they were sold. So, here, T has got to hold until January 16 of Y2, which he did. $1K LTCG.
   b. T bought 100 shs. on Feb. 28 or Y1 at $50/sh. He sold them on Feb. 29 of Y2, for $60/sh.

This is stupid. T has to get to Mar. 1 of Y2 before he has a year in. So, $1K STCG.

d. T told T's broker to buy 100 shs. on December 29 of Y1 at a time when the price was $50/sh. The stock was delivered to T on Jan. 3 of Y2 when it was selling for $52/sh. T told T's broker to sell the sock on Dec. 30 of Y2 when it sold for $60/sh, and it was delivered to B on Jan. 4 of Y3 when it was selling for $63/sh.

Again, it's the trade dates that are used. The day after the acquiring trade date, and the day of the selling trade date. So, T has to get to Dec. 30 of Y2, which he did. $1K LTCG.

f. T's dad bought 100 shs. on Jan. 10 of Y1 at $30/sh. On Mar. 10 of Y1 when they were worth $40/sh. he gave them to T who sold them on Jan. 15 of Y2 for $60/sh.

§ 1223(2) allows for tacking of the holding period with a gift (because the basis stays the same, under § 1015). So, T's holding period begins on Jan. 11 of Y1. He's got a year. $3K LTCG.

g. T's dad purchased 1000 shs. for $10/sh. several years ago. It was worth $50/sh on Mar. 1 of Y1, the date of dad's death. It was distributed to T by the executor on Jan. 5 of Y2 and T sold it for $60/sh. on Jan. 15 of Y2.

§ 1014 gives T a basis step-up to $50/sh. § 1223(11) says that as long as T sells within a year of the decedent's death, he's considered to have held for more than one year. So, $10K LTCG.

<u>Page 751: § 1231 gains/losses</u>

1. H engaged in or encountered the following transactions or events this year. Determine how the matters will be characterized in the current year.

c. H sells a building used for several years in his business, which he depreciated under the SL method. The sale price is $15K and the AB is $5K. His two-year-old car, used exclusively in the business, is totally destroyed in a fire. The care had a $6K AB but was worth $8K prior to the fire. He received $4K in insurance proceeds.

First, we do the subhotchpot (§ 1231(a)(4)(C)) on the casualty of the car. LR = $6K – $4K = $2K. So, that loss becomes ordinary and doesn't go on to the regular hotchpot. Now for the building: GR = $15K AR – $5K AB = $10K gain. So, gains exceed losses, and thus the $10K gain is treated as a LTCG (§ 1231(a)(1)).

d. In addition to the building and the car in (c), H had a painting that he bought two years ago that was held in connection with his business and which was also destroyed in the fire. The painting was bought for $4K and he received $8K in insurance proceeds.

So, we're back in the subhotchpot. The car's a $2K loss, but the painting is an $8K – $4K = $4K gain. The net is a $2K gain, which goes on to the main hotchpot (§ 1231(a)(4)(C)). Again, in the main hotchpot gains ($10K + $2K) exceed losses and so each of the gains and losses ($2K loss on the car, $10K gain on the building, $2K gain on the painting) are treated as long term capital gains and losses, respectively (§ 1231(a)(1)).

e. In addition to the building sale, the car loss, and the painting gain in (c), H sells land used for several years in his business for $30K. H had bought the land for $50K.

We came out of the subhotchpot with a $2K gain. So, now in the main hotchpot we've got that $2K gain, the $10K gain on the building, and now this $50K – $30K = $20K loss from the land. The net of all that is an $8K loss. Thus, all of these gains and losses are ordinary (§ 1231(a)(2)).

<u>Page 766: § 1245 recapture</u>

1. R, a calendar year taxpayer, owns a piece of equipment that R uses in business. The equipment was purchased in Y1 for $100K, is "5-year property," and R has taken the ACRS deductions allowed under § 168. R did not elect § 179, and has no § 1231 losses in prior years.

a. What if R sells the equipment to B in Y7 for $30K?

R will have depreciated his AB down to $0 after seven years. His recomputed basis for § 1245(a)(1)(A), calculated per § 1245(2)(2)(A), is $100K. His § 1245(a)(1)(B) amount is his AR of $30K. So, the (a)(1)(B) amount is the lower, and it exceeds AB ($0) by $30K. Thus, R has $30K OI in the recapture.

b. What if, under (a), R elected § 179?

§ 1245(a)(2)(C) says § 179 deductions are included, so the result is the same—$30K OI recaptured.

d. What if, under (a), R sells the equipment to his spouse?

§ 1041(b)(1) says that this transfer is treated as a gift; thus § 1245(b)(1) says § 1245(a) doesn't apply, and R has no recapture OI. (But when spouse sells, she must recapture because of § 1245(a)(2)(A) (recomputed basis includes deductions allowed to any other person).)

e. What if R is able to sell the equipment to D for $110K?

Then his § 1245(a)(1)(B) amount is $110K, which is greater than his RB of $100K. So he must recapture only $100K, per § 1245(a)(1). That $100K is OI, and the remaining $10K AR is § 1231 gain.

f. What if, under (e), R also sold some land used for storage in R's business for $9K? (R owned the land for three years and it had a $20K AB.)

The land is not § 1245 property (§ 1245(3)), and so he has a LR = $20K – $9K = $11K, which is § 1231 loss. That loss goes into the § 1231 main hotchpot, to be offset by the § 1231 gain, of $10K, R had on the equipment sale. Thus, § 1231 gains don't exceed § 1231 losses, and we're under § 1231(a)(2), meaning R's § 1231 gains and losses are treated as OI. So, he has OI gains of $100K (recapture) + $10K (§ 1231(a)(2) gain) and OI losses of $11K (§ 1231(a)(2) loss), for a net OI effect of $99K.

g. What if, under (f), the land's sale price is $15K?

R has LR on the land of $20K – $15K = $5K. The § 1231 main hotchpot gains ($10K) exceed the losses ($5K), and so R has $10K LTCG and $5K LTCL (in addition to the $100K OI § 1245 recapture).

Page 768: § 1250 recapture

1. To what extent does § 1250 apply to real property placed in service after 1986?
   Property place in service after 1986 will have not depreciation in excess of SL. So, if that property is held for more than one year, § 1250 will not apply to recapture anything. For property not held for more than one year, § 1250 requires recapture of all the depreciation deductions (§ 1250(b)(1)).
2. On January 1 of Y1, O bought some commercial property for $880K—$780K allocable to the building, $100K to the land. O, single, has $100K of OI from services in Y1. O gets an offer to sell the property for $1M—$890K for the building, $110K for the land. Disregard the mid-month convention and assume the property was held for a full year, and that O had no other § 1231 gains/losses for Y1 and no § 1231 gains/losses in prior years.
   a. If the sale occurs on December 31 of Y1, what's the amount, character, and tax rate on O's gain?
      O's RP on the building is 39 years (§ 168(c)), and the SL method applies (§ 168(b)(3)(A)). So, he takes (100/39)% * $780K = $20K in depreciation each year; after Y1, his AB in the building is $760K. (The land is depreciable.) O then has a GR on the building of $890K (AR) – $760K (AB) = $130K. O's § 1250(a)(1)(A)(i) amount is the amount of "additional depreciation." AD, § 1250(b)(1) tell us, is the amount of depreciation, for property not held for more than one year (for property held for *more* than one year, it's only the depreciation in excess of SL). So, O's § 1250(a)(1)(A)(i) amount is $20K, the depreciation deduction he's taken. O's § 1250(a)(1)(A)(ii) amount is his GR, $130K. The $20K amount is lower. The "applicable percentage" is 100% (§ 1250(a)(1)(B)(v)). So, the $20K is OI. As is the rest of the AR, $110K, because O didn't hold for more than one year to get CG treatment.

      On the land, O's AB is $100K, his AR $110K, for a GR = $10K. This is OI since O did not hold for more than a year.
   b. What if O sells the property on January 2 of Y2?
      Then § 1250 doesn't apply to recapture the depreciation adjustments (§ 1250(b)(1)) and so O's entire AR is § 1231 gain.
   c. Should § 1250 be repealed?
      Well, it looks like § 1250 doesn't actually do much under this case. The results would be the same without it and you wouldn't have to go through all this crap to figure out what O has to do.

Page 836: installment sales

1. S owns a parcel of investment land which S bought four years ago for $2K. S sells to B under an arrangement where B pays S $2K cash this year and four 8% interest bearing notes to be paid off in each of the succeeding four years. Each note has a $2K face amount and a $1750 FMV. Disregarding the tax consequences of any interest payments (§ 163), what happens in each of the five years:

a. S is a cash method taxpayer who makes no § 453(d) election.

With no election out (§ 453(d)), the § 453 rules apply to S. The disposition is an installment sale because at least one payment will be received after the close of the taxable year (§ 453(b)(1)), and so the installment method applies (§ 453(a)).

The installment method (Reg. 15a.453-1(b)(2)(i)):

Amount of income from each payment is:

payment * GPR (gross profit ratio)

GPR = (gross profit) / (total contract price)

"gross profit" = selling price – AB (15a.453-1(b)(2)(v))

"selling price" = the gross selling price, unadjusted for anything (15a.453-(b)(2)(ii))

GP = $10K (SP) – $2K (AB) = $8K

"total contract price" = selling price (plus any assumed, qualifying indebtedness *not* in excess of seller's basis) (15a.453-(b)(2)(iii))

TKP = $10K

GPR = $8K (GP) / $10K (TKP) = 0.8

So, 2K * 0.8 = $1600, each year. LTCG.

b. S is an accrual method taxpayer who makes no § 453(d) election.

Same result—the installment method supersedes the other accounting methods (§ 453(a)).

c. What if, under (b), the property was equipment used in business with an AB of $2K, on which S had claimed depreciation and the § 1245 recapture is $3K?

§ 453(i) says that any recapture income has to be recognized in the year of disposition (gain in excess is incomed using the installment method). So S must recognize the $3K recapture income first. Then, his GP = $10K – $3K – $2K (AB) = $5K, and GPR = $5K / $10K = 0.5. Thus, for each payment, S has $2K * 0.5 = $1K. § 1231gain.

e. What if, under (b), the property is a building which S depreciated using the SL method an on which S had previously taken $5K depreciation. Assume S has no prior § 1231 losses and no other § 1231 or capital gains or losses in the years when payments are made.

S has taken nothing in excess of SL, so § 1250 and thus § 453(i) are not triggered. *But*, S has two kinds of gain: unrecaptured § 1250 gain (§ 1(h)(6) of $5K total, and § 1231 gain of $3K total. Reg. 1.453-12(a) says the unrecaptured § 1250 gain is taken into account first. So, the first $5K is UR§1250G, then it's §1231G.

f. What if, under (b), the property was subject to a $2K mortgage which B assumed and gave S $2K of cash and only three $2K notes?

Here, the assumed mortgage doesn't exceed S's AB, and so isn't treated as a payment in Y1 (15a.453-1(b)(3)(i)). But TKP is reduced by the amount assumed, so TKP = $10K – $2K = $8K. Thus, GPR = $8K / $8K = 1. So, $2K * 1 = $2K each year. LTCG.

g. What if, under (b), the property was subject to a $3K mortgage which B assumed and B gave S $2K cash and two $2K notes and a $1K note for the fourth year.

Here, the assumed mortgage exceeds AB, so the excess ($3K – $2K = $1K) is treated as a payment in Y1. GPR = 1 (see (f)). So: Y1, $2K + $1K = $3K gain; Y2, $2K gain; Y3, $2K; Y4, $1K. LTCG, all of them.

h. What if, under (b), prior to collecting any of the notes S sells them to a third-party for their FMV of $7K?

§ 453 installment method no longer applies—now, § 453B applies. This is a sale, so § 453B(a)(1) applies, and S has gain/loss equal to the difference between basis and AR. "Basis" is face value less income returnable, § 453B(b) says. Face value is $2K, and income returnable (using GPR) is $1600; so basis is $2K - $1600 = $400 for each, or 4 * $400 = $1600 for all of them. AR is $7K. So, § 453B(a)(1) gain for S is $7K – $1600 = $5400. Character? § 453B(a) flush language says it's the character that the gain from the sale of the underlying property would be—here, LTCG.

i. What if, under (b), prior to collecting any of the notes, S gives them to his daughter? Assume the notes are still worth $1750 each. What results to D when she receives full payment of the notes?

For S, we're in § 453B(a)(2), and S takes a gain of FMV – basis = $7K – $1600 = $5400, LTCG. As for D, her basis, RR 79-391 tells us, is S's basis + S's gain = $7K. When D receives payment, she has OI, because, although notes are a capital asset, her payments are not from the sale or exchange of that asset, as required for CG/CL under § 1222.

<u>Page 928: computating tax liability</u>

1. T is a calendar year taxpayer. Compute T's tax liability, before credits, assuming T has $174,700 of TI under the 2003 rate schedules.
    a. T's unmarried with no special status.

        TL = $34,926 + (33% * ($174,700 – $143,500)) = 34,926 + 10,296 = $45,222.

    b. On Dec. 31 of this year T married S, a calendar year taxpayer with no income for the year, and they file a joint return.

        § 7703 says marital status is determined on the last day of the year, so the joint return is valid. TL = $30,096.50 + ($0 * .33) = $30,096.50 = $22,282.50 + ((174,700 – 114,650) * .28).

    c. T was married and had two minor children living with him and Spouse that he supported. S had no income and died on Jan. 15 of this year.

        § 7703(a)(1) says T can file a joint return for the last year of S's life. So, the result is the same as (b).

    d. What if, under (c), S died on Dec. 31 of the prior year?

        Now T is a surviving spouse (§ 2(a)). Same result as (b).

e. What if, under (c), S died three years earlier?

Now T is a head of household (§ 2(b)). TL = $37,295.50 + ((174,700 – 159,100) * 0.33) = 37,295.50 + 5,148 = $42,443.50.

f. What if, under (c), T remarried on Dec. 31 of the current year and T and his new spouse file separate returns for this year?

T doesn't get the § 7703(a)(1) final joint return, or § 2(a) surviving spouse, or § 2(b) head or household treatment. His married, filing separately TL = $42,194.50 + ((174,700 – 155,975) * 0.35) = 42,194.50 + 6,553.75 = $48,748.25.

<u>Page 941: credits</u>

2. Ts, married, have three qualifying children and earn $18K wages in 2004, which is Ts's only income for the year. Ts file a joint return and use the SD. Assuming no inflation adjustment and considering only the § 32 (EIC) credit, what are Ts's tax consequences this year?

   They have TI = $18K GI – $6K SD – $10K PE = $2K. They're in the 10% bracket, so have TL = $2K * 0.1 = $200. § 32(a)(1) says they get a EIC = EI – the earned income amount (EIA). EIA = $8,890 (§ 32(b)(2)(A).

   This would be the amount to use to calculate the EIC but for the § 32(a)(2) limitation, which says that the credit amount can't exceed: (credit percentage * EIA) – (phaseout percentage * (EI – phasout amount)). CP = 40% (§ 32(b)(1)(A)); PP = 21.06 (§ 32(b)(1)(A)); PA = $11,610 (§ 32(b)(2)(A)) + $1K (§ 32(b)(2)(B)) = $12,610.

   So, the § 32(a)(2) amount = (0.4 * $8,890) – (0.2106 * ($18K – $12,610)) = $3,556 – $1135.13 = $2420.87 = $2421.

<u>Page 897: like-kind exchanges</u>

2. T has 100 acres of unimproved land that he farms. Its cost basis is $10K but its value much greater. T trades it to B for a city apartment building worth $70K, which has a basis to B of $30K. B also transfers to T $4K of cash and 100 shs. of X Corp., held for three years, with basis of $40K but with FMV of $26K. None of the property is mortgages, and B has always taken SL depreciation on the apartment building.
   a. Wrt. T:
      1. What's T's realized gain on the exchange?

         T gets: $70K + $4K + $26K = $100K. His basis is $10K, so GR = $90K.
      2. What's T's recognized gain on the exchange?

         The aparment building is like-kind property to the unimproved land. § 1031(b) says that with a partially-like-kind exchange, says gain shall be recognized up to money + FMV of other property = $4K + $26K = $30K.
      3. What's T's basis for the stock?

         It's FMV, $26K (§ 1.1031(d)-1(c)).

4. What's T's basis for the apartment building?
    - § 1031(d) tells us:
        - basis of property exchanged: $10K
        - – money received: $4K
        - + gain recognized: $30K
        - $36K
    - That $36 is allocated between the replacement property and the in-kind boot (the stock). $26K goes to the stock, $10K to the apartment building.
5. What if, immediately after the exchange, T sold the apartment building for $70K and the stock for $26K? And what if T had just sold the farm for $100K cash?
    - If he immediately sold everything, he'd be taxed on $70K – $10K = $60K gain on the apartment building (no gain on the stock), but have been taxed for $30K gain on the exchange, for a total of $90K. If he'd just sold the farm, he'd be taxed on $100K – $10K = $90K.

b. Wrt. B:
1. What's B's realized gain/loss on the exchange?
    - For the apartment building, GR = $70K – $30K = $40K. For the stock, LR = $40K – $26K = $14K.
2. What's B's recognized gain/loss on the exchange?
    - No gain recognized on the apartment building part, but the $14K loss on the stock is recognized.
3. What's B's basis for the farmland?
    - Reg. 1.1031(d)-1(e) says:
        - basis of property exchanged: $40K (apt.) + $30K (shs.) + $4K (cash) = $74K
        - -- loss recognized: $14K
        - $60K
4. Could § 1250 affect B if he had claimed depreciation in excess of SL on the apartment?
    - Yes—§ 1250(d)(4) specifies the rules for § 1250 recapture in the case of LKEs.
5. What if B sold the farm immediately after the exchange for $100K? And what if B had just sold the building for $70K and the stock for $26K?
    - If he immediately sold the farmland, he'd have $100K – $60K = $40K gain, and the $14K loss on the stock (recognized in the exchange). If he sold the building and the stock he'd have a $40K gain on the buildingand a $14K loss on the stock.

3. T bought a building and land for $500K—$300K for the building and $200K for the land. He holds the property as an investment. After the building has been totally depreciated, under SL, T transfers the building and land, now worth $800K, for another building and land, also to be hald as an investment. The FMV of the

replacement building is $400K and the FMV of the replacement land is $400K.

a. Does § 1031 apply to the exchange?

Yes (§ 1031(a)(1)).

b. Is T entitled to take depreciation deductions wrt. the building?

Yes, says RR 68-36. T's basis in the replacement property (building and land) is allocated between the two, so the building will gain a basis from the allocation from the land.

4. B wants to acquire S's investment land. S has substantial gain on the land, hates to pay tax on such gains, and wants to convert the investment into commercial real estate in a tax-free exchange.

a. B pays cash for the land and S reinvests the proceeds in commercial property.

This is a sale, and so § 1031 doesn't apply.

b. S agrees to sell the land to B, who puts cash in an amount equal to the value of the land in an escrow account. The escrow provides for S to select commercial proeprty equal in value to the land. B will then acquire the commercial property with the escrowed cash and transfer the property to S. If S fails to find adequate property, the deal collapses. One year after the escrow account is opened, S selects commercial property that B acquires with the escrowed cash and transfers it to S in exchange for the land.

Under RR 77-297, this works as a three-cornered exchange under § 1031. The identification period and exchange period are met (§ 1031(a)(3)), because the transfer is simultaneous. And because the deal collapses if exchanged property can't be found, there's no constructive receipt of money or other property (Reg. 1.1031(k)-1(f)(2)).

c. S, a calendar year taxpayer, transfers land to B on Jan. 1 of this year. B puts cash in an amount equal to the value of the land in an escrow account. S is to select the like kind property S wants a B is to acquire it with the escrowed cash. If at any time B fails to meet B's obligation, S may demand the cash. On Feb. 15, S identifies three properties, any one of which S is willing to accept, and on June 15 B acquire3s on of the properties and transfers it to S.

This also works as a three-cornered like-kind exchange. There's no constructive receipt because S can only demand the cash if B fails to meet B's obligation. The § 1031(a)(3)(A) 45-day identification period is met, as is the § 1031(a)(3)(B) 180-day exchange period. Reg. 1.1031(k)-1(c)(4)(A) allows S to select up to three properties.

d. What if, under (c), after S's transfer of the land to B and B's transfer of the cash to the escrow, but prior to replacement property being acquired, S may at any time opt to take the cash rather than the replacement property.

This is constructive receipt under Reg.1.1031(k)-1(f)(2), and so the "exchange" is treated as a sale—S can demand the cash at any time.

5. A owns some investment real estate with an AB of $200K, worth $500K, and subject to a nonrecourse mortgage of $100K.

a. What if A transfer's A's property to B in exchange for B's investment real estate worth $400K with AB $100K?

A:

GR = $400K (AR) + $100K (liability relief) – $200K (AB) = $300K.

Reg. 1.1031(b)-1(c) says liability relief is cash boot received for § 1031(b) purposes. So, A recognizes that $100K relief, under § 1031(b).

Under § 1031(d), A's new basis is:

$200K (old basis)
-- $100K (liability relief, treated under the last sentence of § 1031(d) as money received)
+ $100K (gain recognized)

$200K new basis

B:

GR = $500K (AR) – $100K (liability assumed) – $100K (AB) = $300K. None of which is recognized.

Under § 1031(d), B's new basis is:

$100K (old basis)
+ 100K (assumed liability) (Reg. 1.1031(d)-2Ex2)

$200K new basis

b. What if A transfers A's property to B in exchange for B's investment real estate worth $470K, with AB $100K and subject to $70K nonrecourse mortgage?

A:

GR = $470K (AR) + $100K (liability relief) – $70K (liability assumed) – $200K (AB) = $300K.

Gain recognized, after the liabilities are offset (Reg. 1.1031(b)-1 (c)), is $100K – $70K = $30K.

Basis:

$200K (old basis)
-- $100K (liability relief)
+ $70K (assumed liability)
+ $30K (gain recognized)

$200K new basis

B:

GR = $500K (AR) + $70K (liability relief) – $100K (liability assumed) – $100K (AB) = $370K.

There's a loss on liabilities, after offset of $30K ($100K – $70K), but under § 1031(c) that loss is not recognized.

Basis:

$100K (old basis)
-- $70K (liability relief)
+ 100K (assumed liability)

$130K new basis

c. What if, under (a), A's investment real estate subject to the liability is worth only $450K and A transfers $50K cash in addition to the real estate to B in exchange for B's real estate?

A:

GR = $400K (AR) + $100K (liability relief) – $200K = $300K.

A recognizes the $100K assumed liability less the $50K cash payment (Reg. 1.1031(d)-2Ex2(b)), or $50K gain, under § 1031(b).

Basis:

$200K (old basis) + $50K (cash)
-- $100K (liability relief)
+ $50K (gain recognized)

$200K new basis

B:

GR = $450K (AR) + $50K (cash) – $100K (assumed liability) – $100K (AB) = $300K.

B recognizes the $50K cash received, under § 1031(b).

Basis:

$100K (old basis)
+ $100K (assumed liability) (Reg. 1.1031(d)-2Ex2)
-- $50K (cash received)
+ $50K (gain recognized)

$200K new basis

<u>Page 226: gain from the sale of a principal residence</u>

1. What amount of gain must Ts, a married coupole filing jointly, include in GI?
   a. Ts sold their principal residence for $600K. They bought the residence several years ago for $200K and lived in it over those years.
      Ts meet the ownership requirements of § 121(a) (owned and used for 2 out of last 5 years). So, under § 121(b)(2)(A), they can exclude up to $500K gain on the sale. They have $400K gain, so they can exclude it all.
   b. What if, under (a), Ts bought another principal residence for $600K an sold it 2.5 years later for $1M?
      They still meet the § 121(a) ownership requirements, and so still can exclude up to $500K. They have $400K gain, so they can exclude it all.
   c. What if, under (b), the second sale occurred 1.5 years later?
      Then they *don't* meet the § 121(a) ownership requirements, and so can't

exclude any of the gain.

d. What if, under (b), Ts sold their first residence and were granted nonrecognition under old § 1034, and as a result their basis in the second residence was $200K?

Then they have $800K gain. They can exclude, under § 121(b)(2)(A), $500K of that. The remaining $300K is not excludable.

e. What if, under (a), the residence was Ts's summer home?

Then they don't meet the "used by T as T's principal residence" requirement of § 121(a), so none of the gain is excludable.

f. What if T, who met the ownership and use requirements, is a single taxpayer who sold a principal residence for $400K, with AB $190K after T took $10K of depreciation deductions on the residence?

Then the $10K depreciation part is *not* excludable, says § 121(d)(6). The remainder, $200K, is excludable.

2. T, single, bought a principal residence for $500K and after using it one year, sold it for $600K because T's employer transferred S to a new job location.

a. How much gain does T have to include in GI?

Due to the transfer, T falls under § 121(c)(2), and so the ownership requirements of § 121(a) don't apply to him. However, his exclusion is limited, by § 121(c)(1), to (§ 121(c)(1)(B)(i) amount) / 2, times the regular dollar limitation (for single T, $250K (§ 121(b)(1))). T's § 121(c)(1)(B)(i) amount is the number of years in the last 5 that he lived in the sold residence—1. So, his limitation is (1/2) * $250K = $125K. So, he had $100K, which is below his $125K limitation, and so he can exclude all of his $100K gain.

b. What, under (a), T has sold for $700K?

Then he'd have $200K gain, of which $125 is excludable. T must include the remaining $75K.

<u>Page 502: mortgage interest deduction</u>

3. Ts bought a home this year that they use as their principal residence. Unless otherwise stated, they obtain a loan secured by the residence and use the proceeds to acquire the residence. What portion of the interest paid on the loan can Ts deduct?

a. The purchase price and FMV of the home is $350K. Ts obtain a mortgage for $250K of the purchase price.

This is § 163(h)(3)(B) acquisition indebtedness. There's a $1M limitation on the amount treated as AI, but we're under it here with $250K. So, all interest on the mortgage is deductible (§ 163(h)(2)(D)).

b. What if, under (a), in two years Ts have reduced the outstanding principal balance to $200K and the FMV of the residence has increased to $400K. In the later year, Ts take out a second mortgage for $100K secured by their residence to add a fourth bedroom and a den to the residence.

Under § 163(h)(3)(B)(i)(II), this is still AI, because it's for "substantially improving" the residence. So, all interest on the second mortgage (and the first) is deductible.

c. What if, under (b), Ts use the proceeds of the $100K mortgage to buy a Ferrari?

> This is § 163(h)(3)(C) home equity indebtedness. It can't exceed FMV – AI (§ 163(h)(3)(C)(i), which here is $400K – $300K = $100K; nor can it exceed $100K, anyways (§ 163(h)(3)(C)(ii)). So, this doesn't exceed the limit, and so the interest on it is deductible.

d. What if, under (a), ten yeas later Ts have paid off $200K of the $250K mortgage and the residence is worth $500K. In the later year, Ts borrow $200K on the residence, $50K of which is used to pay off the remaining balance of the original morgage and the remainder is used to pay personal debts.

> This is refinancing, which falls under § 163(h)(3)(B) flush—it's acquisition indebtedness to the extent that it does not exceed the refinanced indebtedness (and it's subject to the § 163(h)(3)(B)(ii) $1M limitation, too). This $200K refinancing doesn't exceed the $250K refinanced indebtedness, so it's acquisition indebtedness and the interest is deductible.

e. What if, under (a), Ts financial prospects imrpvoe and they buy a luxury residence in Florida for FMV $1.25M. They finance $950K of the price with a note secured by a mortgage on the Florida house, use the house 45 days of the year, and elect to treat the residence as a qualified residence.

> Their election is valid under § 163(h)(4)(A)(i)(II) (one other residence electable). They have $250K acquisition indebtedness on the original home, and this $950K indebtedness, for a total of $1.2M AI. AI is subject to the § 163(h)(3)(B)(ii) $1M cap, and so the interest of the excess $200K is not deductible. The rest is.

f. What if, under (a), the year of acquisition of the $350K residence, subject to the $250K mortgage, was 1985. Also, instead of using all the proceeds to buy the residence, Ts applied $200K towards its cost and used the other $50K to buy a sailboat. By this year, Ts have reduced the outstanding principal on the 1985 loan to $175K. This year, they refinance the property (now worth $500K) with a loan for $300K secured by the residence. They use $175K of the proceeds from this year's loan to pay off the balance of the 1985 loan and the remaining $126K to pay of their children's education loans.

> The 1985 loan falls under the grandfathering rule of § 163(h)(3)(D), which says all pre-1987 indebtedness is treated as AI (and § 163(h)(3)(D)(ii) says the (h)(3)(B)(ii) $1M cap is reduced by the amount of pre-1987 indebtedness (so, it's down to $750K). All the interest on the 1985 loan, thus, is deductible. The refinancing: § 163(h)(3)(D)(ii)(II) says refinancing of pre-1987 indebtedness is AI to the extent that it doesn't exceed the principal of the pre-1987 indebtedness immediately before refinancing. So, this year's refinancing is AI up to $175K (the principal of the 1985 loan before refinancing). The rest ($300K – $175K = $125K) is equity indebtedness, but only up to the § 163(h)(3)(C)(ii) $100K cap. So, total then they have $275K of their $300K indebtedness that they can deduct interest on. Thus, for each year, they can deduct ($275 / $300) * interest.

Page 185: damages

1. P brought suit and unless otherwise indicated successfully recovered.
   a. P's suit was based on recovery of an \$8K loan to D. P recovered \$8,500 cash—\$8K for the loan plus \$500 interest.
      Return of capital is not taxed, says *Raytheon*, so the \$8K is not included. The interest, however, is included, because it would have been taxed to P if D had paid it without the suit (but subject, possibly, to § 163 deduction). This is the "in lieu of" test.
   b. What if, under (a), D transferred some land worth \$8500 with basis \$2K to P to satisfy the obligation? What's P's basis in the land?
      D has AR of \$8500, and so GR = \$8500 – \$2K = \$6500. P's basis is his cost (§ 1012, *Philadelphia*), or \$8500. For D, this is a capital asset, exchanged, and so of CG character.
   c. P's suit was based on a breach of a business K and P recovered \$8500 for lost profits and also \$16K of punitive damages.
      The punitives are taxable, *Glenshaw* says. The lost profits, like the interest on the loan, would have been taxed to P had he gotten then without a suit, and so they're taxable, too. Again, the "in lieu of" test.
   d. P's suit was based on a claim of injury to the goodwill of P's buisness arising from a breach of business K. P had a \$4K basis for the goodwill. The goodwill was worth \$10K at the time of breach.
      1. What if the suit is settled for \$10K, in a situation where the goodwill was totally destroyed?
         P has AR of \$10K, for GR = \$10K – \$4K = \$6K. P's ending basis in the goodwill is \$0.
      2. What if P recovers \$4K because the goodwill was partially destroyed and worth only \$6K after the breach?
         P has no gain—rather, P gets to recover his full basis (\$4K) in the goodwill first, because goodwill is considered an indivisible asset. This is an exception to the Reg. 1.61-6 apportioning of basis rule.
      3. What if P recovers only \$3K because the goodwill was worth \$7K after the breach?
         Still no gain—P eats up his basis of \$4K down to \$1K.

Page 193: personal injury damages

1. P brought suit and successfully recovered in the following situations.
   a. P, a professional gymnast, lost the use of her leg after a psychotic fan assaulted her. P was awarded damages of \$100K.
      The full \$100K is excludable as dadmages for personal physical injuries, under § 104(a)(2).
   b. \$50K of the recovery under (a) is specifically allocated as compensation for scheduled performances P failed to make as a result of the injured leg.
      Here, the "nature of the injury" rather than the "in lieu of test" is supposed to be used. The \$50K stemmed from the physical injury, and so is excludable under the caselaw understanding of § 104(a)(2). The "nature of

the injury" test comes from the "on account of" language in § 104(a)(2).

c. The jury also awards P $200K punitives.

This is expressly *not* excludable under § 104(a)(2).

d. The jury also awards P damages of $200K to compensate for P's suicidal tendencies resulting from the loss of her leg.

This arises from the original physical injury, and so, under the "nature of the injury" caselaw understanding of § 104(a)(2), is excludable.

e. P, in a separate suit, recovered $100K of damages from a fan who mercilessly taunted P about her unnaturally high voice, causing P extreme anxiety.

This is not excludable because it's not a "physical personal injury" under § 104(a)(2).

f. P recovered $200k in a sexual harrasment suit against her former coach.

Assuming this was not a physical personal injury, it's not excludable.

g. P dies a result of the leg injury and P's parents recover $1M in punitive damages awarded in a wronful death action under long-standing state statute.

This may be excludable under § 104(c) ("other than punitive damages" language doesn't apply in wrongful death actions where only punitives may be awarded, in certain cases.

3. N, who has a 20-year life expectancy, recovers $1M in a PI suit arising out of a boating accident.

a. What if the $1M is deposited in a money market account paying 5% interest?

Because the interest looks like interest, unlike in RR 79-313, it's taxed (see RR 65-29).

b. What if the $1M is used by N to buy an annuity to pay him $100K a year for life?

Then, under § 72(b)(1), N gets to exclude payment * (investment / expected return) = $100K * ($1M / ($100K * 20)) = $100K * 1/2 = $50K. $50K each year.

c. What if the case was settled, N to receive payment of $100K from D for life?

Then, under RR 79-313, it's all excludable.

<u>Page 203: alimony</u>

1. Are the following payments "alimony or separate maintenance" and therefor includible in the recipient's GI under § 71(a) and deductible by the payor under § 215(a)? Unless otherwise stated, A and F are divorced and payments are called for by the divorce decree.

a. The decree directs A to make payments of $10K per year to F for her life or until she remarries. A makes a $10K cash payment in the current year.

The § 71(b) requirements are:

- Payment in cash? Yes.
- Received by (or on behalf of) spouse under a divorce or separation instrument? Yes.
- Instrument doesn't designate such payment as a payment not includible in GI under the section and not allowable as a deduction under § 215? Check.

- For legally separated individuals under a decree, the payee and payor are not members of the same household at the time of payment? Assuming they aren't.
- No liability to make any payment after the death of the payee spouse, or payments as a substitute after the payee's death? Check.

b. What if, under (a), A transfers a $10K promissory note to F?

Then the payment in cash requirement isn't met. Not alimony.

c. What if, under (b), A transfers a piece of art work having a $10K FMV?

Still, the cash requirement isn't met. Not alimony.

d. What if, under (a), the decree also provides that payments are nondeductible by A and are excludible from F's GI?

Then that agreement is valid—it's not alimony.

e. What if, in (d), A anticipated that he'd have little or not taxable income in the immediate future, making the § 215 deduction worthless to him, and as a consequence of this agree to the nondeductibility provision in order to enable F to avoid income taxes?

Still valid—motives are irrelevant under the § 71(b) test.

f. What if, under (a), the decree directs A to pay $10K each year to F for 10 years?

Then, there's the possibility that A will be paying after F's death, and so the § 71(b)(1)(D) requirement isn't met. Not alimony.

g. What if, under (f), the local law says that A isn't required to make any post-death payments?

Then, there's no possibility (kind of) that A will pay after F's death. Alimony.

h. What if, under (a), the decree directs A to pay $10K cash each year to F for 10 years or her life, whichever ends sooner. Additionally, the decree requires A to pay $15K each year to F or her estate for 10 years. A pays F $25K this year.

$10K is alimony—the portion that meets the § 71(b)(1)(D) no-payments-after-death requirement.

i. What if, under (a), A and F are living in the same house.

Because it's a decree, § 71(b)(1)(C) can't live in the same house and still call it alimony. Not alimony.

j. What if, under (i), A and F aren't divorced or legally separated—the payments are made pursuant to a written separation agreement, not a divorce decree.

Then, they don't fall afoul of the § 71(b)(1)(C) requirement. Alimony.

<u>Page 207: indirect alimony payments</u>

1. T and N are divorced. Under their written separation agreement, incorporated into the divorce decree, T is required to make the following payments which satisfy the § 71(b) requirements.

a. Rental payments of $1K/mo. to N's landlord.

This is a payment of what's purely N's liability. It gets alimony treatment, not falling afoul of I.T. 4001.

b. Mortgage payments of $1K/mo. on the family home which is transferred outright to N in the divorce proceedings.

Again, purely N's liability. Alimony treatment.

c. Mortgage payments of $1K/mo. and real estate taxes and upkeep expenses on the house where N is living, which is owned by T.

This is T's liability, and so this falls afoul of I.T. 4001. No alimony treatment.

<u>Page 214: child support</u>

1. S and M enter into a written support agreement which is incorporated into their divorce decree at divorce. They have one child, in M's custody.

    a. The agreement requires S to pay M $10K per years and provides that $4K of the $10K is support of their child.

    The $4K is child support, $6K gets alimony treatment (§ 71(c)(1)).

    b. The agreement requires S to pay M $10K per year, but when their child reaches age 21, dies, or marries prior to reaching 21, the amount is reduced to $6K per year.

    Under § 71(c)(2)(A), the child support portion is inferred from the contingency provisions. $4K child support, $6K alimony.

    c. The agreement requires S to pay M $10K per year but that the payments will be reduced to $8K per year on Jan. 1, 2008, and to $6K per year on Jan. 1, 2012. S and M have two children: D, born June 17, 1990, and S, born Mar. 5, 1993.

    Under § 71(c)(2)(B), the contingencies themselves here will be inferred, for purposes of inferring the child support portion. $4K child support, $6K alimony.

    d. What if, under (a), S pays M only $5K of the $10K obligation in the current year?

    § 71(c)(3) says that you have to pay your child support first. To, $4K of the $5K will be applied as child support, and only the remaining $1K as alimony.

<u>Page 212: property settlements in divorce</u>

1. M and L's divorce decree becomes final on Jan. 1 of Y1.

    a. Under the decree, M transfers to L in March of Y1 a parcel of unimproved land he purchased 10 years ago. The land has a basis of $100K and a FMV of $500K. L sells the land in April of Y1 for $600K.

    M has no gain/loss under § 1041(a)(2). L takes M's basis of $100K, under § 1041(b)(2), and under § 1223(2), L tacks M's holding period of 10 years. So, when L sells in Y1 for $600K, she has GR = $600K – $100K = $500K, LTCG.

    b. What if, under (a), the land is transferred to satisfy a debt that M owes L. The land has a basis of $500K and a FMV of $400K at the time of transfer. L sells the land for $350K.

    Under § 1041(c)(1), if the transfer occurs within a year of divorce, it's incident divorce and so § 1041(a)(2) applies. M recognizes no gain/loss, L takes M's basis of $500K, tacks, and so has a $150K LTCL at sale.

c. What if M transfers the land in (a) to L in Y4?

Same result, because under § 1041(c)(2) this is related to the cessation of the marriage. This is confirmed by Reg. 1.1041-1T(b)Q7, which sets up a presumption of "related to the cessation" if the transfer occurs within 6 years of the divorce.

d. What if, under (c), the transfer is required by a written instrument incident to the decree?

Same result—we're within the 1.1041-1T(b)Q7 6 year period.

e. What if, under (c) the transfer is made in Y7?

Then, we're outside the 1.1041-1T(b)Q7 6 year period, and so the transfer is presumed *not* related to the cessation of the marriage. You can rebut the presumption by showing that the transfer was made to effect the division of property owned by the parties at the time of cessation. Here, we can probably rebut since the transfer was directed by a divorce decree.

Page 465: § 212 deductions for defending property in divorce

2. Under *Fleischman*:

a. When can a payor spouse deduct attorney's fees incurred in getting a divorce?

Never, except for fees regarding tax planning, says *Fleischman.*

b. When can a payee spouse deduct attorney's fees incurred in getting a divorce?

Never, except for fees incurred pursuing alimony payments, which are deductible under § 212(1).

c. When can payee spouse's attorney's fees incurred in getting a divorce be deductible by payor if payor pays them?

It could possibly be treated part of alimony—except you'd have to structure it so there'd be no obligation to pay if the payee died, in order to meet the § 71(b) requirements.