FEDERAL INCOME TAX AUDIO COURSE OUTLINE

Seventh Edition

Frank J. Doti
Professor of Law
Chapman University, Fowler School of Law

SUM AND SUBSTANCE AUDIO

WEST ACADEMIC PUBLISHING

Frank J. Doti, Professor of Law and
William P. Foley, II Chair in Corporate Law and Taxation
Chapman University School of Law
One University Drive
Orange, CA 92866
(714) 628-2511
fdoti@chapman.edu

FEDERAL INCOME TAX
COURSE OUTLINE

TABLE OF CONTENTS

FEDERAL INCOME TAX
COURSE OUTLINE

I. TAX DISPUTE PROCEDURES

A. Example: Client owns a mobile home park in Las Vegas but lives and works in Orange County. He goes to Vegas on alternate weekends to check on the mobile home park business. He deducted the expense of the airline fare to and from Vegas as a business expense under IRC §162. During his trips he stays at girlfriend's house. Client is audited by the Internal Revenue Service ("IRS"). IRS auditor disallowed the airline fare as a business expense. IRS auditor concluded that the predominant motivation for the trips was nondeductible personal expense under §262.

B. Thirty-day letter from IRS:

1. States that return was audited and taxpayer owes deficiency. Taxpayer can pay or file written protest with IRS appeals office within 30 days.

2. If taxpayer does nothing, then statutory notice of deficiency (90-day letter) is issued and right to appeal within the IRS is lost.

3. If written protest is filed within 30 days, case is referred to the IRS appeals office.

C. Appeals Office:

1. Appeals officer contacts taxpayer, who then turns it over to his attorney to set up an appointment to discuss the case.

2. Attorney meets with the appeals officer.
.
3. Most cases are settled at appeals level.

D. If IRS alleges tax is due, a 90-day letter is mailed to taxpayer. (§6212 & §6213)

1. Taxpayer has 90-days to file a petition with the U.S. Tax Court.

2. If petition is not filed within the 90-days, IRS may assess the tax and there is no recourse but to pay the deficiency. After payment, however, taxpayer can sue for refund. See court system chart below.

3 If petition is filed within the 90-days, the IRS cannot collect deficiency until after case is settled or Tax Court decides case.

4. Petition must be postmarked on or before 90-days from date issued, which is indicated on the 90-day letter. No extensions are possible.

E. General civil law statute of limitations: Three years from the time the tax return was due to be filed (generally April 15 of the following year) or, if filed late, when the return was filed (§6501).

1. The IRS must mail the 90-day letter certified or registered mail, and it must be post marked before the statute of limitations expires.

2. Three exceptions that toll the three-year general statute of limitations:

a. No return was filed.
b. Fraud (requires specific intent).
c. Signed written agreement to extend in Form 872.

3. A greater than 25% omission of income results in an extended 6-year statute of limitations (§6631).

F. Criminal statute of limitations is six years (§6531)

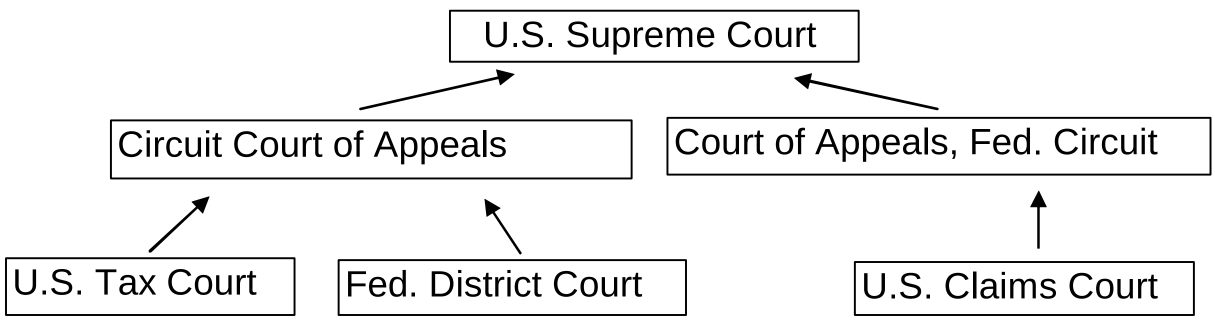
II. COURT SYSTEM

A. Taxpayer gets to choose one of three federal courts.

B. U.S. Tax Court: The amount in controversy (deficiency) does not have to be paid until case is settled or decided. Based in Washington, DC. Judges travel around the country, including Los Angeles. No jury trial is allowed; small claims procedure for cases $50,000 and under.

C. Federal District Courts: Must pay tax deficiency first. Refund cases. Jury trials allowed.

D. United States Claims Court: Based in Washington, DC. Refund cases. No jury trials.


U.S. Supreme Court
Circuit Court of Appeals
Court of Appeals, Fed. Circuit
U.S. Tax Court
Fed. District Court
U.S. Claims Court

III. BASIC TAX FORMULA (2018-2025)

+ Gross Income [§61]

- Exclusions [§101 - §151]
- Business deductions [§162] [1]
- Specified deductions [§62]

= Adjusted Gross Income ("AGI"):

Higher of:
- Itemized deductions, or
- Standard deduction ($12,000 single/ $24,000 married filing joint return)

= Taxable Income

- Credits (Income tax due may be reduced by low income child care credits [§24(h)] and others.

Gross Income [§61]

(Concepts and Limitations)

Gross income is income from whatever source derived (including but not limited to):

1. Compensation for services, including fees, commissions, fringe benefits, and similar items.
2. Gross income derived from business
3. Gains derived from dealings in property
4. Interest
5. Rents
6. Royalties
7. Dividends
8. Alimony, but not divorces effective after 2018
9. Annuities
10. Income from life insurance and endowment contracts
11. Pensions
12. Income from discharge of indebtedness
13. Distributive share of partnership gross income
14. Income in respect of a decedent
15. Income from an interest in an estate or trust

Definition of "Income"

1. Increase in wealth, and
2. In the case of property there must be a realization (sale or exchange of property or lucky find not integrally connected to a purchase)
3. Can take a variety of forms: cash, property, discounts, services, free use of property, and low or interest-free loans

Itemized Deductions [§161]

1. Medical (only in excess of 7.5% AGI) [§213]
2. State/local taxes up to $10,000 [164]
3. Interest [§163] [2]
4. Charitable [§170]
5. Limited others

Specified Deductions [§62]

1. IRA [§219]
2. Alimony, but not divorces effective after 2018
2. Loses from sales of capital assets ($3,000 maximum) [§1211]
3. Student loan interest [§221]
4. Others listed in §62

[1] Business losses subject to passive loss rules [§469]
[2] Subject to interest limitation rules [§163(d) & (h)]

IV. GROSS INCOME: CONCEPTS AND LIMITATIONS (§61)

A. *COMMISSIONER v. GLENSHAW GLASS CO.* Note: 1929 Code at issue and comparable, current §61 is somewhat different.

1. Taxpayer was awarded $800,000 in an anti-trust suit. $324,530 represented receipt of punitive damages for fraud and anti-trust violations. Taxpayer did not report this portion as income. The IRS determined a deficiency claiming that there was taxable income for the entire sum less only deductible legal fees.

2. Issue: Is money received as punitive two-thirds portion of a treble-damage anti-trust recovery gross income?

3. Rule: Except as otherwise provided, gross income means all income from whatever source derived. It does not matter how taxpayer received the increase in wealth. Windfalls are taxable.

B. *CESARINI v. UNITED STATES*

1. Taxpayers found $4,467 of U.S. old currency in a piano they purchased used for $15. Plaintiffs reported the $4,467 as part of their gross income and paid $837 income tax on it. Taxpayers sued for refund.

2. Issues:

   a. Is currency that is found in a purchased item of property included in gross income?
   b. When is the currency considered reduced to undisputed possession and thus income?

3. Rules:

   a. The finder of treasure-trove is in receipt of taxable income to the extent of its value in U.S. currency for the taxable year in which it is reduced to undisputed possession. Taxpayer did not find the money until 1964.
   b. Taxpayer has income in the year he acquires title under state law.

C. Windfalls: If property is already owned before it is discovered, such as oil under ground, then it is not taxable until sold. If property not already owned is found, then the fair market value is taxable at the time of discovery, such as the found money or a lost diamond ring found in a public parking lot. Under Article I, Section 9 of the U.S. Constitution Congress cannot constitutionally tax property you already own. This would be a property tax, and Congress cannot practically impose an ad valorem property tax due to the apportionment clause.

D. *OLD COLONY TRUST COMPANY v. COMMISSIONER*

1. Taxpayer is the estate of the deceased president of a company. The company had paid the president's income tax liability while he was employed.

2. Issue: Did payment of the employee's income tax constitute additional taxable income?

3. Rule: Discharge by a third person of taxpayer's legal obligation is equivalent to receipt of that amount by taxpayer. Income includes indirect economic benefits.

V. GIFTS, BEQUESTS, AND INHERITANCES

A. §102: Gifts and inheritances:

General Rule: Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

B. The threshold question under §102 is whether what is received can be characterized as a gift, bequest, devise, or inheritance. Pursuant to the next case, a gift in the statutory sense proceeds from a detached and disinterested generosity out of affection, respect, admiration, charity or like impulses. In this regard, the most critical consideration is the transferor's intent.

C. *COMMISSIONER v. DUBERSTEIN*

1. Taxpayer was given an auto by a business associate. The auto was given out of appreciation for customer referrals. Taxpayer did not ask for the auto and gave the referrals without expecting consideration. Taxpayer did not include the value of the auto in his income, believing that it was exempt as a gift.

2. Issue: Is an auto given in a business relationship and lacking a contractual obligation a gift under §102?

3. Rule: If the payment proceeds primarily from the incentive of anticipated benefit of an economic nature, it is not a gift for income tax purposes.

4. Holding and Reasoning: The court indicated that a voluntary transfer of property by one to another, without any contractual obligation, is not necessarily a gift within the meaning of the tax statute. A gift in the tax law statutory sense proceeds from a detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses. The most critical consideration is the transferor's intent. The trial court was warranted in concluding that, despite the characterization of the transfer of the auto by the parties and the absence of any obligation, it was really a recompense for taxpayer's past services and an inducement for referrals in the future. What result if Duberstein had retired and not be able to refer customers to Berman?

5. Gift factors:

   (a) No strings attached; goodness of heart
   (b) Family or other noncommercial relationship
   (c) No obligation to make the transfer
   (d) Made out of love and affection

6. Non-gift factors:

   (a) Strings attached; expecting something in return
   (b) Business associate or employee
   (c) Obligatory
   (d) Compensation for past or future services

D. WOLDER v. COMMISSIONER

1. An attorney, contracting with and performing lifetime legal services for a client, received bequest of cash and shares of stock in lieu of payment of fees during the client's lifetime. Attorney-taxpayer did not include this payment in income.

2. Issue: Are payments for services in the form of a bequest in a will taxable?

3. Holding and Reasoning: There is no dispute that the parties contracted for services and they were actually rendered. Thus, the provisions of the will satisfied her obligation under the contract. The contract was one for the postponed payment of legal services. A transfer in the form of a bequest was the method that the parties chose to compensate taxpayer for his legal services. Nevertheless, the transfer is subject to taxation.

4. Here there was a contract and exchange of services for payment. Tax law is not based on legal formalities of acquisition of title. What matters is the substance of what was truly intended by the parties.

VI. GAINS DERIVED FROM DEALINGS IN PROPERTY

A. Tax Basis (§1001) Taxable gain is amount realized minus (-) adjusted basis equals (=) taxable gain or loss:

Need to know how property was acquired to determine its basis;

Purchase: Basis is cost. (§1012)
Exchange: Basis is fair market value of property received in a taxable exchange.
Gift: Generally donor's basis (§1015)
Inheritance: Basis is generally fair market value at time of decedent's death. (§1014)
Lucky find: Taxable find: Basis is fair market value of property at time of discovery.
Nontaxable find: Basis is cost.

B. Co-ownership of property

1. Joint tenancy: Husband and wife basis = one-half at acquisition and one-half fair market value at death. (Example: $100,000 purchase cost and $500,000 on date of death value = $50,000 + $250,000 = $300,000. If sold for $500,000 then taxable gain would be $200,000). Under §2040 a special rule applies to joint tenancy property owned by persons other than a husband and wife.

2. Tenancy in Common: Basis = same as joint tenancy.

3. Community Property: Basis = entire fair market value at time of death. §1014(b)(6). Significant tax advantage for survivor because she receives a double step-up in basis. (Using above example: $500,000 selling price at death minus $500,000 basis = zero gain). Thus, no taxable gain if sold for $500,000.

VII. COMPENSATION FOR PERSONAL INJURY AND SICKNESS (§104(a))

A. Under §104(a)(1) gross income does not include:

1. Amounts received under worker's compensation acts as compensation for personal injuries or sickness, or

2. Amounts received through taxpayer paid accident or health insurance for personal injuries or sickness. Taxable, however, if the employer paid the cost of the insurance coverage and the benefits cover more than medical care costs.

B. Under §104(a)(2) gross income does not include personal physical injury or sickness damages.

Required elements:
Tort or tort-like cause of action
Personal physical injury or physical sickness
["Physical" requirement was added in the 1996 Tax Act]

1. Emotional distress by itself (e.g., insomnia, headaches, and stomach disorders) is not treated as a physical injury. However, reimbursement of medical expenses attributable to emotional distress is excludable.

2. If there is a physical injury or physical sickness, then <u>all</u> compensatory damages are excluded, including lost wages.

3. Punitive damages are always taxable, except in a very few states where only punitive damages may be awarded in wrongful death action. [1996 Tax Act]

C. *AMOS V. COMMISSIONER*

1. Taxpayer was a television camera operator who was kicked in the groin by Chicago Bulls basketball player Dennis Rodman during a game.

2. Issue 1: Is $200,000 settlement payment excludable under §104(a)(2) even though camera operator may have brought a bogus physical injury claim?

3. Holding and reasoning: The settlement was excludable even if the physical injury claim was possibly invalid. As long as a good faith claim is made, the validity and likelihood of success are not relevant.

4. Issue 2: Are damages received to not defame Rodman, keep settlement confidential, and not bring a criminal action excludable, if they are lumped together with physical injury damages?

5. Court arbitrarily determined that $80,000 was attributable to the nonphysical injury portion of the settlement. Thus, only the $120,000 portion was excludable under §104(a)(2).

D. *STADNYK v. COMMISSIONER*

1. Taxpayer was improperly arrested and jailed for allegedly passing an NSF check. Her bank mistakenly stamped "NSF" instead of "stop payment." Passing NSF checks is a crime in the state.

2. She was handcuffed, had to strip in front of police officer and made to wear a prisoner jump suit.

3. She sued bank for wrongful incarceration. She testified that she did not suffer physical harm but visited a psychiatrist for eight sessions. Mediation agreement required bank to pay her $49,000.

4. Court ruled cause of action was tortious conduct, but no physical injury proven. Court also rejected U.S. Constitutional argument that she should not be taxed for her lost human capital.

E. Legal fees incurred in connection with personal injury claims are –

1. Not deductible if recovery is exempt under §104(a)(2). (§265(a)(1))

2. Deductible if recovery is taxable as an employment discrimination or comparable claim. (§62(a)(20))

VIII. TAX CONSEQUENCES OF DIVORCE (§71)

A. The following alimony income tax law rules are applicable to divorce decrees executed before 2019.

1. To constitute taxable/deductible alimony, the payment must satisfy all of the following:

a. Must be in cash under a written contract. A payment in the form of property or services does not qualify as alimony.
b. Must be received by or on behalf of the spouse or former spouse. Thus, payments to a third party for the benefit of former spouse qualify as alimony.
c. Must be made under a divorce or separation instrument.
d. Must not be designated in the instrument as one that is excludable from the gross income of the recipient and nondeductible to the payer.
e. If the spouses are legally separated under a decree of divorce or separate maintenance, they must not be members of the same household at the time the payment is made.
f. The payer spouse must have no obligations to make payments for any period after the death of the payee spouse.

California Family Code §4337 provides that any spousal support type payments (if not stated otherwise) terminate on death of the payee spouse.

g. "Front Loading" is not allowed.

(1) Not front loading if there are at least three years of equal payments.

(2) If under $15,000 per year, then not front loading in any case.

2. Tax Consequences of Alimony before 2019:

a. Payer: Above the line deduction (§215).

b. Payee: Taxable income (§71)

c. If not alimony for tax purposes, then payment is not deductible and not taxable income. It is treated as a §1041 transfer between spouses.

B For divorce decrees executed after 2018, alimony is not taxable income to the payee and not deductible by the payer.

C. Property Transfers

§1041 provides that there is no gain or loss on a property transfer between spouses or incident to divorce. The transfer is treated as a gift for income tax purposes, with the transferee taking the transferor's basis.

D. Pre-nuptial Agreements

1. Typically used to contract out of the community property consequences so as to maintain separate property ownership after marriage.

2. If transfer of ownership under the pre-nuptial agreement occurs before the marriage, then it appears to be a taxable event because §1041 does not apply. Parties were not yet married.

3. To get around tax problem, the contract should provide that the transfer of property will occur after the parties are married. (§1041)

IX. DISCHARGE OF INDEBTEDNESS (§108)

A. General Rule: Included in income.

B. Exception and Not Taxable: If discharge is on account of the taxpayer declaring bankruptcy.

C. Discharged student loans are not taxable, if the student works for a public service organization for a minimum period of time.

D. Unpaid taxes are discharged in bankruptcy, if taxes are more than three years in arrears at time of bankruptcy filing, no fraud involved, and IRS did not have a prior perfected lien on taxpayer's property.

X. FRINGE BENEFITS

A. §132: Six categories of excludable benefits:

1. No-additional-cost service -- §132(b):

a. The service must be one offered for sale to customers in the ordinary course of business.
b. The service must be in the line of business that the employee is working for.
c. The employer incurs no substantial additional cost.
d. No discrimination in favor of highly compensated employees.
e. Example: Free airline ticket if employee goes standby.

2. Qualified employee discount -- §132(c):
a. Services limited to 20% of the price at which the services are being offered by the employer to customers.
b. Property limited to the gross profit percentage. Generally, not less than the purchase cost of goods to the employer.

3. Working condition fringe -- §132(d):
If the employee is able to deduct if she paid the expense herself, then qualifies here.

4. De minimis fringe -- §132(e):

a. Non-cash benefit is so small that to keep track of it would be administratively impracticable.
b. Example: coffee, copies, turkey at holiday season.

5. Qualified transportation fringe -- §132(f):
Parking on company premises, car pooling, transit pass, etc.

XI. EXCLUSION OF GAIN ON SALE OF PRINCIPAL RESIDENCE (§121)

A. Taxpayer can exclude up to $250,000 ($500,000 for a married couple) of gain realized on the sale of a principal residence.

B. Requirements:

a. The taxpayer must have owned and used the residence for at least two out of the five years before the sale, and
b. The exclusion must not have been previously claimed within two years preceding the sale.

C. Special rules in §121(d) are applicable to deceased and divorced spouses.

a. A taxpayer who receives property from a deceased spouse is treated as owning and using the property for the period the deceased spouse owned and used the property before death.
b. The full $500,000 exclusion applies if the surviving spouse sells her home within two years after death of predeceased spouse.
c. A taxpayer who obtains property from a spouse or former spouse by gift or in a divorce is treated as owning the property for the period the transferor spouse owned the property.
d. A taxpayer whose spouse or former spouse is granted sole use of the property pursuant to divorce is treated as using the property, if the occupying spouse so uses the property.

XII. ASSIGNMENT OF INCOME

A. The Progressive Rate Structure
Since the income tax rates increase based on income levels, there is a tax advantage in shifting income from a higher-bracket taxpayer to a lower-bracket taxpayer, such as a child.

B. Accelerating Income:

If income will be taxed at a higher rate in subsequent years, there is an incentive to find a way to accelerate future income into the present tax period or vice versa.

C. Who is subject to tax?

1. Income from services is taxed to the taxpayer who performs the services. No assignment will be effective to deflect that income to someone else.
2. Income from property is taxed to the owner of the property. But watch for assignments of gain on a sale of property as in *Salvatore.*

D. Cases

1. *LUCAS v. EARL*

    a. Taxpayer entered into a valid contract with his wife to the effect that income earned, or property received by either shall be held and owned as joint tenants.
    b. Issue: Should the taxpayer pay tax on his entire earnings?
    c. Rule: Income is taxed to the person who earns it. No assignment, however skillfully drafted, will be effective.
    d. Note:
        (1) A valid contract to avoid probate.
        (2) Contract assignment was enforceable by Mrs. Earl against her husband or his employer, if notice was given to employer.

2. *STRANAHAN v. COMMISSIONER*

    a. Taxpayer, to accelerate his income, assigned to his son anticipated cash dividends from common stock. He did this because his income that year was not high enough to fully absorb his interest deduction.

b. Issue: In which year is father taxable?

c. Rule:

(1) A cash basis taxpayer ordinarily includes income in the year of receipt, rather than the year when earned.

(2) A taxpayer who assigns the right to future income for consideration in a bona fide commercial transaction will ordinarily realize income in the year of receipt.

(3) A taxpayer is free to arrange his financial affairs to minimize his tax liability, provided the transaction had economic substance.

3. *SALVATORE v. COMMISSIONER*

a. Taxpayer-mother inherited ownership of a gas service station from her husband. Mother's three sons and daughter operated the station. Mother on July 24 accepted Texaco's oral offer to buy the station by executing an agreement to sell to Texaco. On August 28 mother transferred by deed ownership of a one-half interest in the station to her five children. Mother and children reported their gain on the sale in accord with their respective ownership shares. IRS challenged and alleged that mother was responsible for the income tax on the entire gain.

b. Was mother's transfer to the children effective for income tax purposes?

c. Taxpayer was taxable on entire gain, because she held full ownership on the date of sale to Texaco. The title transfer to the children came too late. Court applied the substance over form doctrine.

E. Congress codified the economic substance doctrine in §7701(o).

F. Kiddie tax (§1(g))

1. Applies to any child under age 18 and to full-time students ages 18-23.

2. Applies to unearned income such as interest and dividends received in excess of a base amount.

3. Regular standard deduction in excess of a base amount and personal exemption allowance do not apply to child's unearned income.
4. Unearned income over the base amount is taxed to child at the highly progressive rate structure applicable to estate and trusts. Highest 37% rate kicks in currently at over $12,500 of unearned income.
5. Does not apply if both parents are deceased.

G. Uniform Trust for Minors Act ("UTMA")

Custodial account for minor under which the minor cannot withdraw money from the account until he reaches majority. The custodian (usually a parent) manages the account. Earnings on the account (interest, dividends, etc.) are taxed to the child.

H. "Totten" trust bank account

1. The parent solely owns typical bank account.
2. When the parent dies, the account passes to the child or other person named as the beneficiary.
3. Child has no rights while the parent is alive, and parent can revoke account and change beneficiary.
4. Parent responsible for income tax on the account.
5. Does not shift income.
6. Does avoid probate.

XIII. BUSINESS AND PROFIT SEEKING EXPENSES (§162)

A. Expense v. capital outlay

1. Expense: Benefit to the business within one-year period.

2. Capital: Benefit to the business goes beyond one year.

3. Post-1993: Amortization (deduction) of goodwill and most other purchased intangibles is deductible over 15-year period. (§197)

B. Business deductions (§162)

1. Requirements

a. Expense
b. Ordinary
c. Necessary
d. Paid or incurred during the taxable year
e. Paid or incurred in carrying on a trade or business, and
f. No deduction for illegal bribes, fines, etc.

2. Ordinary

a. A cost that would be customary or expected in the life of a business. Not limited to something that everyone does in the same business. If it is appropriate and helpful, it will generally be ordinary.
b. There are rare cases where the IRS has been successful on the "ordinary" issue.

3. Necessary

a. Means appropriate and helpful.
b. There must be a causal connection between the expense and the business.
c. The IRS must be slow to override the judgment of the taxpayer as to what is necessary.

C. Cases

1. *WELCH v. HELVERING*

a. Taxpayer paid off the bankruptcy debts of his former employer to establish good business relations with his customers.
b. Issue: Was the payment of the debts of another an ordinary and necessary expense of the business?
c. Rule: Necessary means "appropriate and helpful." Here there was a causal relationship between expense and business. Problem, however, was the capital nature of outlay.

2. *MIDLAND EMPIRE PACKING COMPANY v. COMMISSIONER*

a. Taxpayer added a concrete lining in the basement of its meat packing plant to oil proof it against seepage caused by a neighboring refinery.
b. Issue: Is this a repair and deductible as an ordinary and necessary expense or is it a capital outlay?
c. Rule: A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. This is distinguishable from replacements, alterations, improvements, or additions, which appreciably prolong the life of the property, significantly increase its value, or make it adaptable to a different use.
d. Holding and Reasoning: The expenditure did not add significantly to the value or prolong the expected life of the property over what it was before the nuisance occurred. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit taxpayer to continue the use of the plant, and particularly the basement, in its normal operating condition.

3. *MT. MORRIS DRIVE-IN THEATRE CO. V. COMMISSIONER*

a. Taxpayer purchased farm land and proceeded to construct a drive-in outdoor theatre. The adjacent property owner complained that the altered slope of the land caused an acceleration and concentration of the flow of rain water.
b. The neighbor sued for damages. The taxpayer settled by agreeing to construct a diversion drainage system to remedy the problem.
c. Taxpayer claimed that it could deduct the entire $8,224 cost of the drainage system.
d. Issue: Is the drainage system cost a repair or capital outlay?
e. Court held that the taxpayer knew when the property was purchased that the drainage system was inadequate. The taxpayer's overall investment was incomplete until the drainage system was installed. It was not merely the repair of an existing faulty system. But was it?

f. Note the strong dissenting opinion.
g. Contrast this decision with *Midland Empire*.

IV. CAPITAL EXPENDITURES (§263)

A. Costs related to the acquisition of property:

1. Purchase price, including delivery charge and sales tax

2. Defending or perfecting title

3. Making asset suitable for its intended use, or

4. Other costs associated with acquiring an asset

B. Outlays for the permanent improvement or betterment of existing property:

1. Add substantially to the value of existing property

2. Appreciably prolong its useful life, or

3. Adapt property to a new or different use

C. Depreciation on buildings and improvements, but not land (§167 & 168)

1. Residential rental realty = 27.5 years straight line

2. All other commercial realty = 39 years straight line

3. Personalty - - MACRS generally applies

a. Generally based on the declining balance method
b. 5-years for office machines (computers, copiers, and printers) and autos
c. 7-years for office furniture and fixtures (desks, filing cabinets, etc.)

4. Important election allowed to expense §179 depreciable non-real and qualified improvement real property business assets.

Businesses can deduct the entire cost of depreciable non-real property purchases in the year placed in service subject to $1,000,000/$2,500,000 limits as adjusted.

D. Incidental repairs and maintenance. Exception to the general rule of having to capitalize any benefit to the business exceeding one year:

1. Repair is intended to keep a capital asset in good operating condition. It is not a capital outlay under part B above.

2. Thus, entire cost is deductible in the year incurred. See *Midland Empire* case above.

XV. QUALIFIED BUSINESS INCOME DEDUCTION (2018-2025)

A. Twenty percent (20%) deduction allowed below AGI of a taxpayer's qualified business income (QBI).

B. QBI includes income only from a U.S. trade or business.

C. QBI is generally taxable income from a partnership, S corporation, or sole proprietorship.

D. The deduction is phased out for taxpayers in service related businesses, such as healthcare, law, accounting, actuarial science, performing artists, consulting, athletics, financial services, brokerage services, or where the business is the reputation or skill of the service providers. The phase out applies if taxable income exceeds $157,500 if single and $315,000 if married filing a joint return.

E. There is a further phase out for all taxpayers if taxable income exceeds $207,500 if single and $415.000 if married filing a joint return.

XVI. DEDUCTION LIMITATIONS ON TAX SHELTERS

A. Passive Activities

1. A passive activity involves the conduct of any trade or business in which the taxpayer does not materially participate. §469(c)(1). Deductions of net passive losses are restricted.
2. Reference to a "trade or business" includes those activities involving the conduct of a trade or business within the meaning of §162 and not §212 personal investment activities.

3. Material Participation

   a. To be material, taxpayer's participation must be regular, continuous, and substantial.
   b. Per Treasury Regulation (§1.469), more than 500 hours per year involvement in the business constitutes material participation.
   c. Generally a limited partner does not materially participate with respect to his interest in the limited partnership.
   d. A limited liability company member can be a material participant if the general tests are met.

4. Rental Activities

   a. Regardless of whether the taxpayer is a material participant, a rental activity without substantial services, such as a motel, is a passive activity subject to §469. See §469(c)(2).
   b. Rental activity is any activity where payments are principally for the use of tangible property. See §469(j)(8).
   c. Exception for real estate professional whereby it is not a treated as a passive activity:
      (1) If more than one-half of the personal services the taxpayer performs in all her trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and
      (2) The taxpayer performs more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates.

d. Exception for a 10% or higher owner (other than a limited partner) who actively participates in rental real estate. If a taxpayer actively participates in rental real estate activities, the taxpayer may offset the net losses from all rental real estate against up to $25,000 of the taxpayer's non-passive income. A husband and wife who file a joint return are subject to an overall $25,000 cap. See §469(i)(1)(2). The relief is phased out for taxpayers with adjusted gross income over $100,000. See §469(i)(1)(3)(A). Active participation requirement is relativity easy to satisfy and generally requires merely hiring a property manager.

B. Treatment of losses

The net losses from a passive activity are first offset against overall net profits from other passive activities in the same year. Any excess is carried over to subsequent years for the life of the taxpayer.

C. Disposition of taxpayer's entire interest in passive activity

If a taxpayer disposes of her entire interest in a passive activity, any suspended losses allocable to that activity (as well as any loss realized on the disposition of a passive activity) are no longer treated as passive activity losses. Instead, they are deductible against non-passive income as set forth in §469(g)(1)(A).

PASSIVE LOSS FLOWCHART

Code § 469

Passive

Rental Real Estate

§ 469(c)(7)

Non-Passive

Material participation > 500 hours per year

Loss is fully deductible against all other income

Loss is deductible only against other passive income in same year. Unused loss has to be carried over to subsequent years. See §469(a)	Non-real estate professional who owns at least 10% and actively participates***** is allowed an annual $25,000 maximum deduction against other income subject to phase-out based on modified AGI above $100,000. See §469(i)	Real estate professional who satisfies > 50% overall and 750 + hours per year tests may elect to aggregate multiple rental real estate properties in satisfying the material participation test. See §469(b)(7)

***** The requirement that a taxpayer "actively participate" is relatively easy to satisfy and generally requires meeting with prospective tenants or merely hiring a property manager to manage the property.

XVII. INTEREST EXPENSE LIMITATIONS (§163(h))

A. Determine why taxpayer incurred the interest expense

1. If trade or business of taxpayer with material participation, fully deductible under §162.

2. Qualified principal home and one second home:

   (a) Fully deductible up to an overall cap of $750,000 in secured loans on principal and one second home.
   (b) Only allowed for properly secured loans. If loan is not secured (e.g. informal loan from parents), then interest on that loan is not deductible.

3. No deduction for interest on consumer debt (e.g. personal autos, credit cards and tax deficiencies

4. Investment portfolio related profit-making activities without customers (e.g. margin account and vacant land) are not subject to passive loss rules (§212 type). Interest is deductible only to extent of net investment income with lifetime carry over.

5. Interest expense of a passive loss activity is subject to passive loss limitation rules. Interest expense is treated the same as any other expense of the business.

INTEREST EXPENSE LIMITATIONS
Code §163

REASON DEBT WAS INCURRED	DEDUCTIBILITY RULE
Trade or business of taxpayer with material participation	Fully deductible as any other business expense
Qualified principal and one second home	Fully deductible up to $750,000 of debt[1]
Consumer (e.g., personal autos, credit cards, tax deficiencies)	No deduction allowed[2]
Investment portfolio related interest (e.g., margin account and vacant land) not subject to passive loss rules	Deductible only to extent of net investment income with carry-over of any nondeductible interest
Passive loss activity	Interest expense is treated as any other expense of a passive activity, subject to passive loss limitation rules

[1] Qualified residence interest is deductible only to the extent that the total secured debt does not exceed "acquisition debt" incurred in acquiring, constructing, or substantially improving any qualified residence. Any interest paid in excess of the debt caps is treated as non-deductible consumer debt. §163(h)(3)

[2] Educational loan interest up to $2,500 per year may be deductible under §221, provided AGI does not exceed phase out amount. Interest paid on the unpaid portion of wealth transfer taxes may be deductible under §6601.

XVIII. CAPITAL GAINS AND LOSSES (§1211)

A. Code provides favorable lower rates on most long-term capital gain and qualified dividends.

Adjusted Net Capital Gain	Favorable Rate
Joint return amounts:	
Up to 77,200	Zero
Over $77,200 to $452,400	15%
Over $452,400	20% plus 3.8% Health Care Act add on tax

B. The above favorable rates apply to the sale of a capital asset owned more than one year and on qualified cash dividends on corporate stock.

C. Types of capital gain or loss property (§1201)

1. Sale or exchange of property

   a. §212 type investments: Gain or loss on the sale of an asset held for investment purposes (i.e. stocks, bonds, and land held for investment)
   b. Goodwill of business and patents

2. Trade or business (§162 type)

   a. Depreciable property used in a business. Capital gain if sold at a gain, and ordinary loss if sold at a loss. (§1231)
   b. Depreciation taken on §1250 real property must be "recaptured" on sale at a special higher rate of 25%.

3. Personal used assets (§262 types) (i.e., personal home, auto, clothes): Capital gain if sold at gain, but no tax benefit if sold at loss.

D. There is an overall $3,000 cap per year on net capital losses against ordinary income with a lifetime carryover to subsequent years. Losses carried forward can be applied against capital gains in subsequent years plus a $3,000 offset against ordinary income.

TYPES OF INCOME
ORDINARY v. CAPITAL GAIN OR LOSS
Code § 1221

TYPE OF INCOME	**INCOME TAX TREATMENT**
Salary and interest received	Ordinary income
Business profit or loss: Performance of services Sale of inventory Sale of intellectual property (other than a patent or musical composition) by its creator or donee of the creator	Ordinary income or loss[1]
Dividend on corporate stock[2] Sale or exchange of investment property: Stocks, bonds, and land held for investment Goodwill of a business Patent and a musical work sold by its creator	Capital gain Capital gain or loss
Property used in a trade or business (§162) Business property which can be depreciated (§1231) Subject to depreciation recapture under §1250	Capital gain or loss Capital gain or ordinary loss if sold at loss
Personal used asset (§262 type)	Capital gain[3] if sold at a gain No tax benefit if sold at a loss

[1] Subject to passive loss limitation rules
[2] Qualified dividends taxed at long-term capital gain rate.
[3] Primary residence capital gain is subject to §121 exclusion.

IX. LIKE-KIND EXCHANGES (§1031)

A. Exchanges of real property held for productive use in business (but not if held primarily for sale) or for investment purposes qualify for tax deferred treatment. No longer applicable to personalty after 2017.

B. Gains and losses from exchanges of like-kind assets are deferred

C. "Like-kind" generally means any type of business or investment real property exchanged for any other kind of business or investment real property.

D. For delayed exchanges, taxpayer has 45 days to locate replacement property and 180 days to close on the replacement property after the date of closing of the sale of the relinquished property.

E. *DECLEENE v. COMMISSIONER*

   a. Taxpayer owned and operated a trucking repair business on improved real property (McDonald Street) in Green Bay, Wisconsin.
   b. To expand his business, taxpayer acquired by purchase unimproved real property (Lawrence Drive) on which a new building for his business would be constructed.
   c. Taxpayer found a buyer for the McDonald Street property. To facilitate a §1031 reverse exchange, the taxpayer convinced the buyer to formally purchase the Lawrence Drive property from him and then exchange it with taxpayer for the McDonald Street property.
   d. The IRS challenged the reverse exchange because taxpayer did not use a third-party exchange facilitator as required by the IRS regulations.
   e. The court ruled against the taxpayer because he first purchased the Lawrence Drive replacement property a year or more before he was ready to relinquish the McDonald Street property. The court ruled that a taxpayer cannot engage in an exchange with himself. A tax-deferred §1031 exchange requires "a reciprocal transfer of property, as distinguished from a transfer for a money consideration." The buyer of the "exchanged" property did not have beneficial ownership of the replacement property.
   f. What should the taxpayer have done differently to qualify the transactions as a tax-deferred §1031 exchange?

XX. OVERALL DEDUCTION ANALYSIS

A. Step One: Classify the deduction:

1. §162: Business: Taxpayer has clientele and sells a product or service.

   a. General rule: Above the line ("AGI") deduction.
   b. But not deductible are illegal bribes, lobbying expenses, fines, and penalties, such as penalties for EPA violations.

2. §262: Personal:

   a. General rule: no deduction
   b. Exception for itemized deductions
      (1) Medical in excess of 7.5% of AGI.
      (2) Taxes [Up to an overall maximum of $10,000 starting in 2018.]

         (a) State and local income taxes, including California SDI are deductible.
         (b) State sales and use taxes are deductible in lieu of state and local income taxes for taxpayers.
         (c) State and local real and personal property taxes are deductible.

      (3) Interest is deductible subject to interest expense limitations described above.
      Prepaid interest is not deductible pursuant to §461(g). Exception for points on a home mortgage. Applies only to loan origination fees on a principal residence secured loan to buy or improve the home. §461(g)(2)

      (4) Charitable contributions
         (a) 50% of AGI maximum per year is general rule for cash contributions.
         (b) Entire fair market value of the property is deductible, and there is no taxable income on the appreciation to the taxpayer.

B. Step Two: Determine if payment is an expense or capital outlay

1. Capital: Benefit to the business exceeds one year. Then entire cost is not currently deductible unless repair or maintenance. Look to applicable depreciation rules if tangible asset and §197 if intangible asset.

2. Expense: Must be ordinary and necessary and meet other requirements under §162. Then entire amount is currently deductible.