Capsule Summary

I. IS IT INCOME?

A. CONSTITUTIONAL BACKGROUND

1. Constitutional Provisions

The Constitution provides that Congress has the power to tax; however, direct taxes must be apportioned, and historically this precluded the federal income tax.

2. Sixteenth Amendment

This amendment gives Congress the power to tax income, from whatever source derived, without apportionment.

3. *Eisner v. Macomber*

The Supreme Court held that a tax on stock dividends was unconstitutional because there had been no "realization." No other recent Supreme Court cases have invalidated an income tax as violative of the Constitution.

4. Remaining Constitutional Issues

a. ***Unreasonable or arbitrary taxes may violate due process;***

b. ***Tax not on income*** cannot be sustained under the Sixteenth Amendment but may be upheld as an indirect tax (where no apportionment is required);

c. ***Tax procedures*** might invalidate Fourth and Fifth Amendment rights.

B. DEFINITION OF "GROSS INCOME"

1. I.R.C. Definition

Section 61 defines gross income as "***all income*** from whatever source derived."

2. Early Attempts to Define Income

Gross income is something "derived from capital, from labor, or from both combined. . . ." Today this concept has been abandoned.

3. Net Worth Concept

Any item that increases a taxpayer's net worth (*i.e.*, difference between assets and liabilities) is gross income. This is the prevailing definition.

a. Change in Form

There is ***no income*** from a mere change in form (*e.g.*, repayment of a loan, return of invested capital), from borrowing money, or from receiving money as a trustee. The receipt must increase net worth to be considered income.

b. "Income" That Is Not Cash

Income need not be received in cash to be taxable. The receipt of property or services is frequently treated as taxable income.

c. Windfalls

Windfalls (*e.g.*, winning the lottery or finding money) are taxable.

d. **Unsolicited Property**

Unsolicited property is not taxable until the taxpayer indicates an intent to retain it (*e.g.*, by donating and claiming a charitable deduction).

e. **All-Inclusive Definition**

Any increment in net worth is presumed income unless: (i) it is specifically excluded by the Code, or (ii) it falls within a nonrecognition provision. Note that taxation depends on ***realization***.

4. **Imputed Income**

Imputed income arises when a taxpayer ***works for himself or uses his own property*** (*e.g.*, housekeeping services done for one's own family). This type of income has never been taxed.

a. **Working for Oneself**

If one renders services to himself and ***an employment relationship is also involved***, that benefit is held to be gross income. And ***interest income*** often must be imputed.

b. **Exchange of Services**

If two taxpayers exchange goods or services, ***both*** have gross income, unless an exclusion applies.

C. EXCLUSIONS FROM GROSS INCOME

1. **Gifts and Inheritances**

Gross income does not include the value of property received by gift, devise, bequest, or inheritance.

a. **What Is a "Gift"?**

The donor's ***motive*** must have been one of ***"detached and disinterested generosity."*** If there are mixed motives, the "primary" motive controls. The concept of a "gift" is narrowly construed for income tax purposes.

b. **Gift vs. Compensation**

A problem arises when a payment is made without a legal obligation to one who has rendered services to the payor. The donor's primary motivation will determine the taxability. Payments by employer to employee are not gifts.

(1) **Deduction by Donor**

An attempted deduction does not rule out a gift.

(2) **Death Made Benefits**

Payments made by an employer "on behalf of" an employee are not considered gifts. Whether or not death benefits qualify as these types of payments has not been determined.

(3) **Gratuities**

Tips and gratuities are ***not gifts***, nor in most cases are ***strike benefits*** paid by a union.

(4) **Gifts to Spouses**

Transfers to spouses are not taxable as income, even if they were not intended as gifts.

(5) **Bargain Purchases**

When property is sold for less than fair value, the excess value may be a gift depending on the seller's motive. However, bargain purchases by an employee from an employer generally produce income to the employee.

c. **What Is "Inheritance"?**

Any payment "referable" to an inheritance is excluded (*e.g.*, money received in settlement of a will contest). However, bequests to employees are taxable as income, as are bequests to executors that are intended as a substitute for their fees.

d. **Income Derived from Gifts**

Although the property transferred is a gift, all income derived from the gift is taxable to the donee. All money received from a gift of future income is taxable to the donee.

2. **Awards and Scholarships**

a. **Prizes and Awards**

Prizes and awards are ***included in gross income***.

b. **Scholarships and Fellowships**

A scholarship or fellowship is taxable unless it must be applied to tuition or books ("qualified scholarship").

3. **Contributions to Capital**

Amounts received by partnerships and corporations as capital contributions are not taxable. Government inducements and amounts contributed by customers, however, are taxable.

4. **Life Insurance**

Amounts paid by reason of the ***insured's death*** are excluded.

a. **"Life Insurance" Defined**

A "life insurance" contract ***shifts the risk*** of premature death to the insurance company.

(1) **Employer-Paid Benefits**

Death benefits paid by an employer are taxable.

(2) **Debtor's Insurance**

When a creditor takes out insurance on the life of a debtor, the amount received by the creditor is ***not excludible*** life insurance. This money is treated as payment of a debt.

(3) **Accelerated Death Benefits**

Life insurance amounts payable before death to a terminally or chronically ill individual are treated as if paid by reason of death.

b. **Premium Payments**

An exclusion is generally available to a recipient of insurance proceeds, ***regardless of who paid*** the premiums.

c. **Purchasers of Existing Policies**

Purchasers of existing policies do ***not*** qualify for the life insurance exclusion, unless the purchaser is the insured, his partner or partnership, or a corporation in which the insured is a shareholder or officer.

d. Installment Payments

Benefits payable in installments are taxed to the extent that they represent ***interest*** on the unpaid balance.

5. Annuities

The portion of an annuity payment that represents the ***taxpayer's investment*** in the policy is exempt as a return of capital. The excluded portion is computed by dividing the consideration paid for the policy by the total expected return.

a. Employees' Annuity Plans

Annuity rules apply to amounts received from employee pension plans. If the employee has a nonforfeitable right to the policy, she is taxed on the purchase price when the employer purchases it. However, tax on ***qualified pension or profit-sharing plans*** is ***deferred*** until payments are made.

6. Interest on State and Local Bonds

Interest on state and local bonds is ***excluded*** from the income tax; however, interest received on ***federal*** obligations (*e.g.,* treasury bonds or notes) is ***included***.

7. Government Benefits

a. Social Security Benefits

A portion of Social Security benefits (old age and disability) is included in income if the taxpayer's ***modified*** adjusted gross income plus 50% of his Social Security benefits exceed $25,000 ($32,000 on a joint return). A greater portion is included in income if this sum exceeds $34,000 ($44,000 on a joint return). However, Supplemental Security Income ("SSI") payments are nontaxable.

b. Welfare Benefits

Government benefits based on need (*e.g.,* welfare) are ***excluded*** from income—even payments for government work required of welfare recipients.

c. Unemployment Compensation

These payments are taxable.

8. Medical Insurance and Private Disability Payments

a. Medical Insurance—Employee-Paid Premiums

When the employee paid for medical or disability insurance, any benefit payments received under the policy are excluded from income. However, if the employee ***deducted*** the medical expenses and then was ***reimbursed*** for them, these reimbursements must be included in income.

b. Employer-Paid Premiums

If the employer pays for health and accident insurance for its employees, the employees are ***not*** taxed on the premiums. Nor are they taxed on direct payments of medical expenses by the employer if the payments are made pursuant to a nondiscriminatory plan. All other ***disability*** payments are included in income.

9. Damage Payments

a. Payments for Personal Injuries

Under the Code, damages received, in lump sum or periodic payments, as a result of a judgment or settlement on account of personal physical injuries or physical sickness are ***excluded***. Punitive damages are not excluded.

(1) Scope of Exclusion

Damages for ***emotional distress alone*** are income unless a physical injury was also involved. Damages for ***illegal discrimination*** are also taxable.

(2) Attorneys' Fees, Costs, and Taxable Tort Recoveries

Since the taxpayer owns the tort claim, attorneys' costs and fees must be included in income and then claimed as a deduction.

b. Damages for Business Injuries

(1) ***The recovery for damage to goodwill*** was originally held excludible, but it was later held taxable to the extent that it exceeds the basis of the goodwill.

(2) ***Damages for lost profits*** are income.

(3) ***The Code partially excludes damages for*** patent infringement, breach of contract, breach of fiduciary duty, and antitrust violations. The amount excludible is the compensatory amount or the unrecovered losses, whichever is less. (The effect is an exclusion if there was no benefit from the prior losses.)

10. Meals and Lodging Furnished for Convenience of Employer

The value of meals and lodging received by an employee and his family is ***excluded*** from gross income if the meals and lodging are furnished on the employer's business premises and, in the case of lodging, is accepted as a condition of employment.

a. Convenience of Employer

Under the Regulations, the "convenience of the employer" requires a ***"substantial noncompensatory business reason."*** However, a recent Supreme Court case indicates a narrower ***"business necessity" test***.

b. Campus Lodging

The value of "qualified campus lodging" received by an employee of an educational institution is ***excluded*** from gross income if it is located on or near the campus and the employee pays "adequate rent."

c. Fixed Charges for Meals

An employee can ***exclude*** fixed charges for meals furnished for the convenience of the employer; however, she ***cannot exclude cash reimbursements*** for meals and lodging paid for by the employer.

11. Fringe Benefits

Fringe benefits are generally taxable, but employees may exclude "no additional cost" services, qualified employee discounts, working condition fringes (*e.g.*, car provided for business use), qualified transportation fringes (*e.g.*, vanpool), de minimis fringes (*e.g.*, on-premises gym), qualified moving expense reimbursement (*e.g.*, expenses employee would have been allowed to deduct if paid herself), qualified retirement advice (if the employer has a qualified retirement plan), and group term life insurance premiums (up to $50,000). "Employee" includes an employee's spouse and dependent children, and also a retired or disabled former employee.

12. Miscellaneous Other Exclusions

a. Foreign Earned Income

Taxpayers working abroad may exclude up to $101,300 of their service income from a foreign source.

b. Frequent Flier Miles

The value of frequent flier miles earned by an employee for a business trip is ***excluded***, even if the employee subsequently applies the miles toward a personal trip. However, if the miles are turned into cash, it is taxable.

c. Lessee's Improvements

Lessee's improvements on leased property are ***not*** income to the landlord unless they are intended as ***substitutes for rent***.

d. Insurance Reimbursements for Above-Normal Living Expenses

Expenses resulting from fire, storm, or other casualty losses to a ***taxpayer's home*** are excludible.

e. Investment Interest—Higher Education

Income from redemption of savings bonds, purchased after 1989 by a taxpayer at least 24 years old that is used for higher education purposes is excluded. The exclusion starts to phase out as AGI exceeds $116,300 ($77,550 for singles) and is completely phased out when AGI reaches $146,300 ($92,550 for singles).

f. Compensation for Holocaust Victims

Excluded compensation includes direct payments, returned assets, and certain interest payments from funds arising from Holocaust litigation.

g. Other Items

A minister's rental allowance, payments to foster parents, and combat and mustering-out pay to those in the service are excluded.

D. INCLUSIONS IN GROSS INCOME

1. Compensation for Services Rendered

Irrespective of the form of the payments, compensation for services rendered is includible in gross income.

a. Payment of Employee's Income Taxes

The payment of an employee's income taxes or debts by an employer increases the employee's taxable income.

b. Reimbursements or Expense Payments by Employer

Reimbursement for ***travel, meals, and entertainment*** costs is not income if the employee is primarily engaged in the employer's business and the reimbursement is made pursuant to an accountable plan.

2. Income from Cancellation of Indebtedness

Unless within an exception (below), or unless the taxpayer had no net economic benefit, cancellation of debts is treated as income.

a. Exception as to Insolvent Taxpayers

No income exists to the extent that a debtor is insolvent before the debt cancellation (including discharge in bankruptcy). Note that other tax benefits are correspondingly reduced.

b. Exception for Qualified Real Property Business Indebtedness

A taxpayer can elect to exclude debt cancellation from income where the debt is secured by real property used in a trade or business.

c. Exception for Deductible Payments

Income is not recognized on cancellation of a debt to the extent that payment of the debt would have given rise to a deduction.

d. Cancellation as a "Gift"

If the cancellation is a gift to the debtor, there is no income. There is rarely a gift motive unless there is a personal or family relationship.

e. Student Loans

A student loan made by the government, a charitable hospital, or an educational institution that has been forgiven because the borrower has met certain conditions (*e.g.,* worked in certain areas or for certain employers), does not give rise to income.

f. Shareholder Debt Forgiveness

If a shareholder cancels a debt owed her by the corporation (either in exchange for stock or as a contribution to capital), the cancellation is treated as giving cash to the shareholder, and the corporation will also have debt cancellation income.

g. Reduction in Purchase Money Debt

A reduction in purchase money debt by the ***seller*** is treated as a reduction in the basis, not as debt cancellation income.

h. Settlement of Disputed Claim

A compromise of a disputed claim does ***not*** produce income.

3. Illegal Increases in Net Worth

Money or property received through illegal activities is ***included*** in gross income irrespective of a promise to repay (*e.g.*, extortion money or embezzled money is included).

4. Gambling Winnings

Gambling winnings are included in gross income. Gambling losses are deductible to the extent of the winnings.

5. Spousal and Child Support Payments

Payments by a separated or divorced spouse to the other spouse are **neither taxable to the recipient nor deductible by the payor**.

E. TAX-EXEMPT ORGANIZATIONS

1. Charitable Organizations

To qualify, an organization must be organized and operated for religious, charitable, scientific, educational, etc., purposes; it must be nonprofit; no substantial part of its activities can include attempts to influence legislation. Contributions to such organizations are deductible.

a. Other Tax-Exempt Organizations

Organizations such as unions, fraternities, civic leagues, etc., are exempt but contributions to them are ***not*** deductible.

b. Discrimination Disqualifies Organization

Organizations engaging in racial discrimination are not tax-exempt.

2. Unrelated Business Income

Income from an activity substantially different from the nonprofit, charitable purpose is ***not exempt***.

a. Rental Income

Rental income from ***real property*** is exempt; however, rental income from personal property is not.

b. Debt-Financed Property

Investment income is taxed if the property involved was acquired with borrowed funds (unless the property is used solely for the purposes substantially related to the organization's charitable purposes).

3. Private Foundations

Foundations are subject to special restrictions; in any event, a blanket 2% tax is imposed on net investment income.

4. Political Organizations

These organizations are taxed like corporations on ***investment*** income, but they are not taxed on ***"exempt function income."***

II. TO WHOM IS THE INCOME TAXABLE?

A. INCOME SPLITTING BY GIFTS

1. Gifts of Income vs. Gifts of Income-Producing Property

Income remains taxable to the ***donor*** if she retains ownership of the property to which she has transferred income.

a. Transfers of Property

When the donor transfers income-producing property, income from the property is taxed to the donee. However, income accrued prior to the transfer is taxed to the donor. (Transfers of income-producing property are subject to gift tax.)

b. Sham Transfers

A transfer lacking donative intent, delivery, and acceptance does ***not*** shift the income to the donee; nor will a transfer be effective if the donor retains ***excessive controls***.

c. Transferring Income While Retaining Property

Generally, if a donor transfers income from property while retaining the property itself, the income is taxed to the ***donor*** at the time the donee collects it.

(1) Rental Income

Rental income is taxable to the ***owner*** of the reversion even though he has gratuitously assigned his right to another.

(2) Assignments of Trust Income

A trust beneficiary can shift trust income by assigning the ***entire beneficial interest*** (or an ***undivided portion*** thereof) to the donee. But no shift occurs if the interest transferred is considered insignificant (*e.g.*, shift for only one year).

(3) Distinguish—Assignments for Consideration

The tax burden on income ***always shifts*** when the transfer of the income right is supported by bona fide consideration.

d. No Realization of Income to Donor Making Gift

Even if the donor receives an immediate tax benefit (*e.g.*, a charitable deduction), he realizes no gain or loss.

(1) Exception—Gifts to Political Organizations

A taxpayer will recognize gain, but not loss, from a transfer of property to a ***political organization***.

(2) Exception—Certain Gifts

Realization can also occur from gifts of ***mortgaged property*** or gifts upon which the donee ***pays gift tax***.

2. Personal Service Income

Generally, personal service income is taxed to the person who earned it, even if an agreement exists splitting it.

a. Obligatory Assignments

Results are unclear when the employer is willing to make payments only to someone ***other than the employee***. The decision may turn on whether the employment relation was a regular one, or whether the payment is pursuant to a "one-shot situation" wherein services do not resemble normal employment services (*e.g.*, father enters contest, but prize is paid to child). *Note:* I.R.C. section 83(a) requires that the service provider be taxed on compensation, regardless of who receives the payment, making even the exception for one-shot situations unclear.

b. Working for Charity

A taxpayer can work for free without being taxed on the value of her services. But she cannot avoid taxation on income from employment by diverting it to a charity.

c. Working for Oneself

If the taxpayer creates something and then gives it away, this is treated as a ***transfer of property*** and the income shifts to the donee.

d. Commonly Controlled Businesses

To clearly reflect the income of two or more businesses where there is common control, the IRS can allocate income, deductions, or credits.

3. Excessive Controls

Generally, the retention of excessive controls over transferred property causes income to be taxed to the transferor. (For example, in *Helvering v. Clifford*, the grantor remained subject to the tax on the income from the trust property because he retained a reversion and broad managerial powers, including the right to control when the wife-beneficiary would receive the income.) The law is now codified in "grantor trust rules" (*infra*).

a. Transfers of Patents

A taxpayer who licenses his patent to a manufacturer ***that he controls*** is taxed on the royalty income; but the income shifts if the taxpayer does not control the donee-manufacturer.

b. Gift and Leaseback

A taxpayer can give away a business asset and ***lease it back***, and then deduct the rental as a business expense only if there is a transfer considered effective for tax purposes.

c. Family Partnerships

When a parent seeks to make her children her partners, the income will shift as long as the capital is a ***"material income-producing factor"*** in the partnership; if not, the income shifts only if the done contributes capital or services.

B. STATUTORY DIVISIONS OF INCOME

1. Income Earned by Children

Income earned by a child is taxable to the child even though it is paid to the parent. It is the parent's responsibility to file a tax return for the child. ***Unearned*** income of a child under age 18 over $2,100 is taxed in the parents' bracket.

2. Income of Spouses

a. Right to File Joint Return

Spouses can ***elect*** to file a joint return, the effect of which is to tax the income one-half to each spouse, irrespective of which spouse earned it. *Note:* The option to file jointly is available only to married persons. This includes same-sex couples, who are now permitted to marry.

b. Marriage Penalty and Single Penalty

The tax rate is structured so that single people are taxed more than a joint return for the same income. However, where married people have substantial income, they could pay less combined tax if they were single.

(1) "Quickie" Divorce

Obtaining a "quickie" divorce each year to avoid the marriage penalty will be ignored as a sham for tax purposes.

(2) Reduction of Marriage Penalty

The standard deduction and the maximum income in the 15% tax bracket for married taxpayers filing joint returns was increased so that the resulting amounts are the same for each joint taxpayer as they would be for a single taxpayer.

c. Liability for Tax Due on Joint Return

Each spouse is ***jointly and severally*** liable for the payment of the income tax reported on a joint return.

(1) Exception—"Innocent Spouse" Rule

A spouse ***without knowledge*** of an omission can escape liability for the tax, as long as he did not benefit from the item.

3. Income Earned by Head of Household

Unmarried persons who maintain a household for qualified relatives can file a special return where, in effect, 25% of the income is split with the dependents.

C. BELOW-MARKET INTEREST ON LOANS

1. In General

Interest is imputed (income to lender, deduction to borrower) if there is a failure to charge the applicable federal rate ("AFR").

a. De Minimis Exception

The rule is inapplicable to gift loans any time the balance is ***$10,000*** or less ***unless*** the loan is used to purchase income-producing assets. For loans under $100,000, the imputed amount is limited to the borrower's net investment income, absent tax avoidance purposes. Several loans between the same parties must be aggregated to determine the dollar amount ceilings.

2. Mechanism for Imputing Interest

If interest on a loan is below the rate set periodically by the IRS, different rules apply to different types of loans (*e.g.*, gift loans, nongift demand loans, nongift term loans).

D. TAXATION OF TRUSTS

1. Grantor Trust Rules—in General

The Code now sets forth the exclusive criterion for when trust income will be taxed to a grantor. If the grantor is deemed ***"owner of the trust,"*** he must report all of its income on his individual return, but he can claim allowable deductions and credits attributable to that income; the trust and beneficiaries are not taxed thereon and cannot take deductions and credits.

a. Reversionary Interest Retained

If the grantor retains a ***reversionary interest*** and that interest is worth at least 5% of the corpus at the inception of the trust, he is taxed on the trust income unless the reversion follows a life estate in an income beneficiary who is a lineal descendant of the grantor and who dies before age 21.

b. Power to Alter Beneficial Enjoyment

The grantor is taxed on the income if he or a ***"nonadverse party"*** (*i.e.*, a nonbeneficiary who has nothing to lose should the power be exercised) or both have the ***powers of disposition*** over the trust corpus or income. The result is contra if the power can be exercised only with the consent of an adverse party.

(1) Exceptions

The grantor of a trust is not taxed on the income in the following situations:

(a) ***An independent trustee has the power to apportion the income or principal*** among the beneficiaries. The grantor cannot be a trustee and not more than half of the trustees can be relatives or subordinates subservient to the grantor's wishes;

(b) ***The power of the trustee is limited by a reasonably definite external standard***, and neither the grantor nor a "nonadverse" spouse is trustee; or

(c) ***The reasonable alterations of beneficial enjoyment*** (*e.g.*, the power to postpone income payments to beneficiaries under age 21 or under a legal disability) can be retained.

c. Power to Revoke

If the power to revoke the trust is ***retained by the grantor***, grantor's spouse, or a nonadverse party, the grantor is taxed on the income.

d. Income for Benefit of the Grantor or Spouse

Income is ***taxable to the grantor if***, in the discretion of the grantor or a nonadverse party, it is or may be:

(1) ***Distributable to the grantor or spouse*** (even if the income is not in fact distributed);

(2) ***Accumulated for future distribution to the grantor or spouse;***

(3) ***Used to pay premiums on life insurance policies*** of the grantor or spouse unless a charity is the beneficiary of the policy; or

(4) ***Used to support dependents*** whom the grantor is legally obligated to support, but only to the extent that the income is so applied. (*Note:* Alimony trusts do shift the tax burden to the beneficiary.)

e. Administrative Powers That May Benefit Grantor

Where administrative control is or may be exercised for the grantor's benefit, the income is taxed to the grantor (*e.g.*, where the grantor or a nonadverse party, or both, have the power to deal with trust property or income for less than adequate consideration, without the approval of an adverse party in interest).

f. Trust Income Taxable to Person Other than Grantor

If a person other than the grantor has a general power of appointment, the trust income is taxed to her, whether or not she takes it, subject to the following limitations:

(1) ***If the power is for the support of dependents*** of the third party, the income is taxed to her only to the extent it is so applied;

(2) ***If the income is taxed to the grantor*** under the grantor trust rules, it is not taxed to the third party. Nor is a taxpayer taxed when she disclaims a power within a reasonable time after becoming aware of its existence.

2. Trusts Recognized for Tax Purposes

A trust is the recognized taxable entity where the grantor has not retained any substantial "strings."

a. Taxability of Income

The income is taxed to the beneficiaries when it is distributed to them, and to the trust when it is retained by it. The beneficiaries are not taxed on distributions of the ***corpus***.

b. Distributable Net Income ("DNI")

To prevent trust income from being taxed twice, a special deduction is allowed for distributions. (Distributions out of income or principal may be included in the deductible amount to the extent the deductible amount does not exceed DNI.) DNI is the maximum amount includible in a beneficiary's income and deductible by the trust. DNI for the trust is the trust's ***taxable income*** before the deductions for the distributions to the beneficiaries, the trust's personal exemption, or the undistributed capital gains or losses allocated to the corpus.

c. "Simple Trusts"

Simple trusts are trusts that ***must distribute all the current income*** to the beneficiaries, but cannot distribute the corpus or deduct charitable contributions. The beneficiaries are taxed on the amounts distributed, or required to be distributed, and a corresponding deduction is given to the trust. Note that the deduction cannot exceed DNI. The trust is taxed on capital gains allocated to the corpus.

d. "Complex Trusts" and Estates

(1) First Tier

All the income required to be distributed is taxed to the beneficiaries who are entitled to receive it, to the extent of DNI.

(2) Second Tier

If DNI exceeds the amount required to be distributed, then ***additional payments*** (*e.g.*, discretionary income payments) to the beneficiaries become taxable. Note that the includible amount ***cannot exceed DNI less the amount taxed to first tier beneficiaries***.

(3) Tax to Trust

The trust may deduct the amounts includible in the income of the first and second tier beneficiaries; however, if taxable income remains, the trust is taxed thereon.

(a) Exemptions

Simple trusts have a $300 personal exemption, complex trusts have a $100 personal exemption, and estates have a $600 personal exemption.

e. Throwback Rule

A distribution in excess of the current DNI is "thrown back" into the accumulated income of the preceding years. It is treated as if it had been distributed in those years to the extent of the undistributed income of those years.

(1) Taxing Beneficiaries

The beneficiary is taxed on the accumulated distribution in the year made, but the tax is determined by the amount the beneficiary would have paid had a distribution been made in prior years. A credit is given for taxes previously paid by the trust.

III. IS IT DEDUCTIBLE OR IS IT A CREDIT?

A. INTRODUCTION

1. Deductions and Credits Defined

A ***"deduction"*** is subtracted ***from gross income*** or adjusted gross income to arrive at ***taxable income***. ***"Credits"*** are subtracted ***from taxes*** due.

2. Business vs. Personal Deductions

Generally, business costs are deductible, while personal costs are not.

3. No Shifting of Deductions

Payment of ***another's liabilities*** is not deductible, unless it serves an independent business purpose (*e.g.*, protecting taxpayer's job).

B. BUSINESS AND INVESTMENT DEDUCTIONS

1. Business Expenses

All "***ordinary and necessary expenses*** paid or incurred during the taxable year in carrying on any trade or business" are deductible.

a. "Trade or Business" Defined

The Code does not define a "trade or business," but it generally requires an expectation of profit, regular and continuous operation, and the active pursuit thereof.

(1) Legality of Business

The legality of the business is not per se relevant, but certain illegal expenses are not deductible.

(2) Nature of Taxpayer

Expenses incurred in connection with a trade or business are deductible by any kind of taxpayer—corporation, trust, or individual. However, a stockholder is not in business merely because his corporation is in business.

(3) Tax Shelters

Activities involving flagrant tax shelters do not meet the "trade or business" requirement; therefore expenses arising from these activities are not deductible.

b. Business vs. Personal Expenses

Individual taxpayers must prove that the particular expense was incurred ***in connection with*** the taxpayer's trade or business. Corporate taxpayers have the benefit of a ***presumption***.

(1) Requirement of Proximate Relationship to Trade or Business

If several purposes are involved, the ***predominant*** one controls.

(2) Travel Expenses

Travel expenses incurred while ***away from home in pursuit of a trade or business*** are deductible.

(a) Pursuit of Trade or Business

1) Commuting to and from Work

Costs for commuting to and from work are ***not*** deductible.

2) Combined Business and Pleasure Trips

The entire cost of the transportation is deductible if the ***primary*** purpose of the trip was business, but lodging and meal expenses must be allocated.

3) Foreign Meetings

Certain limitations are placed on expense deductions for attendance at foreign conventions.

4) Presence of Spouse

A spouse's expenses are deductible only if there is a sufficient business connection.

(b) "Away from Home"

There has been considerable controversy over whether this phrase means away from ***business headquarters*** or away from the ***residence***.

1) **“Homeless” Taxpayers**

If no business headquarters exist, the taxpayer’s permanent residence can be “home.” However, if the taxpayer has neither, there are no deductions for travel expenses.

2) **Taxpayers with Several Offices**

If the taxpayer has several business headquarters, he can deduct expenses of traveling between them.

3) **Deductibility of Meals**

Only ***50%*** of meal costs are deductible, and that deduction is available only if the taxpayer is away from home for a time requiring ***“sleep or rest.”***

4) **“Temporary” vs. “Indefinite” Rule**

Deductions are not allowed when the taxpayer is away on an assignment of an ***indefinite*** duration, but are allowed for temporary assignments.

(3) Expenses of “Businesses” Operated for Pleasure—Hobby Farm Problem

Expenses are generally not deductible unless a ***significant purpose*** of the business is to earn a profit. However, interest and property taxes are deductible since they do not require profitseeking, and if income exceeds this amount, expenses up to this balance can be deducted.

(4) Moving Expenses

Before 2018 and after 2025, employees or self-employed persons can deduct the costs of moving family and furniture to a new home, subject to certain limitations: The new job site must be more than ***50 miles*** farther from the old home than the old home was from the old job site; the taxpayer must work full-time; and the new place of work must be permanent.

(5) Entertainment Expenses

No deduction is allowed for an activity considered to be entertainment, amusement, or recreation.

(6) Business Gifts

Business gifts are generally deductible up to $25.

(7) Litigation Expenses

Whether legal fees or other costs incurred in a lawsuit are deductible depends on the nature of the dispute. If the ***origin of the dispute is related to a trade or business*** and the expenses are ***“ordinary and necessary,”*** they are deductible. Litigation expenses incurred for the ***production of income*** are deductible, but only as miscellaneous itemized deductions. Special provisions allow a deduction for costs in connection with tax matters.

(8) Educational Expenses

Educational expenses that qualify the taxpayer for a ***new*** trade or business, or constitute the ***minimum education requirement*** for qualification in her job, are ***not*** deductible. However, costs to ***maintain or improve*** skills required in a taxpayer’s job, or for education that is required as a condition to retention of the job, are deductible.

(9) Insurance Premiums

The cost of insurance on business ***property*** is an ordinary and necessary business expense. ***Life*** insurance premiums for a "key person" (*i.e.*, officer or employee) are deductible only if the taxpayer is not the beneficiary.

(10) Offices at Home

Generally, ***no*** deductions are given for a taxpayer's residence. There is a special exception for ***certain business uses*** if a portion of the home is used ***exclusively*** for business (*e.g.*, principal place of business, certain storage use, or if the residence is used as a day care facility). The deductible amount is limited to the gross income from such use, less the nonbusiness deductions.

(11) Vacation Homes

Generally, no deduction is allowed in excess of the income if the dwelling unit is used ***as a "residence"*** (*i.e.*, if used for personal purposes for more than 14 days or 10% of the days rented, whichever is greater). Also, expenses must be prorated between rental and personal use.

(a) Limited Rental Use

If the dwelling unit is rented fewer than 15 days, no deduction is allowed, and the rental income is excluded from gross income.

(12) Clothing

Clothing is ***not*** deductible unless it cannot appropriately be worn for nonbusiness purposes (*e.g.*, firefighter's uniform).

c. Current Expense vs. Capital Outlay

To be deductible as a business expense, an item must be an ***expense***, rather than a ***capital outlay***.

(1) Test

An expense is considered a "capital outlay" if it brings about the ***acquisition of an asset or some advantage*** to the taxpayer having a ***useful life in excess of one year***.

(a) "Capitalization" Distinguished

A ***capital asset***, when sold, qualifies for capital gain or loss treatment (*infra*). However, expenditures must be ***capitalized*** if they create an asset or advantage lasting beyond the taxable year, whether or not a capital asset is produced (*i.e.*, match up income with costs of earning that income).

(b) Future Benefit

An outlay must be capitalized if it produces significant long-term benefits (*INDOPCO* case). Thus, the costs of arranging a friendly corporate takeover must be capitalized because the benefits will inure into the future, but the costs of resisting a hostile takeover can be deducted currently because there is no long-term benefit created by the expenses.

(c) Ramifications

The *INDOPCO* case has cast doubt on many decisions that allowed expensing, rather than capitalization, of business expansion costs because no distinct asset resulted, although a long-term benefit was produced.

(2) Repairs of Property vs. Capital Improvement

Maintenance and repairs are current expenses and are deductible in the year paid ***unless they improve*** the value of the original property, make it suitable for a different purpose, or extend its original useful life. Certain ***environmental cleanup*** costs also may be deducted instead of capitalized.

(3) Property Produced or Sold

Taxpayers must capitalize the direct and indirect costs of producing property, including materials, labor, rent or depreciation on equipment, etc. ***Interest*** allocable to produced property must be capitalized only if the property has a long useful life or production period.

(a) Resale Property

Costs associated with property acquired for resale (*e.g.*, inventory storage costs) are capitalized if the taxpayer has average gross receipts of more than $10 million.

(b) Exception for Authors

Mandatory capitalization rules are inapplicable to the "qualified creative expense" of authors, artists, or photographers (*i.e.*, costs are deductible).

(4) Rent Payments

Rental payments for the use of another's property are deductible. But ***prepayments*** of rent are ***not*** currently deductible, nor are ***leases*** that are actually payments towards the ***purchase price*** of the property.

(5) Acquisition Costs

Amounts paid to ***purchase*** a business or an asset are capital outlays, as are "start-up" costs. However, costs of expanding an existing business are deductible. To equalize this situation between new and existing businesses, ***section 195*** was enacted to allow ***amortization over a 15-year period*** of the costs of investigating and starting up a new business. However, the purchase price must still be capitalized.

(a) Finding Employment

Employment agency fees are deductible (except the costs of seeking a ***first*** job).

1) Distinguish—Running for Office

Costs of running for office are ***nondeductible***.

(b) Corporate Organization and Reorganization

Legal fees connected with the organizing or reorganizing of a business are capital outlays but can usually be amortized over a 15-year period.

(c) Patents, Copyrights, and Trademarks

The purchase of patents, copyrights, and trademarks are ***capital outlays***; but costs in creating them are currently deductible.

(d) Bar Exam

Bar exam costs must be capitalized.

(e) Selling Costs

Commissions paid on the sale of property are ***not*** deductible as expenses, but they do decrease the amount realized on the sale.

(f) Acquiring Goodwill

The costs of acquiring goodwill in a new business are nondeductible. But amounts paid for the ***protection or improvement*** of the goodwill may be deductible. Purchased goodwill can be amortized over a 15-year period.

(g) Short-Term Prepayments

Routine and recurring payments lasting into the following year may be entirely deducted in the year in which they are made.

d. "Ordinary and Necessary" Expense

An expense must be: (i) of a type encountered by other businesses in the community, and (ii) appropriate or helpful to the business.

(1) Determinative Factors

The following are the chief factors in determining if an expense is in fact "ordinary and necessary": the ***voluntariness*** of the payment, the ***customariness*** of the payment, and whether it is ***"reprehensible"*** (*e.g.*, legal kickback).

(2) Compensation

"Reasonable" compensation costs for services rendered are deductible. A court considers the value of the service to the business and what similar businesses would pay for like services.

(a) Tests for Reasonableness

Salary based on a ***percentage of income*** may be suspicious. Some courts consider what an ***independent investor*** would pay for the services. A salary ***unrelated to the value*** of the services may be disallowed on the basis that it is a "constructive dividend." A few cases have disallowed a reasonable salary to the extent the employee-shareholder has not received a reasonable return on her investment.

(b) Salaries in Excess of $1 Million

A publicly held corporation cannot deduct remuneration in excess of $1 million per year to certain top executives.

e. Public Policy Limitation

Bribes to government employees, payments ***illegal under the criminal law***, ***fines*** paid for a violation of the law, and payments in connection with ***political campaigns or lobbying are not*** deductible.

(1) Damages

Civil penalties or damages paid to a victim are usually ***deductible***, but two-thirds of the payments made in connection with antitrust violations are not.

2. "Nonbusiness" Expenses—Expenses for Production of Income

a. General Rule

An ***individual*** taxpayer can deduct expenses paid or incurred for ***production or collection*** of income; for management, conservation, or maintenance of ***property***

held for the production of income; or in connection with the ***determination, collection, or refund of any tax***.

(1) Scope of Deductible Expenses

Expense must be ***current, ordinary and necessary, not violative of public policy***, and ***not incurred for personal reasons***.

(2) Illustrations

Proxy fight expenses are deductible; stockholders' expenses for travel to stockholder meetings are generally deductible; litigation expenses are ***not*** deductible if the ***primary purpose*** is to establish or defend title or ownership; divorce and property settlement expenses are generally nondeductible personal expenses.

3. Depreciation and Amortization

Reasonable deductions are allowed for exhaustion and wear and tear of property used in a trade or business, or held for the production of income (depreciation). If an asset is intangible, the deduction is known as ***amortization***.

a. Limitations

(1) ***Passive loss deductions*** cannot exceed income from those activities;

(2) ***The "at risk limitation"*** (*infra*); and

(3) ***Depreciation is not deductible*** if the property is worth less than the amount of a nonpersonal liability mortgage.

b. Depreciable Property

All physical property, except land, that is used in a trade or business, or held for the production of income, and that has a ***limited useful life***, may be depreciated. Many intangibles (*e.g.*, goodwill) can be amortized over a 15-year period.

(1) Books, Films, Sound Recordings, Software

Production costs are amortized over the period that these items are expected to produce income.

(2) Unlimited Useful Life

Assets other than intangibles (*e.g.*, works of art, land) cannot be depreciated.

c. Who Is Entitled to Depreciation Deduction

Generally, the person suffering the economic loss due to the decreased value of the property from depreciation can claim the deduction.

(1) Landlord-Tenant

The landlord gets the deduction if he improves the land and leases it to the tenant except when the ***tenant is required to maintain*** the land so that when it is returned it will be of equivalent value. If the tenant erects a building on unimproved land or constructs improvements in a leased building, the tenant gets the deduction.

(2) Sale-Leaseback

The investor in a sale-leaseback transaction is entitled to the deduction if he is treated as the ***owner***.

(3) Purchaser

The purchaser under an executory sale contract gets the deduction on the property after the ownership burdens and benefits pass to him.

(4) Future Interest Holder

A life tenant is entitled to the deduction.

(5) Trustee-Beneficiary

In trusts, the deduction is apportioned among income beneficiaries and the trustee.

d. Computation of Depreciation

(1) Recovery Periods

The accelerated cost recovery system ("ACRS") provides "recovery periods" of certain assets. These recovery periods are: for residential buildings—27.5 years; for nonresidential buildings—39 years; for tangible personal property—3, 5, 7, 10, 15, or 20 years.

(2) Salvage Value

ACRS ignores salvage value and makes no distinction between new and used property.

(3) Methods of Depreciation

ACRS provides two types of depreciation: straight-line and accelerated. ***Straight-line depreciation*** is computed by dividing the cost (or other basis) by the useful life. This method results in the same deduction for every year during the recovery period. ***Accelerated depreciation*** provides for a greater deduction in the early years and a lower deduction in later years.

(4) Personal Property—Accelerated Depreciation

Double-declining balance is permitted for most personal property.

(a) Half-Year Convention

Regardless of when personal property is purchased, it is treated as if it were purchased halfway through the year. If more than 40% of assets are bought during the last quarter of the year, ***all*** assets acquired during the year are considered purchased in the middle of the ***quarter*** in which they are purchased.

(b) Straight-Line Election

A taxpayer may elect to use ***straight-line depreciation***.

(5) Stimulus Bill

To stimulate the economy Congress permitted the deduction of 100% of the cost of qualified assets placed in service after Sept. 22, 2017 and before Jan. 1, 2023.

(6) Amortization of Intangibles

Under section 197, many intangibles (*e.g.*, purchased goodwill, licenses, covenants not to compete, and franchises) are amortized over a 15-year period. Intangibles not covered by section 197 (*e.g.*, interests in companies, land, software, sports franchises, films) can be amortized only according to their proved useful lives.

(7) **Real Property**

Depreciation is calculated on a monthly basis in the year in which the buildings are purchased or constructed (purchase is deemed to occur at mid-month in year of purchase). Only straight-line depreciation is permitted.

e. **Limitations on Consumer Items**

Limitations on depreciation and rental expense deductions apply to "listed property" (*e.g.*, cars, cellular telephones, home computers used for business). Only straight-line depreciation can be used for listed property used less than 50% for business.

f. **Caution—Ultimate Effect of Deduction**

A depreciation deduction ***reduces basis***; hence, the more depreciation taken, the greater the taxable gain (or less loss) is when the property is sold.

4. **Depletion**

The owner of the ***economic interest*** in a wasting asset (*e.g.*, oil, gas, or minerals) is entitled to a reasonable annual allowance to compensate for the diminution of the asset.

a. **Methods of Computing Depletion**

(1) **Cost Method**

The cost or other basis of the wasting asset is allocated to each unit of the mineral deposit. Then, the depletion allowable for each year is computed by multiplying this amount by the number of units actually sold or withdrawn during the year.

(2) **Percentage Method**

Under this more popular method, the deduction is a fixed percentage of the property's gross income during the taxable year. *Note:* With respect to ***oil and gas***, the percentage depletion cannot exceed 50% of the taxpayer's net income from the property. *And note:* Percentage depletion is especially attractive because greater income results in a greater deduction and the deduction goes on ***indefinitely***.

b. **Drilling Costs**

The costs of production are deductible as ***expenses***. Intangible drilling and development expenses (*i.e.*, wages, supplies, etc., in locating sites and preparing for production) in connection with oil and gas wells may be deducted as current expenses or capitalized and recovered through subsequent depletion and depreciation deductions.

5. **Losses**

A loss occurs when a transaction ends and the taxpayer has not recovered her basis for the assets involved. Corporate losses are generally deductible as business losses. Individuals can deduct only limited losses.

a. **Types of Losses Allowed to Individuals**

(1) **Losses Incurred in a Trade or Business**

Any loss incurred in a trade or business is deductible.

(2) **Losses Incurred in Transactions Entered into for Profit**

These are generally deductible. For example, losses from the sale of securities or other investments are deductible (as capital losses—the deductibility of which is limited); however, losses suffered on the sale of a ***personal residence*** are ***not*** deductible.

(3) Wagering

Wagering losses are deductible to the extent of any winnings.

(4) Demolition Losses

Losses from the demolition of a structure are not deductible ***unless the loss was incurred before the demolition*** (*e.g.*, the building was damaged by a tornado and then demolished—the casualty loss is deductible).

b. When Loss Allowable—"Realization"

Generally, a loss must be realized (evidenced by a closed and completed transaction in the current tax year) to be deductible. A mere decline in value is ***not*** enough.

(1) Time of Realization

The realization on a tangible asset usually occurs in the year of the intention to abandon ***and*** the affirmative act of abandonment. The remote possibility of recoupment is irrelevant.

(2) Exchanges

For loss to be realized on an exchange of property, the property received must differ materially either in kind or in extent from the property transferred.

(3) Exceptions

Theft losses are deductible the year in which the taxpayer discovers the loss. Casualty losses from natural disasters are deducted either in the year of occurrence or on the return for the prior year. Declines in value in inventory may be deducted in the year they occur. The year they become worthless is the year of loss for stocks and securities.

c. Disallowed Losses

(1) Losses Between Related Taxpayers

Losses arising from a sale or exchange ***directly or indirectly*** of property between related taxpayers are not allowed. However, ***gain*** upon such transactions is taxable.

(2) Losses from "Wash Sales" of Securities

When a taxpayer sells stocks or securities and ***buys*** substantially identical assets within 30 days before or after the sale, the transaction is ignored, and losses are not deductible.

(3) Sham Transactions

If, in reality, there was no real interruption of the taxpayer's beneficial ownership, despite the appearance of a sale, losses from this "sham transaction" are disallowed.

(4) Public Policy

Loss deductions violative of public policy are disallowed.

6. Bad Debts

a. "Bad Debt" Defined

A "bad debt" arises when an obligation owed to the taxpayer becomes uncollectible.

b. Requirements for Deductibility

There must be a ***valid debt*** owing that arose from a ***debtor-creditor relationship***, and the debt must have become unenforceable or uncollectible ***during the tax year*** for which the deduction is claimed.

c. Business and Nonbusiness Bad Debts

Business bad debts are fully deductible, and a deduction is allowed for "partial worthlessness." Nonbusiness bad debts are deductible as ***short-term capital losses*** (*e.g.*, a loan to a friend or family, or most shareholder loans to corporations (Whipple rule)).

d. Amount Deductible

The amount deductible is ***limited to the basis*** of the debt. Uncollectible ***accounts receivable*** are deductible only if the taxpayer is on the accrual basis.

e. Recovery of Bad Debts

If a bad debt is deducted and then recovered, it must be included in the ***gross income*** in the year it is received. But to the extent that the previous bad debt deduction failed to effect a ***tax benefit***, the income can be excluded.

7. "At Risk" Limitation on Tax Shelter Deductions

Deductions from operating losses for all investments ***except real estate*** are limited to the amount "at risk," *i.e.*, the amount of investment in the property excluding nonpersonal liability money loans. Operating losses are the excess of deductions from the activity over income from the activity during the year.

8. Passive Losses

Taxpayers who do not ***materially participate*** in a business cannot deduct losses from such "passive" activities except against income from such activities. Deductions are deferred until future years when there is passive income or the activity is disposed of.

a. Exceptions for Real Estate Rentals

A taxpayer may deduct up to $25,000 in losses from real estate ***rental activity*** if he ***actively participates***. The deduction is phased out when adjusted gross income ("AGI") exceeds $100,000. A taxpayer who is a ***real estate professional*** can deduct all losses if the taxpayer spends more than 750 hours a year materially participating in the business.

C. PERSONAL DEDUCTIONS

1. Introduction

Personal deductions are allowed for certain items even though there is no connection to a business or investment.

2. Definitions

A deduction is taken either from gross income or adjusted gross income.

a. Adjusted Gross Income

Adjusted gross income is gross income less certain deductions (*e.g.*, nonemployee trade or business or real estate investment deductions, and deductions for alimony). The remaining deductions are taken from AGI in computing taxable income.

b. Miscellaneous Itemized Deductions—Two-Percent Floor

Many miscellaneous itemized deductions are allowable only to the extent they exceed 2% of AGI. This category includes employee business expenses and many other items. Deductions ***not*** subject to the floor include interest, taxes, casualty losses, charitable contributions, and medical expenses. No deduction is allowed for expenses incurred between Dec. 31, 2017 and Jan. 1, 2026.

c. Phaseout of Itemized Deductions—Three-Percent Rule

Except for medical expenses, investment interest, or casualty losses, all itemized deductions are reduced by 3% of the excess of AGI over the applicable amount, but no more than 80% of the deductions are wiped out.

d. Standard Deduction

In lieu of itemizing deductions, taxpayers can deduct the "standard deduction," which is an amount adjusted annually for inflation. In 2019, the standard deductions are $24,400 on a joint return, $18,350 for heads of households, and $12,200 for single taxpayers.

(1) Marriage Penalty

The standard deduction for married taxpayers has been increased to twice the standard deduction for a single person.

(2) Elderly and Blind Taxpayers

An additional standard deduction is provided for taxpayers who turn 65 years of age during the tax year or who are blind.

3. Interest

Personal interest (except on a residence and some student loans) is ***not*** deductible. Business or investment interest is deductible, but there are numerous limitations.

a. Requirements

To be deductible, the interest must be incurred with respect to ***bona fide debt*** owed by the ***taxpayer***. Interest is not deductible if the debt is a sham, there is no definite possibility of gain or loss, or if the taxpayer's sole motive was tax saving.

(1) Identifying Interest

Payments for the use of borrowed money are interest and deductible (*e.g.*, "points"), while payments for a lender's ***services*** are ***not*** interest. Interest may be ***imputed*** in some situations when interest charged is less than the applicable federal rate.

b. Nondeductible Interest

(1) Personal Interest

Personal interest (*e.g.*, on credit cards) is not deductible. *Exception:* Interest on certain educational loans or on acquisition debt (cannot exceed $1 million), and home equity debt (cannot exceed $100,000) is deductible if ***secured*** by a principal residence (or a second residence).

(a) Interest on Education Loans

A taxpayer can deduct ***from gross income*** interest on educational loans (up to $2,500) incurred to pay higher education expenses for the taxpayer, her spouse, or a dependent. The deduction begins phasing out when AGI exceeds $70,000 on a single return or $140,000 on a joint return.

(2) Expense Allocable to Exempt Income

Interest expenses attributable to the production of tax-exempt income are disallowed.

(3) Tax-Exempt Interest

Interest on debts incurred to purchase or carry tax-exempt state and municipal bonds is not deductible.

(4) Loans to Purchase Insurance

No interest deduction is allowed on a debt incurred to buy "single premium" life insurance, endowment, or annuity contracts, or on loans made as part of a systematic plan of financing insurance premiums. *Exception:* The disallowance rule is inapplicable if: (i) no part of four of the first seven premiums is borrowed; (ii) the amount disallowed would be less than $100, if borrowing occurred because of unforeseen financial problems; or (iii) the borrowing was incurred in connection with a trade or business.

(5) Unpaid Interest

Unpaid interest owed by a debtor on an accrual basis to a related creditor on the cash basis is not deductible ***until paid***.

(6) Prepaid Interest

Prepaid interest must be capitalized and deducted in the years the underlying loan is outstanding (except that ***points*** paid on a loan secured by a principal residence are immediately deductible).

(7) Excess Investment Interest

If the interest deductions on investments exceed the net investment income, the excess is ***disallowed***, but may be ***carried forward*** and deducted against investment income in future years.

(8) Passive Activity

Interest incurred in the purchase or operation of passive activity is disallowed.

4. Taxes

a. Taxes Deductible as Such

Real or personal property taxes, and ***state or local*** income taxes (including payroll tax used to finance a disability income fund) are deductible as such.

(1) Deduction of General Sales Tax in Lieu of State Income Tax

Taxpayers can elect to deduct state and local general sales taxes instead of state and local income taxes.

b. Taxes Deductible Only as Business or Investment Expense

Taxpayers engaged in a trade or business, or holding property for the production of income, can deduct taxes incurred ***in connection with that business or property***.

c. Nondeductible Taxes

Federal income taxes, Social Security tax imposed on employees, excess profit taxes, federal estate and gift taxes, and state and local inheritance taxes are ***not*** deductible.

5. Charitable Contributions

Taxpayers are entitled to a deduction for contributions to ***recognized*** charities. ***Individuals*** cannot deduct more than 50% of their AGI (60% between Jan. 1, 2018 and Dec. 31, 2025); ***corporations*** are limited to 10% of net income; and ***estates and trusts*** have no limitation.

a. Gifts in Kind

Certain limitations apply when property, rather than cash, is given.

(1) Fractional and Future Interests

Gifts of a fractional or future interest in a donor's ***personal residence or farm*** are deductible in the amount of the value of the interest at the time of the gift. Gifts of ***remainder*** interests in ***other real property*** or gifts to a ***trust*** are deductible only if made in the form of a "fixed annuity trust," or "unitrust," or "pooled income fund."

(a) Tangible Personal Property

Gifts of a ***future*** interest in tangible personal property are deductible only when the charity's interest becomes ***possessory***.

(b) Income Trusts

Gifts of an ***income interest*** in a trust are not deductible unless the income remains taxable to the ***donor*** and the interest is in the form of a fixed annuity or percentage of value of the property.

(2) Gifts of Appreciated Property

Formerly, a taxpayer could deduct the present ***fair market value*** of property without realizing a gain or loss. This is still true if the donated property would (if sold) produce ***long-term capital gain*** and is donated to a ***public charity***. However, the amount of the deduction is limited to 30% of the donor's AGI.

(a) Amount Limitations

The amount deductible is reduced by the capital gain if the gift is to a ***private foundation*** (unless an ***"operating"*** foundation), the gift is of ***tangible personal property unrelated*** to the charity's charitable purpose, or the gift is of a patent, copyright, or other intellectual property.

(b) Gift That Would Not Produce Long-Term Capital Gain

If the property would produce short-term capital gain or ***ordinary income***, then only the donor's basis, in effect, is deductible. However, if the gift is of inventory to a public charity to be used solely for the care of the ill, needy, or infants (and the charity does not resell the property), an amount in excess of basis is deductible.

(3) Property Description and Appraisals

Taxpayers must submit property descriptions if the contribution is worth more than $500, and an appraisal if the contribution is worth more than $5,000.

(4) Contributions of Used Cars, Boats, and Airplanes

The taxpayer must receive a written acknowledgment of the vehicle's identification number if it is worth more than $500.

b. Bargain Sales

When property is ***sold*** to a charity ***below*** the fair market value, the difference between the fair market value and purchase price is deductible, but the basis must be ***apportioned*** between the gift and sale elements.

c. Contribution of Services or Use of Property

The value of ***personal services*** donated to a charity is nondeductible; ***out-of-pocket expenses*** (*e.g.*, automobile expenses) can be deducted. If the taxpayer donates the use of his property, he cannot deduct the value of the use.

d. No Deduction If Taxpayer Benefits

Contributions made with the anticipation of future economic benefit are not deductible.

6. Medical Expenses

Amounts paid for the "***diagnosis, cure, mitigation, treatment or prevention of disease***, or for the purpose of affecting any structure or function of the body" are specifically deductible, as is the cost of prescription drugs. ***Transportation*** costs for essential medical care and the amounts paid for ***medical insurance*** (not disability insurance) are also deductible.

a. Borderline Expenses

The deductibility of borderline expenses (*e.g.*, long-term care costs) turns on the relationship of the expense to health needs.

b. Health Savings Accounts

Contributions made to health savings accounts are deductible by the employee. The contributions are used to reimburse the employee for her medical expenses, and any excess at the end of the year carries over to the next year.

c. Effect of Insurance

If an expense is compensated by insurance, it is ***not*** deductible.

d. Limitation on Deductible Amount

Only medical costs in ***excess of 10% of AGI*** are deductible.

e. Self-Employed Persons

Self-employed persons are entitled to deduct their medical insurance premiums.

7. Personal and Dependency Exemptions

The personal and dependency exemptions have been reduced to zero between Jan 1, 2018 and Dec 31, 2025.

8. Casualty and Theft Losses

Individuals can deduct each casualty and theft loss to the extent it ***exceeds $100*** but ***only if the damage is to taxpayer's own property***. And the ***total*** of casualty and theft losses is deductible only if it is ***in excess of 10% of AGI***. Any insurance recoveries reduce casualty losses. After Dec. 31, 2017, casualty losses are only deductible to the extent of casualty gains except in federally-declared disasters.

a. Amount Deductible

Taxpayer can deduct the ***lesser*** of:

(1) ***The adjusted basis*** of property; or

(2) ***The difference between the value*** of the property before and after the casualty.

b. Personal Casualty Gains and Losses in the Same Year

If the gains exceed the losses, the gains are treated as capital gains and the losses (in excess of $100 per loss) are deductible. If the losses exceed the gains, both the gains and losses are ordinary, not capital. The losses (in excess of $100 per loss) are deductible to the extent of the gains.

9. Other Personal Deductions

Nonbusiness bad debts, alimony payments, and certain contributions to retirement plans are allowed.

a. Contributions to Retirement Plans

A taxpayer may establish an individual retirement account ("IRA") and contribute and deduct up to $5,500 per year ($6,500 for taxpayers age 50 and older). Investment gains are not currently taxed, but are taxed when withdrawn. The deduction begins phasing out for single taxpayers when AGI reaches $61,000 ($98,000 for married taxpayers) ***if*** the taxpayer is covered by an employer-maintained retirement plan, but there is no phaseout for taxpayer not covered by such a plan.

(1) Roth IRAs

Contributions to Roth IRAs are not currently deductible, but like regular IRAs, investment gains are not taxed. Moreover, ***none of the distributions*** are taxed if made after the taxpayer reaches age 59½ and more than five years after the first contribution.

(2) Education IRAs

A taxpayer can contribute up to $2,000 per year to an education IRA for a beneficiary under age 18. The contributions are not deductible but investment income and distributions are not taxable.

D. TAX RATES

The tax rates depend on marital status. Married taxpayers may file joint or separate returns. Singles may qualify for the head of household rate. From 2018 through 2025, there are seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. [I.R.C. § 1(j)] Under the Affordable Care Act, individuals and certain estates and trusts are subject to an additional 3.8% tax on their net investment income for each taxable year.

E. CREDITS

Credits reduce the tax payable dollar for dollar.

1. Credit for Taxes Withheld and Prepaid

The taxpayer is entitled to a credit against taxes payable for all sums withheld from wages and for all amounts prepaid in connection with declarations of estimated tax.

2. Foreign Tax Credit

The taxpayer may elect to take as a credit in lieu of a deduction from income the amount of income and similar taxes paid or accrued during the year to foreign countries or possessions of the United States.

3. Credit for the Elderly

Taxpayers who are age ***65 or over*** (or retired on total or permanent disability) receive a credit of 15% of their "section 22 amount" ($5,000 for singles, $7,500 on a joint return if both spouses are eligible, or $3,750 for a married person filing separately). However, the "section 22 amount" must be reduced by excludible Social Security or other amounts excluded from gross income. And if gross income exceeds $7,500 ($10,000 on joint return, $5,000 for a married person filing separately), there is a further reduction of one-half of the excess.

4. Work Incentive Credit

The Code allows a credit of 50% of the salaries paid to disadvantaged employees (*e.g.*, welfare recipient).

5. Child or Dependent Care Credit

A credit is given for at least 20% (35% for lower income taxpayers) of expenses for household services and care of a "qualifying individual" (dependent under age 13 or unable to care for himself or herself). But the expenses must be incurred to enable the taxpayer to be gainfully employed.

a. Dollar Limit

Expenses for which the credit is allowed cannot exceed earned income (if married, income of lower earning spouse used) or $3,000 for one qualifying individual or $6,000 for two or more.

b. Divorced Parents Included

Even though the parent is not entitled to claim the exemption, she can take the child care credit.

6. Child Tax Credit

A taxpayer who claims a ***child under age 17 as a dependent*** is entitled to a child tax credit of $2,000 per child. The credit is gradually phased out when AGI exceeds $400,000 on a joint return and $200,000 on a single return or for a married person filing separately. The child tax credit is refundable even if it exceeds an individual's tax liability for the year.

a. Divorced Parents

A noncustodial parent can receive the credit if the custodial parent signs a written waiver.

7. Earned Income Credit

A lower-income taxpayer with one child under age 19 can claim a credit of 34% of earned income (the percentage is 40% if he has two or more children) up to a threshold amount (adjusted for inflation). The credit is less for taxpayers without children and is phased out above certain income levels.

8. Adoption Tax Credit

A taxpayer can claim a credit for adoption expenses up to $14,080 per child in 2019, although the credit phases out when AGI exceeds $211,160.

9. Education Credits

The American Opportunity Tax Credit, is available for the first $2,000 of expenses for the first four years of post-secondary education, plus 25% of the expenses in excess of $2000, but not in excess of $4,000, for a maximum credit of $2,500. The lifetime learning credit, which applies in years when the American Opportunity Credit is not claimed, is equal to 20% of the first $10,000 of tuition and related expenses. The American Opportunity Credit begins to phase out when AGI exceeds $80,000 on a single return and $160,000 on a joint return and the Lifetime Learning Credit begins to phase out when AGI exceeds $58,000 on a single return and $116,000 on a joint return.

IV. GAIN OR LOSS ON SALE OR EXCHANGE OF PROPERTY

A. COMPUTATION OF BASIS, GAIN, OR LOSS

1. Computation Formula

a. ***Adjusted basis = unadjusted basis + additions − reductions***

b. ***Gain = amount realized − adjusted basis***

c. ***Loss = adjusted basis − amount realized***

2. Basis

a. Unadjusted Basis

This is usually cost. However, there are special rules for ***gifts, inheritances***, and ***tax-free exchanges***.

(1) Cost Basis

Generally, the basis of property is the cost thereof. It includes cash, mortgages, or other property paid to obtain the asset. Income charged to the taxpayer in acquiring the property also is added to the basis.

(2) Inter Vivos Gifts

For the purpose of computing ***gain***, the donee takes the ***donor's basis***; but for ***loss*** purposes, the donee's basis is the ***fair market value*** at the time of the gift or the donor's basis, whichever is less.

(a) Increase by Gift Tax Paid

The basis is increased by the gift tax the donor paid, which is attributable to an appreciation in property, but not in excess of the fair market value at the time of the gift.

(3) Tax-Free Exchanges

The basis of property in a tax-free exchange is that of the property transferred—adjusted upward for gain recognized and downward for money received on the exchange.

(4) Inherited Property

The basis of inherited property in the hands of decedent's estate or the person inheriting it is the property's value at the date of death of decedent (or six months later if the alternate valuation date is elected).

(a) Form in Which Property Is Held

1) Community Property

If decedent and her surviving spouse owned the property as community property, both halves receive a new basis.

2) Tenants in Common

On the death of one tenant in common, the person inheriting the decedent's interest receives a new basis, but the surviving tenants in common do not.

3) Joint Tenancy

Property owned as joint tenants receives a new basis if includible in the estate for estate tax purposes, and maintains its former basis if excluded from the estate.

(b) Term Interests

"Term interests" include life estates, term for years, or an income interest in a trust. Special rules apply to determining the recipient's basis in the term interest.

(c) Income in Respect of a Decedent

This refers to situations wherein income is not taxed to the decedent even though events leading to its realization occurred prior to his death. In these cases income is taxed to the recipient, but a deduction is available if the item was subject to estate tax.

b. Adjusted Basis

Adjusted basis is determined by ***adding*** to the unadjusted basis all subsequent expenditures chargeable to the asset that were not deductible as current expenses. From the sum is subtracted (i) receipts, losses, or other items properly chargeable to a capital account; and (ii) depreciation, depletion, amortization, or obsolescence allowed.

c. Allocation of Basis

Where the taxpayer sells or exchanges only a ***part*** of her asset, she must allocate the basis between the part sold and the part retained. Allocation also applies when ***several assets*** are purchased for a lump sum.

B. THE REQUIREMENT OF REALIZATION

1. In General

A ***realization*** must occur prior to the taxation of the increase in the net worth.

2. Realization in Property Transactions

The owner of property realizes gain or loss only on the ***sale or other disposition*** of the property.

a. Mortgages

Mortgaging alone and gifts alone are not realizing transactions, but if both are combined, there may be a realization.

(1) Mortgage Foreclosure

Foreclosure is a realization; it is treated as a sale by the debtor to the creditor, and a transfer in satisfaction of a claim.

(2) Exchanges

An exchange is a realization if the properties ***differ materially***.

3. Amount Realized

The amount realized is the sum of money, plus the fair market value of any other property, received by the taxpayer in the realizing transaction.

a. Mortgaged Property

The amount realized on mortgaged property is cash received ***plus*** the amount of any debt secured by the property for which the taxpayer is no longer liable.

b. Sale for Future Payments

Where the sale price for the property sold consists of payments to be made in the future, the amount realized is the full sale price unless the ***fair market value*** of the future payments is less than the sale price.

C. NONRECOGNITION OF GAIN OR LOSS

1. In General

Generally, all gain or loss is ***recognized*** (taxed), subject to certain exceptions.

2. Nonrecognition Provisions

In certain transactions, gain or loss is ***not*** recognized, and the basis of new property is the same as the transferred property. Gain or loss is merely ***deferred*** until the acquired property is sold.

a. Like Kind Exchanges

No gain or loss is recognized where the property held for investment or a business use is exchanged ***solely for like kind real property***.

(1) Sale and Leaseback

If the lease is for ***more than 30 years***, the IRS considers it a fee interest and the "like kind" requirement is met. However, the judicial approach is contra.

(2) Effect of "Boot"

If a taxpayer receives like kind and non-like kind property in an exchange, the non-like kind property is considered "boot," and the ***realized gain is recognized*** to the extent of the boot. The basis is adjusted: new basis = old basis + gain recognized − money received.

(3) Effect of Mortgages

For tax purposes, an exchange subject to an outstanding mortgage is treated the same as if the acquiring party paid cash.

(4) Exchanges Between Related Persons

If a relation with whom taxpayer exchanged property disposes of the property ***within two years*** (or vice versa), the taxpayer must recognize gain or loss on the original exchange.

(a) Exceptions

Dispositions after the death of either the taxpayer or related person, involuntary conversion of the property, or a transaction that satisfies the IRS that tax avoidance is not a principal purpose do not trigger recognition of gain or loss.

b. Involuntary Conversions

If the converted property is replaced with "similar or related in service or use" property ***within two years*** after the close of the tax year in which the insurance proceeds were received, gain is recognized only to the extent the amount realized exceeds the replacement cost. Nonrecognition under this section is ***elective***.

(1) Special Rules for Condemnation of Business Real Property

Condemnations (or threat of) causing sale of ***business real property*** results in no gain if the proceeds are reinvested in like kind property, whether or not it is similar or related in service or use. The replacement period is three years.

c. Nonrecognition of Gain on Sale of Principal Residence

No loss can be recognized on the sale of a personal residence. Gain from the sale of a principal residence generally is not recognized unless in excess of $250,000 (or $500,000 on a joint return), which excess is taxable as capital gain. To qualify for the exclusion, the taxpayer must have ***owned and used*** the dwelling as a ***principal residence*** for periods aggregating ***two years or more in the five-year period*** ending on the date of the sale or exchange.

(1) Married Couples

To qualify for the $500,000 exclusion, a married couple must file a joint return for the year in which the sale or exchange occurs and must still be married on the last day of the taxable year. Either spouse can be the record owner of the house, but ***both*** spouses must meet the two-year use and two-year prior sale requirement.

d. Sales Between Spouses

If the sale is between spouses (or former spouses incident to a divorce), no gain or loss is recognized.

e. Mortgage Repossessions

Gain is not recognized when the taxpayer forecloses on property he sold and financed with a mortgage.

V. WHAT KIND OF INCOME IS IT? CAPITAL GAINS AND LOSSES AND TAX PREFERENCES

A. INTRODUCTION

1. Capital Gains

The tax on an individual's net capital gain is 20% for single filers with income above $434,550 and joint filers with income above $488,850. It is 15% for all others, except for individuals in the 15% or 10% brackets, who pay a 0% rate on net capital gains. Net capital gain means the excess of net long-term capital gain over net short-term capital loss. For this purpose, long-term means a holding period of ***more than 12 months***.

2. Capital Loss

Capital loss can be deducted against capital gain for the year plus $3,000. Any excess can be carried forward to future years and offset against capital gain in that year plus $3,000.

3. Approach

In classifying the transaction, the following factors are considered: whether the property is a ***capital asset***; whether there was a ***sale or exchange***; and whether the gain or loss is ***long-term or short-term***. If the gain or loss is long-term, apply the rules for limitation of ***capital loss deductions*** and ***capital loss carryforwards***.

B. IS IT A CAPITAL ASSET?

1. General Rule

All property held by a taxpayer is a capital asset with certain exceptions. However, courts have interpreted "all property . . . except" to mean that the statutory exceptions are ***not*** exclusive.

2. Statutory Exceptions

a. Property Held for Sale

Inventory and property held for sale ***to customers*** in the ***ordinary course of business*** are not capital assets. Problems arise in determining whether ***real estate*** is sold by an investor (making the land a capital asset) or by a dealer (one who holds the property for sale to customers). Securities are generally treated as capital assets, but assets acquired in a "hedging transaction" are not.

b. Receivables

Accounts receivable ***or notes*** acquired in the ordinary course of business in ***payment for services rendered*** by taxpayer, or on a sale of an ***inventory item*** are not capital assets.

c. Depreciable Property and Realty

Depreciable property and any ***real property used in a trade or business*** are not capital assets. However, most of these assets are treated as ***"quasi-capital assets"*** if held for more than one year and are accorded favorable tax treatment.

d. Copyrights and Patents

Copyrights and other literary or artistic property are ***not*** capital assets in the hands of the creator (or any donee), although there is a limited exception for musical property.

e. Options

If the optioned property would be, if acquired, a capital asset, then the option itself is a capital asset.

3. Exceptions Developed in Case Law

Courts have created other exceptions to provide a form of ***income averaging*** for long-term gains and to ***remove disincentives*** against sale of appreciated property. Courts generally try to distinguish ***investments*** from mere ***substitutes for ordinary income***.

a. Sale of Rights to Income

If a taxpayer sells the right to future income from her property while retaining the property, the sale proceeds are taxable to her as ordinary income, not capital gains.

(1) Sale of Life Estates

A sale of a life estate by a trust beneficiary is taxed as a capital gain.

b. Contract Rights

(1) Is It "Protectable in Equity"?

If the contract right is property "protectable in equity," it will be taxed as a capital gain (*Ferrer* case).

(2) Leases

Amounts paid to a ***lessee*** for an ***assignment***, ***cancellation***, or ***change in terms*** of a lease are given capital gains treatment. However, amounts paid for a ***release*** or ***sublease*** are not capital gains.

(3) Personal Services

Proceeds from the sale of a personal service contract are ordinary income.

(4) **Insurance Policies**

Amounts received for assignments of beneficial interests are capital gains but a sale of an ***annuity or endowment*** may be ordinary income.

c. **"Personal Rights"**

Personal rights are not "property"; therefore, income from the sale therefrom is given ***ordinary income treatment*** (*e.g.*, compensation paid for the sale of one's right of privacy).

d. **Classification Through Correlation with Related Transaction**

A transaction may be classified as ordinary or capital because it is part of a related transaction.

(1) **Tax Benefit Rule**

If taxpayer deducts certain notes as bad debts and later recovers on the notes, the recovery produces ordinary income. Thus, if taxpayer sells these notes, it would result in ordinary income, not capital gain.

4. **Sale of Business Interests**

a. **Sole Proprietorships**

In determining capital gain vs. ordinary income on the sale of a proprietorship (or the sale of assets by a partnership or corporation), each asset is examined separately to determine if it qualifies as a capital asset (***fragmentation theory***). The parties can make a ***reasonable allocation*** of price to each asset.

(1) **Goodwill**

Goodwill is a capital asset and is depreciable by the buyer over a 15-year period.

(2) **Covenant Not to Compete**

Payment for a covenant not to compete is ordinary income to the seller. The amount paid is an asset to the buyer, which can be amortized over a 15-year period.

b. **Partnerships and Corporations**

A partnership ***interest*** or corporate stock is generally a capital asset. ***Sale of assets*** is treated the same as in a proprietorship.

5. **Assets Used in Trade or Business—Quasi-Capital Assets**

Real property and depreciable personal property ***used in a trade or business*** and ***held for more than one year*** are "quasi-capital assets."

a. **Other Assets**

Quasi-capital assets also include ***unharvested crops*** sold with the land, ***livestock herds*** held at least 24 months, and in certain cases, ***coal, timber, and minerals***.

b. **Computation**

If the gains exceed the losses, all the transactions are ***long-term capital transactions***. If the losses exceed the gains, all the transactions are ***ordinary***. Losses within the preceding five years will result in treating current gain as ordinary income to the extent of previously unrecaptured losses (***recapture of losses***).

c. Special Rules for Casualties

If the taxpayer has recognized gains and losses from business or investment casualties and gains exceed losses, all such casualties are included in the section 1231 calculation.

d. Limitation—Recapture of Depreciation

Recapture of depreciation provisions ***supersede*** section 1231, turning capital gain into ordinary income. However, capital gains treatment for ***any depreciable property*** (not just section 1231 assets) is ***not*** allowed in sales or exchanges ***between "related" taxpayers***, and ***losses*** are ***not*** deductible (*supra*).

C. WAS THERE A "SALE OR EXCHANGE"?

1. In General

Usually, there must be a "sale or exchange" of a capital asset for the transaction to be taxed as a capital gain or loss.

a. Aborted Sales

If a "sale" occurred and the seller repossessed the property because of failure to pay the entire price, the amount that the seller keeps is capital gain.

b. Transfer of Mineral Interest

A mineral interest is a capital asset, but if the seller retains an ***economic interest***, she is treated as not having sold the minerals (she can deduct depletion).

c. Transfers of Franchises, Trademarks, and Trade Names

Capital gains treatment is available on the transfer of a franchise, trademark, or trade name ***only if*** the transferor retains ***no significant interest or power*** therein. *Note:* ***Sport franchises*** are always entitled to capital gains treatment.

d. Contract Rights

Generally, the transfer of contract rights between contracting parties is considered a "sale" and is given capital gains treatment. However, a minority of jurisdictions hold that this transfer does not constitute a "sale or exchange."

e. Foreclosure

Foreclosure is treated as a sale or exchange by the debtor; consequently it is given capital gain or loss treatment. But the ***abandonment*** of worthless property is ***not*** a sale or exchange and thus is an ordinary loss.

2. Special Situations in Which "Sale or Exchange" Deemed to Occur

a. Worthless Debts and Securities

Nonbusiness bad debts and worthless securities are deductible as capital losses.

b. Payments to Creditors

Ordinarily, amounts paid by a debtor to a creditor are a return of capital and ***not*** a "sale or exchange." This general rule has been partially superseded by statute in that collection of a debt instrument (*e.g.*, bond, promissory note) is treated as a sale or exchange by the creditor.

c. Involuntary Conversion

This is deemed equivalent to a "sale or exchange."

3. Validity of "Sale or Exchange" Not Affected by Seller's Retention of Control

If there is a complete transfer of title for a fair consideration, there is a sale. If the purchase price exceeds the value of the assets sold, the excess is ordinary income. Note that the grantor trust rules do not apply.

D. WAS THERE A SUFFICIENT "HOLDING PERIOD"?

1. In General

A capital asset must be held ***more than 12 months*** prior to a "sale or exchange" to qualify for a ***long-term*** capital gain; if held 12 months or less, it is a short-term gain.

2. "Tacking" of Holding Period Where Substituted Basis

A holding period commences only on a ***change in basis*** on the property. If there is no change, the taxpayer acquires the holding period of the transferor and can "tack" it to the time he holds the property.

E. GAINS ON SMALL BUSINESS STOCK

1. General Rule

A taxpayer (other than a corporation) can exclude from income 50% of the gain on the sale of qualified small business stock that has been held for at least five years.

2. Limit

The amount of gain subject to the 50% exclusion cannot exceed the greater of $10 million or 10 times the adjusted basis of the stock.

3. Qualified Small Business Stock

The stock must have been ***issued after August 1993***, taxpayer must be the ***original purchaser***, and the corporation must conduct an ***active business*** (excluding most service and real estate businesses) with ***assets*** after stock issuance ***not exceeding $50 million***.

F. SPECIAL COMPUTATIONS

1. In General

Special rules may turn capital gain into ordinary income or require the deferral of certain losses.

2. "Imputed Interest"

Interest is imputed on sales wherein the payments are ***deferred*** and interest is charged at less than the prescribed rate. Interest produces ordinary income.

a. Exceptions

Total and partial exceptions to imputed interest rules include a selling price of $3,000 or less (***de minimis rule***) and ***intrafamily real estate deals*** (imputed interest cannot exceed 7%). The rules also are inapplicable to ***buyers of personal use property***.

3. Recapture of Depreciation

Long-term or short-term gain attributable to prior depreciation may have to be reported as ***ordinary income*** if subject to special provisions.

a. Personal Property

The realized gain on most depreciable tangible personal property is treated as ordinary income to the extent of all depreciation previously deducted by a taxpayer.

b. Real Property (Buildings)

Depreciation deductions in excess of straight-line rate (available only under prior law) taken with respect to buildings are recaptured.

c. Certain Transfers Not Subject to Depreciation Recapture

Depreciation is recaptured on any sale or disposition of property ***except:***

(1) ***Transfers by reason of death or gift;*** and

(2) ***Most nonrecognition transfers.***

4. Disallowed Losses

a. Losses Between Related Taxpayers

Losses between "related" taxpayers are not deductible, even if it was a bona fide transaction.

b. Personal Losses

Personal expenses or losses not in connection with a trade or business or investments are not deductible.

c. Losses on "Wash-Sales"

These are not recognized and cannot be deducted.

d. Passive Losses

Loss on passive activity is deductible only to the extent of income from that activity.

e. "At Risk" Rules

For certain investments, annual operating losses are limited to the amounts "at risk."

G. ALTERNATIVE MINIMUM TAX

1. Computation

Start with AGI, less certain deductions, plus "tax preferences" to arrive at alternative minimum taxable income ("AMTI"). Then subtract an exemption ($111,700 on joint returns, $71,700 on single). The exemptions are phased out for higher income taxpayers. The balance is taxed at a rate of 26% or 28%. If the alternative minimum tax ("AMT") exceeds the taxpayer's regular income tax, she must pay the AMT instead of the regular tax.

a. Capital Gains

AMT on net capital gain is computed separately from the AMT on ordinary income. The AMT on net capital gain is at the same rate as for regular tax purposes.

2. Disallowed Deductions Under the AMT

Certain deductions are not allowable under the AMT, including miscellaneous itemized deductions (*supra*), state and local taxes, standard deductions and personal exemptions, and home equity loan interest. Medical deductions are allowed but only if in excess of 10% of AGI, and depreciation is deductible only under a 150% declining balance formula.

3. Tax Preferences

The most important preferences are the bargain element of an incentive stock option, the excess of percentage depletion, intangible drilling costs, and interest on private purpose municipal bonds.

VI. TAX ACCOUNTING PROBLEMS

A. ACCOUNTING METHOD—WHEN IS AN ITEM TAXABLE OR DEDUCTIBLE?

1. Introduction

The Code authorizes the taxpayer to use whatever method she uses in keeping her books. However, a taxpayer may not change the method used, even if it is wrong, without prior government approval. The Commissioner may change a taxpayer's method if it does not clearly reflect income.

2. Cash Receipts and Disbursements Method

Items of income are includible in the year in which ***cash*** (or a cash equivalent) is received. Deductions are taken in the year the ***payment is made***.

a. Constructive Receipt Doctrine

If a cash basis taxpayer has an ***unqualified*** right to a sum of money or property, plus the power to obtain it, this is equivalent to actual receipt and it is currently income.

(1) Deferred Compensation

The doctrine often arises in connection with deferred compensation. Deferred compensation is not taxed until actually paid unless the agreement to defer compensation is made after services are rendered or after payment is due, or unless the taxpayer receives an economic benefit as payment (*e.g.*, the employer's promise to pay is secured, or the compensation is paid into a trust that is shielded from the employer's creditors).

b. Qualified Pension and Profit-Sharing Plans

The Code allows deferral of an employer's contributions to qualified plans for employees. The employer is entitled to an ***immediate deduction***; however, the employee is taxed only upon distribution.

(1) Tax Treatment on Retirement

Upon retirement, the employee's ***own*** contributions are returned (tax free) and the amount of the employer's contributions are generally taxed as ***ordinary income***.

(2) Limits on Contributions and Benefits

There are limitations on the amount of contributions in any one year. Also, the plans must be nondiscriminatory.

c. Property Transferred in Connection with Performance of Services—"Timing Rule"

I.R.C. section 83 gives rules for the "timing" of an employee's income when the employer uses property (including stock) as compensation. Generally, the employee is taxed when he receives the property. However, if the property is subject to ***both*** a substantial risk of forfeiture ***and*** is nontransferable, the employee is not taxed (and the employer does not claim a deduction) until the first year in which the property is either nonforfeitable or transferable. The amount includible is the value of the property at the later date.

(1) Nonlapse Restrictions

If the property is subject to a restriction that will never lapse, the includible amount is the formula price.

(2) **Other Restrictions**

Restrictions on property not amounting to a substantial risk of forfeiture or a nonlapse restriction are ignored in valuing the property.

(3) **Employee Election**

In any event, the taxpayer can elect to include value in income when the property is received.

d. **Employee's Stock Options**

Generally, stock or an option to buy stock issued by an employer is taxed as ***ordinary income*** to the employee. The ***exercise*** of the option is usually the taxable income when received.

(1) **Employer's Deduction**

The employer gets a deduction when the employee has income.

(2) **Incentive Stock Options**

If a stock option qualifies as an "incentive stock option" based on certain requirements, there is no tax on either the grant or exercise of the option. The employee is taxed when he sells the stock. The employer receives no deduction at any time.

e. **Claim of Right Doctrine**

If a taxpayer receives money or property and claims she is entitled to it and can freely dispose of it, it is immediately taxable, despite the fact that she might have to give it back.

(1) **Repayment**

If repayment is made, the taxpayer receives a deduction in the year of repayment.

f. **Prepaid Income**

Prepayments are income when received.

(1) **Deposits**

An advance payment for goods or services is currently taxable to the seller even if the goods or services are to be furnished in a later year. A security deposit, however, is not currently taxable.

g. **Prepaid Expenses**

Amounts prepaid for goods or services to be received in later tax years must be ***capitalized*** and deducted ratably in future tax years.

h. **Credit Card Payments**

Payment for any deductible item by a credit card gives rise to a deduction when the item is charged, not when the bill is paid.

3. **Accrual Method**

The taxpayer reports income in whatever year it is ***earned*** (not necessarily paid) and deducts expenses in the year ***incurred***. This method is required in all cases where ***inventories*** are a material factor affecting income, and for corporations, partnerships with a corporate partner, and tax shelters.

a. Exceptions

Important exceptions to the accrual method requirement include ***S corporations***, corporations or partnerships with average ***annual gross receipts of less than $5 million***, ***qualified personal service corporations***, and ***farming businesses***.

b. Special Problems with Income Under Accrual Method

(1) Deferred Income

The test applied is whether ***all events have occurred*** that establish a right to income and the amount is reasonably determinable.

(2) Prepaid Income

Supreme Court cases hold that prepaid income is taxable ***when received***; the IRS permits deferral of advance payments from sale of goods and limited deferral for advance payments for services.

(3) Dividends

Taxpayer is treated as having no income until dividends are actually received.

(4) Increasing Rents

When a lease calls for increasing payments with total rent payments in excess of $250,000, both lessor and lessee must account for the rent on an accrual basis.

c. Deductions Under Accrual Method

The criteria for deductibility are whether: (i) all events have occurred that establish an ***unconditional duty to pay***; (ii) ***economic performance*** has occurred; and (iii) the amount is ***reasonably ascertainable***.

(1) Fixed Duty to Pay

It must be established that there is an unconditional duty to pay a reasonably determinable amount. Contingent liabilities and reserves are therefore not deductible.

(2) Economic Performance Rule

The all events test is not met until economic performance occurs. Economic performance occurs when services or property are actually provided to, or used by, the party obligated to pay for them.

(3) Disallowance of Deduction for Amount Owed to Related Taxpayer

The Code ***disallows*** the accrual of such a deduction ***until paid***. *Note:* No deduction is allowed until "economic performance" has occurred.

d. Inventories

When inventories are an income-producing factor, the taxpayer ***must*** account for purchases by using an ***inventory***. The effect is that the taxpayer cannot deduct the cost of goods or materials in the year of the purchase ***unless he sells them that year***. There are two methods by which the taxpayer may take his inventory:

(1) First-In, First-Out ("FIFO")

The theory is that the goods first acquired were those that were first sold. The "cost" of the goods on hand at the close of the tax year is the cost of the goods last purchased.

(2) **Last-In, First-Out (“LIFO”)**

The last items placed in inventory are assumed to be the first sold. LIFO can be used for tax purposes only if also used for financial purposes.

4. Installment Method

This method is intended to allow sellers of ***property*** (other than “dealers”) who are receiving payments on a deferred basis to include their gain only as they receive cash from the sale. The mechanics involve a fraction of the “gross profit” over “total contract price” being applied to each installment payment to determine how much of the payment is income (but interest payments are entirely includible). The installment method can be used only for sales of non-dealer property, not services, and only if the transaction produces a gain.

a. Restrictions

The installment method cannot be used for ***debts payable on demand*** (or readily transferable), ***sales to related persons***, ***dealer property***, or ***sale of assets of an accrual method business***.

b. Interest on Deferred Income

When the installment sale price ***exceeds $150,000***, the taxpayer must pay interest to the government on the deferred tax liability if the face amount of ***all*** such obligations held by the taxpayer and that arose during, and are still outstanding at the close of, the taxable year, exceeds ***$5 million***.

c. Mortgaged Property

When a buyer takes subject to a mortgage, the mortgage is not considered in determining the seller’s total contract price or payments received in the year of the sale, unless the seller’s basis is less than the mortgage.

d. Disposition of Installment Obligations

If the taxpayer has been using the installment method and sells or otherwise disposes of the obligation, the gain that was not previously taken into income is immediately recognized. ***Exceptions*** from the disposition rule occur upon the ***death of a taxpayer*** and ***transfers between spouses***.

B. THE ANNUAL ACCOUNTING PERIOD

1. Introduction

The taxpayer ordinarily must pay the tax each year based on the income that year, even though taxpayer is engaged in transactions stretching over several years.

2. Selection of Tax Year

Generally, taxpayers must report on a calendar year.

3. Repayment of Income Reported in Prior Year

Payments made to the taxpayer during the tax year that he receives them under a “claim of right” are taxed as income to him during that year. The repayment in the later year does not “reopen” the prior tax computation, but a ***deduction is allowed in the year of repayment***. The taxpayer can choose to use the bracket of the earlier year or the current year if the amount repaid is at least $3,000.

4. Tax Benefit Rule

A recovery of an item deducted in a prior year is included in income in the year received if the deduction in a prior year gave the taxpayer a tax benefit in that earlier year. Any event inconsistent with that earlier deduction can trigger income in a later year even if there is no "recovery" in the later year.

5. Net Operating Loss ("NOL") Deduction

If all of the business deductions exceed his income, the taxpayer has a "net operating loss."

a. Use of NOL

The NOL can be ***carried forward*** indefinitely after a loss year and used as a deduction, but only up to 80% of the taxable income in any given period. The NOL may not be carried back.

b. Amount of NOL

The amount of an NOL that may be carried forward is equal to a negative taxable income figure adjusted as follows:

(1) ***No deduction for capital losses in excess of capital gains*** is allowed;

(2) ***Personal exemptions*** are disallowed; and

(3) ***Deductions not attributable to trade or business*** are allowed only to the extent of the income not attributable to that trade or business.