Federal Income Tax

Professor Lon Sobel

Southwestern Law School

Study Guide

Fall 2010

Southwestern Law School
FEDERAL INCOME TAX
Syllabus, Course Requirements, and Grading Criteria
Professor Lon Sobel
SCALE II- Period 4
Fall 2010

PHONE: 213-738-6756 **EMAIL:** lsobel@swlaw.edu **OFFICE:** BW325

I. COURSE MATERIALS

A. Required Text or Course Materials

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B. Recommended Text

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A. Class Preparation

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III. ASSIGNMENTS:

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Day/Date	Topics	Study Guide	Read in Posin & Tobin	√
	Principles of Federal Income Tax			
Tuesday August 10	Overview of Course and Federal Tax **Income** Introduction Income in General	1	1- 8 51 - 59	
	Fringe Benefits Prizes	2	59 - 65 117 - 118	
Wednesday August 18	Interest Dividends Rents Royalties	3	79 - 83 86 - 89 89 - 89 89 - 92	
	Life Insurance Proceeds Gifts and Inheritances	4	92 - 96 101 - 111	
Thursday August 26	Discharge of Debt Damages Assignment of Income	5	121 - 122 136 - 143 329 - 336	
	Deductions Structural Issues	6	354 - 362	
Thursday September 2	Ordinary and Necessary Business Expenses Rental Expenses Bribes and Penalties Lobbying and Political Expenses Moving Expenses	7	362 - 364 - 472 - 475 475 - 476 406 - 407	
	Capital Expenditures vs. Business Expenses Depreciation	8	457 - 464 422 - 435	
Tuesday September 7	Itemized Deductions in General Tax Advice and Attorney's Fees Taxes Interest	9	487 - 489 489 - 490 498 - 500 490 - 498	
	Casualty Losses Charitable Contributions Floor on Miscellaneous Itemized Deductions Standard Deduction	10	500 - 506 519 - 527 527 - 528 529 - 530	
Thursday September 16	**Income & Deductions, Combined:** **Sales and Exchanges of Property** Overview of Sales and Exchanges The Requirement of Realization	11	148 - 152 152 - 166	
	Computation of Gain or Loss Realized	12	171 - 184	
Thursday September 23	Carryover Basis of Gifts Basis of Property Received from Decedents	13	198 - 203 205 - 209	
Thursday September 30	Recognition of Gain or Loss: In General Exchanges of “Like-Kind” Property	14	217 - 220 220 - 228	
Thursday October 7	Recognition of Gain or Loss: Involuntary Conversions “Wash Sales” of Stock	15	237 - 239 242 - 246	

Day/Date	Topics	Study Guide	Read in Posin & Tobin	√
Thursday October 14	**Tax Rates** Ordinary Income vs. Capital Gains Capital Assets Capital Losses	16	 251 - 252 282 - 289 301 - 306 266 - 268	
	Section 1231 Property Calculation of Capital Gains Tax Capital Gains Policy	17	- - 319 - 322	
Thursday October 21	**Tax** Alternative Minimum Tax Social Security and Medicare Taxes	18	 532 - 539 -	
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Selected Applications				
Thursday November 4	**Family** The Marriage Tax Personal and Dependents Exemptions Dependents Exemptions after Divorce	20	 448 - 451 530 - 532	
	Alimony and Child Support	21	443 – 447	
Thursday November 11	Property Division in Divorce Child and Dependent Care Credit Child Tax Credit	22	166 - 171 634 - 637 640 - 642	
	Health Care Medical Expenses	23	 514 - 519	
Thursday November 18	**Home Ownership** Home Mortgage Interest Property Taxes First-Time Homebuyers Credit	24	 490 - 498 - -	
	Home Office Expenses Vacation Homes	25	412 - 417 417 - 422	
Monday November 22	Gains (and Losses) on Sales of Homes	26	210 - 217	

Tuesday November 30	For this class session, we will cover whichever *one* of the following topics the class selects			
	Education Scholarships Education Expenses Student Loan Interest Hope Scholarship/Lifetime Learning Credits	27	118 - 121 384 - 388 - 642 – 646	
	Travel Business Travel Expenses Business vs. Pleasure Travel Expenses	28	370 – 380 394 – 396	
	Entertainment, Amusement, and Recreation Expenses Entertainment, Amusement, and Recreation Expenses Limits on Deductibility of Business Meals and Entertainment Expenses Hobby Expenses	29	396 – 403 403 – 404 407 – 412	
Review and Exam				
Thursday December 2	Review and Distribution of Final Exam Questions			
Monday December 6	Final Exam Answers Due by 9:30 am			

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Mon	Sept 6	No class. Labor Day.			
Wed	Sept 8	**Deductions** Structural Issues	6	 354 - 362	
Thurs	Sept 9	No class. Rosh Hashanah.			
Mon	Sept 13	Ordinary and Necessary Business Expenses Rental Expenses Bribes and Penalties Lobbying and Political Expenses Moving Expenses	7	362 - 364 - 472 - 475 475 - 476 406 - 407	
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Wed	Nov 3	**Entertainment, Amusement, and Recreation Expenses** Entertainment, Amusement, and Recreation Expenses Limits on Deductibility of Business Meals and Entertainment Expenses Hobby Expenses	29	396 – 403 403 – 404 407 – 412	
Thur	Nov 4	The topics for these class meetings will be selected later in the semester. In choosing topics, we will take into account what is then new and newsworthy and what you and your classmates are interested in covering. I currently have in mind these possible topics: Tax treatment of: - Retirement - Deferred compensation - Taxation of personal income earned abroad			
Mon	Nov 8				
Wed	Nov 10				
Thur	Nov 11				
Mon	Nov 15				
Wed	Nov 17				
Thur	Nov 18				
Mon	Nov 22				
Wed	Nov 24	No class. Thanksgiving.			
Thur	Nov 25	No class. Thanksgiving.			
Mon	Nov 29	Selected topics (continued)			
Tue	Nov 30				
Wed	Dec 1				
Thur	Dec 2	Review and Distribution of Final Exam Questions			
Mon	Dec 6	Final Exam Answers Due (at Time To Be Announced)			

PART 1: PRINCIPLES OF FEDERAL INCOME TAXATION

INCOME

<u>Introduction</u>

Read (in Posin & Tobin)

Pages 1-8

Questions

We begin with a high-level overview of federal income tax – "the view from 40,000 feet," so to speak. We'll get down to ground level (and below) in classes to follow. But before we do that, you'll need to know some tax terminology. The following questions will enable you to test yourself on whether you picked up the meanings of critical terms as you read the pages assigned for this lesson.

1. Federal income tax is "progressive." Why is it called "progressive"?
   a. Because the tax system is designed to finance progress.
   b. Because the tax system was designed by the Progressive Party (a political party formed in 1912 by Theodore Roosevelt when he lost the Republican Party nomination for President to William Howard Taft).
   c. Because federal income tax rates increase as a taxpayer's income increases.
   d. Because federal income tax rates decrease as a taxpayer's income increases.
2. Tammy Taxpayer will have *taxable* income of $100,000 in 2008 and will be in the 28% tax bracket. This means that for 2008, she will pay federal income tax of:
   a. $28,000 (i.e., 28% of $100,000).
   b. less than $28,000, because she will pay 28% in taxes only on the last several thousand dollars that she earns; the first several thousand dollars that she earns will be taxed at lower rates.
   c. more than $28,000, because she will pay 28% in taxes on the first several thousand dollars that she earns; the last several thousand dollars that she earns will be taxed at higher rates.
   d. None of the above.
3. In order to get a "progressive" tax system, the Internal Revenue Code uses something called "marginal tax rates." What are "marginal tax rates"?
   a. They are tax rates that are printed in the margins of the pages of the Code, like footnotes.
   b. They are rates that are applied on last dollar a taxpayer earns.
   c. They are rates that are applied on the first dollar a taxpayer earns.
   d. None of the above.

4. Because federal income tax is “progressive,” it isn’t “regressive.” What is a “regressive tax”?
    a. A type of tax system advocated by the Regressive Party – a ultraconservative political party that seeks to return America to the kind of society it enjoyed during the 19th century.
    b. A tax system whose rates increase as a taxpayer’s income increases, thereby reducing the taxpayer’s incentive to work and causing society to regress.
    c. A tax system that requires those who earn high incomes to pay a greater percentage of their total income in tax than those who earn low incomes.
    d. A tax system that requires those who earn low incomes to pay a greater percentage of their total income in tax than those who earn high incomes.
5. The Social Security tax is 12.4% of a taxpayer’s wages up to $102,000 per year (for 2008). Half of that – 6.2% – is paid by the taxpayer’s employer and the other half is paid by the employee him or herself. This means that a taxpayer who earns $102,000 in 2008 will pay $6,324 in Social Security tax (6.2% x $102,000). It also means that a taxpayer who earns $1 million in 2008 will pay the same $6,324 in Social Security tax. As a percentage of his or her total income, the taxpayer who earns $102,000 will pay 6.2%, while the taxpayer who earns $1 million will pay just 0.6324%. The Social Security tax is:
    a. Progressive.
    b. Regressive.
    c. Neither progressive nor regressive, but is instead an example of a “flat tax.”
    d. None of the above.
6. What is a taxpayer’s “effective tax rate” (sometimes called the “average tax rate”)?
    a. The rate determined by the taxpayer’s tax bracket.
    b. The average of the taxpayer’s tax bracket rate and Social Security rate.
    c. The percentage of the taxpayer’s taxable income actually paid in federal income taxes.
    d. The percentage of the taxpayer’s taxable income actually paid in federal income and Social Security taxes.
7. “Gross income” is:
    a. All income, from every source, including income that does not have to be reported to the IRS.
    b. Income from sources that are too disgusting to be discussed.
    c. Income from all sources that the law requires to be reported to the IRS, which means income from absolutely all sources.
    d. Income from all sources that the law requires to be reported to the IRS, which means that some income – including income that is received, enjoyed and even spent – is not included in “gross income.”

8. What is a taxpayer's "adjusted gross income"?
    a. The amount the taxpayer is required to include in "gross income" after being audited by the IRS.
    b. The amount of the taxpayer's income after taxes are paid.
    c. The amount of the taxpayer's income after "above-the-line" deductions are taken.
    d. The amount of the taxpayer's income after the *employer*'s share of Social Security tax is added to the taxpayer's gross income.
9. "Above-the-line deductions" are:
    a. The same as "above the table" deductions, i.e., deductions that are legitimate and honest.
    b. Deductions that may be taken by all taxpayers (who actually incurred the relevant expenses), including taxpayers who do not itemize their deductions.
    c. Neither of the above.
    d. Both of the above.
10. A "standard deduction" is:
    a. A deduction for an expense that is so common that virtually all taxpayers incur such expenses and take deductions for it.
    b. A deduction that every taxpayer is entitled to take, including those taxpayers who itemize their deductions.
    c. A deduction that every taxpayer is entitled to take, but actually is taken only by those whose itemized deductions would amount to less than the amount of the standard deduction.
    d. None of the above.
11. What are "itemized deductions"?
    a. Deductions for specific expenses permitted by the Internal Revenue Code.
    b. Deductions that are listed on tax returns, expense by expense (or at least by category).
    c. Both of the above.
    d. Neither of the above.
12. Will a taxpayer's itemized deductions always will be greater than his or her standard deduction?
    a. Yes.
    b. No.
13. Do all types of itemized deductions reduce a taxpayer's taxes by the same amount?
    a. Yes.
    b. No.

14. “Personal and dependency exemptions” are:
    a. Circumstances that exempt some taxpayers from the obligation to file tax returns.
    b. Amounts that all taxpayers may deduct, for themselves and their dependents, from their Gross Incomes in calculating their Taxable Incomes.
    c. Amounts that taxpayers who itemize their deductions may deduct for themselves and their dependents.
    d. Amounts that taxpayers who do not itemize their deductions may deduct for themselves and their dependents.
15. What is a “tax credit”?
    a. A deduction for federal taxes paid the prior year.
    b. A deduction for state and local taxes paid for the current year.
    c. A credit against the following year’s taxes given by the IRS to taxpayers who overpay their taxes for the current year.
    d. A credit against taxes that would otherwise be payable for the current year.
16. Which saves taxpayers more in taxes?
    a. A $1,000 standard deduction.
    b. A $1,000 itemized deduction.
    c. A $1,000 credit.
    d. All three save taxpayers the same amount in taxes.
17. A taxpayer bought property for $100,000 and later sold it for $200,000. What was the taxpayer’s “basis” in the property?
    a. $100,000
    b. $200,000
    c. $300,000
    d. None of the above.
18. In question 17, how much did the taxpayer “realize”?
    a. $100,000
    b. $200,000
    c. $300,000
    d. None of the above.
19. In question 17, what was the taxpayer’s “gain”?
    a. $100,000
    b. $200,000
    c. $300,000
    d. None of the above.

20. Is a tax deduction this year a benefit to you, even if you have to pay tax on the amount deducted at some point in the future?

    a. Yes

    b. No

21. During George Bush's first term as President, Congress passed four bills that cut the taxes of some Americans. However, those tax cuts – which were referred to during the last Presidential campaign as the "Bush Tax Cuts" – will automatically expire in 2010, at which time they will disappear and taxes will return to their pre-2001 levels, unless new legislation prevents that from happening. Why did Congress insert expiration dates into the very laws that cut taxes in the first place, and why did Congress choose 2010 as the expiration date for the cuts?

    a. To put pressure on Americans to elect a Republican as President in 2008, because a Republican would have been more likely than a Democrat to extend the tax cuts beyond 2010.

    b. To give Congress an opportunity to see whether the tax cuts had a positive or negative impact on the U.S. economy, and to make adjustments if necessary.

    c. To reach a compromise between Republicans who wanted to cut taxes permanently and Democrats who didn't want to cut taxes at all.

    d. To comply with an already existing rule that required Congress to offset tax cuts with spending reductions, so as not to increase the deficit; but spending reductions weren't necessary until 2010 (Congress calculated) because of budget surpluses that were earned while Bill Clinton was President.

Income in General

This begins our study of what is included in "gross income," and in particular, what kinds of *compensation for services* are "gross income." But before we zero in on "compensation," you'll want to know how "income" is defined generally. As a result, our study will start with some types of income that aren't actually "compensation for services." Then we'll segue into compensation for services by looking at Fringe Benefits.

Read (in Posin & Tobin) re Income in General

Pages 51-59

Internal Revenue Code re Income in General

§ 61. Gross income defined

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

Questions re Income in General

22. Teresa Taxpayer bought a used guitar on eBay for $5. Ten years later, Teresa's son accidentally knocked the guitar off a table, and the guitar broke open like an egg. Teresa then discovered that an envelope had been taped to the inside of the guitar, and inside the envelope she found five $1,000 bills. The $5,000:

    a. is not income to Teresa, and never will be.

    b. is not income to Teresa unless and until she spends the money, at which time it will be income to her.

    c. was income to Teresa in the year in which she bought the guitar.

    d. became income to Teresa in the year in which she found the money.

23. Tex Taxpayer is a successful football coach. In addition to paying Tex a salary and bonuses, his team leases a Cadillac for his wife and a Corvette for his son. The team does this, because when Tex's agent negotiated Tex's employment contract, the agent demanded that the team do so. Tex's employment contract requires the team to lease both cars and to make the lease payments directly to the auto leasing company. The auto lease money does not go to Tex (or his wife or son). The lease payments:

    a. are not income to Tex, because he doesn't receive that money.

    b. are not income to Tex, because he doesn't drive the cars.

    c. are income to Tex, because his agent demanded that the team lease the cars; if the team had volunteered to lease the cars for Tex's wife and son, and Tex's contract said nothing about the leases, the payments would not have been income to Tex.

    d. are income to Tex, because they are part of his compensation for coaching the team.

24. Tuffie Taxpayer sued her former investment advisor for investing her money in a what turned out to be a Ponzi scheme run by the advisor himself. In addition to recovering all of the money Tuffie lost on the investment, Tuffie also obtained a judgment for, and actually collected, punitive damages. The punitive damages:

    a. are income to Tuffie, because they were an "accession to wealth" which she "realized" and over which she had "complete dominion."

    b. are income to Tuffie, even if she had been unable to collect them, because she got a judgment for them.

    c. are not income to Tuffie, because they were a windfall.

    d. are not income to Tuffie, because although they were a "gain" to her, that gain was not derived from labor or capital.

25. [True story:] In August 2007, Barry Bonds, then of the San Francisco Giants, hit his 756th career home run – a new Major League Baseball record. The home run ball was caught by a baseball fan named Matt Murphy. The ball was estimated (by whom, I'm not clear) to have a value of $500,000, and Murphy was told (again, by whom, I'm not sure) that he would have to pay income tax on the ball's value, when he filed his tax 2007 return, even if he kept the ball and didn't sell it. The tax could have amounted to as much as $175,000. So Murphy arranged to sell the ball by auction. The winning bidder – fashion designer Marc Ecko – reportedly paid $752,467.20. [Questions:] Which of the following is true?

    a. Murphy got bad advice. He wouldn't have had to pay tax on the ball, unless and until he sold it.

    b. Murphy got good advice. He would have had to pay tax on the ball, even if he didn't sell it.

    c. As things turned out, Murphy got bad advice, because if he had kept the ball, he would have had to pay tax on its $500,000 estimated value, but since he sold the ball for more than that, he had to pay tax on the full amount he received when he sold it.

    d. Murphy got inaccurate advice, but only he can say whether it was "good" or "bad," because he wouldn't have had to pay tax the ball if he kept it, and he didn't have to pay tax on the money he received when he sold it. So the question – for Murphy – is simply whether he would have preferred to hang on the ball or whether he prefers the money.

    Note: If you find this question to be particularly interesting, or you are a serious baseball fan (in which case you *should* find this question to be interesting!), take a look at *Ball Busters: How the IRS Should Tax Record-Setting Baseballs and Other Found Property under the Treasure Trove Regulation*, by Andrew D. Appleby, 33 Vermont Law Review 43 (2008), available at SSRN: http://ssrn.com/abstract=1310846.

<u>Fringe Benefits</u>

Read (in Posin & Tobin) re Fringe Benefits

Pages 59-65

Internal Revenue Code re Fringe Benefits

§ 132. Certain fringe benefits

(a) Exclusion from gross income.—Gross income shall not include any fringe benefit which qualifies as a—

(1) no-additional-cost service,
(2) qualified employee discount,
(3) working condition fringe,
(4) de minimis fringe,
(5) qualified transportation fringe,
(6) qualified moving expense reimbursement,
(7) qualified retirement planning services, or
(8) qualified military base realignment and closure fringe.

(b) No-additional-cost service defined.—For purposes of this section, the term "no-additional-cost service" means any service provided by an employer to an employee for use by such employee if—

(1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and
(2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).

(c) Qualified employee discount defined.—For purposes of this section—

(1) Qualified employee discount.—The term "qualified employee discount" means any employee discount with respect to qualified property or services to the extent such discount does not exceed—

(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or
(B) in the case of services, 20 percent of the price at which the services are being offered by the employer to customers.

(2) Gross profit percentage.—

(A) In general.—The term "gross profit percentage" means the percent which—

(i) the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer, is of
(ii) the aggregate sale price of such property.

(B) Determination of gross profit percentage.—Gross profit percentage shall be determined on the basis of—

(i) all property offered to customers in the ordinary course of the line of business of the employer in which the employee is performing services (or a reasonable classification of property selected by the employer), and
(ii) the employer's experience during a representative period.

(3) Employee discount defined.—The term “employee discount” means the amount by which—
   (A) the price at which the property or services are provided by the employer to an employee for use by such employee, is less than—
   (B) the price at which such property or services are being offered by the employer to customers.

(4) Qualified property or services.—The term “qualified property or services” means any property (other than real property and other than personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.

(d) Working condition fringe defined.—For purposes of this section, the term “working condition fringe” means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.

(e) De minimis fringe defined.—For purposes of this section—

(1) In general.—The term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

(2) Treatment of certain eating facilities. – The operation by an employer of any eating facility for employees shall be treated as a de minimis fringe if -
   (A) such facility is located on or near the business premises of the employer, and
   (B) revenue derived from such facility normally equals or exceeds the direct operating costs of such facility. The preceding sentence shall apply with respect to any highly compensated employee only if access to the facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees. For purposes of subparagraph (B), an employee entitled under section 119 to exclude the value of a meal provided at such facility shall be treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to such meal.

(f) Qualified transportation fringe.—

(1) In general.—For purposes of this section, the term “qualified transportation fringe” means any of the following provided by an employer to an employee:
   (A) Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment.
   (B) Any transit pass.
   (C) Qualified parking.

(2) Limitation on exclusion.—The amount of the fringe benefits which are provided by an employer to any employee and which may be excluded from gross income under subsection (a)(5) shall not exceed—

(A) $100 per month in the case of the aggregate of the benefits described in subparagraphs (A) and (B) of paragraph (1), and

(B) $175 per month in the case of qualified parking.

(3) Cash reimbursements.—For purposes of this subsection, the term "qualified transportation fringe" includes a cash reimbursement by an employer to an employee for a benefit described in paragraph (1). The preceding sentence shall apply to a cash reimbursement for any transit pass only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

(4) No constructive receipt.—No amount shall be included in the gross income of an employee solely because the employee may choose between any qualified transportation fringe and compensation which would otherwise be includible in gross income of such employee.

. . .

(i) Reciprocal agreements.—For purposes of paragraph (1) of subsection (a), any service provided by an employer to an employee of another employer shall be treated as provided by the employer of such employee if—

(1) such service is provided pursuant to a written agreement between such employers, and

(2) neither of such employers incurs any substantial additional costs (including foregone revenue) in providing such service or pursuant to such agreement.

(j) Special rules.—

(1) Exclusions under subsection (a)(1) and (2) apply to highly compensated employees only if no discrimination.—Paragraphs (1) and (2) of subsection (a) shall apply with respect to any fringe benefit described therein provided with respect to any highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees.

. . .

(4) On-premises gyms and other athletic facilities.—

(A) In general.—Gross income shall not include the value of any on-premises athletic facility provided by an employer to his employees.

(B) On-premises athletic facility.—For purposes of this paragraph, the term "on-premises athletic facility" means any gym or other athletic facility—

(i) which is located on the premises of the employer,

(ii) which is operated by the employer, and

(iii) substantially all the use of which is by employees of the employer, their spouses, and their dependent children. . . .

§119. Meals or lodging furnished for the convenience of the employer

(a) Meals and lodging furnished to employee, his spouse, and his dependents, pursuant to employment.—There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if—

(1) in the case of meals, the meals are furnished on the business premises of the employer, or

(2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

(b) Special rules.—For purposes of subsection (a)—

(1) Provisions of employment contract or state statute not to be determinative.—In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a State statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

(2) Certain factors not taken into account with respect to meals.—In determining whether meals are furnished for the convenience of the employer, the fact that a charge is made for such meals, and the fact that the employee may accept or decline such meals, shall not be taken into account.

(3) Certain fixed charges for meals.—

(A) In general.—If—

(i) an employee is required to pay on a periodic basis a fixed charge for his meals, and

(ii) such meals are furnished by the employer for the convenience of the employer,

(iii) there shall be excluded from the employee's gross income an amount equal to such fixed charge.

(B) Application of subparagraph (A).—Subparagraph (A) shall apply—

(i) whether the employee pays the fixed charge out of his stated compensation or out of his own funds, and

(ii) only if the employee is required to make the payment whether he accepts or declines the meals.

(4) Meals furnished to employees on business premises where meals of most employees are otherwise excludable.—All meals furnished on the business premises of an employer to such employer's employees shall be treated as furnished for the convenience of the employer if, without regard to this paragraph, more than half of the employees to whom such meals are furnished on such premises are furnished such meals for the convenience of the employer.

Questions re Fringe Benefits

1. The law firm of Kind & Generous specializes in estate planning, and writes wills for its support staff. The firm charges clients $2,500 or more to prepare wills, but it doesn't charge its staff anything. The wills are prepared by lawyers who are members of the firm, whenever they have time to so. No paying clients are turned away. So the firm doesn't incur any out-of-pocket costs to write wills for its staff, nor does it lose any revenue by doing so. Which of the following best states the tax circumstances to staff members for whom the firm prepares wills?
    a. They will have to report $2,500 as income.
    b. They will have to report something as income, but the amount they report may be less or more than $2,500, depending on what the firm would charge a client for a similar will.
    c. They will not have to report anything as income, unless and until they die and the will is actually used.
    d. They will not have to report anything as income (attributable to the preparation of the will), ever.
2. The law firm of Rough & Tumble specializes in criminal defense. No one in the firm knows how to prepare wills. But the firm wanted to provide its support staff with wills, at no cost to the staff. As a result, Rough & Tumble made a written deal with Kind & Generous: Kind & Generous writes wills for Rough & Tumble's staff at no charge; and Rough & Tumble handles criminal defense matters for Kind & Generous's staff at no charge. Neither firm incurs out-of-pocket costs to provide these services; nor does either firm turn away any paying clients to do so. Which of the following best states the tax circumstances to Rough & Tumble staff for whom Kind & Generous prepares wills, and Kind & Generous staff for whom Rough & Tumble handles criminal defense matters?
    a. The staff of both firms will have taxable income.
    b. The staff of neither firm will have taxable income.
    c. The staff Rough & Tumble will have taxable income, but the staff of Kind & Generous will not.
    d. The staff of Kind & Generous will have taxable income, but the staff of Rough & Tumble will not.

3. A department store gives all of its employees a 20% discount from the retail price the store charges its customers. Even after the discount, the amount that employees pay is slightly more than the wholesale price the store paid to buy the merchandise in the first place. Is the amount of the discount "income" to the store's employees?
    a. Yes, because the discount is part of compensation the store's employees receive for working there.
    b. Yes, because the store incurred some cost in buying the merchandise, and therefore this fringe benefit does not qualify as a no-cost benefit.
    c. No, because employees pay more than the wholesale price paid by the store, so this is a qualified employee discount.
    d. No, because the discount does not put cash in the hands of the store's employees; it simply saves them money if they choose to buy something using the discount.
4. A department store gives all of its employees a 60% discount from the retail price the store charges its customers. After the discount, the amount that employees pay is less than the wholesale price the store paid to buy the merchandise in the first place. Is the amount of the discount "income" to the store's employees? Is any amount income to the store's employees?
    a. Yes, because the discount is part of compensation the store's employees receive for working there.
    b. Yes, because the store incurred some cost in buying the merchandise, and therefore this fringe benefit does not qualify as a no-cost benefit.
    c. Yes, because employees pay less than the wholesale price paid by the store, so this is not a qualified employee discount.
    d. No, because the discount does not put cash in the hands of the store's employees; it simply saves them money if they choose to buy something using the discount.
5. A law firm has a charge account with a restaurant near the firm's offices, and the firm allows its lawyers and staff to charge dinner at that restaurant if they return to the office after dinner and work until 10:00 pm (or later). Is the cost of the dinners income to the lawyers and staff?
    a. Yes, because the dinners are part of the compensation the firms lawyers and staff receive for working there, and the meals are not furnished on the premises of the law firm.
    b. Not if paying for the dinners is for the convenience of the firm, which it may be if it encourages lawyers and staff to work late.

6. A law firm operates its own dining room within its suite of offices. Lawyers and staff are permitted to eat breakfast and lunch there. The dining room is for the convenience of the lawyers and staff – not for the convenience of the firm. The firm doesn't charge anything at all for the meals. Is the cost of the breakfasts and lunches income to the lawyers and staff?
   a. Yes, because the meals are part of the compensation the firms lawyers and staff receive for working there, and the meals are furnished for the convenience of the lawyers and staff rather than for the convenience of the firm.
   b. No because the meals are furnished on the premises of the law firm.
7. A law firm provides free coffee to its lawyers and staff. Do those who drink it have any income?
   a. Yes, because the coffee is part of the compensation the firms lawyers and staff receive for working there.
   b. No because the coffee is a de minimis fringe benefit.
8. A law firm provides free parking in the building where the firm's offices are located for the firm's associates and staff, but not to its partners. The parking costs the firm $200 per person per month – the same amount that partners have to pay. Is the cost of the parking income to the associates and staff?
   a. Yes, because the parking is part of the compensation the firms associates and staff receive for working there.
   b. Yes, because partners do not get free parking, and this discrimination against partners means that free parking for associates and staff is not a qualified transportation fringe benefit.
   c. No, because the parking is a de minimis fringe benefit.
   d. No, because the parking is a qualified transportation fringe benefit.

<u>Prizes</u>

Read (in Posin & Tobin) re Prizes

Pages 117-118

Internal Revenue Code provisions re Prizes, Fellowships and Scholarship Grants

> **§ 74. Prizes and awards**
>
> (a) General rule.—Except as otherwise provided in this section or in section 117 (relating to qualified scholarships), gross income includes amounts received as prizes and awards.
>
> (b) Exception for certain prizes and awards transferred to charities.—Gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if -
>
> (1) the recipient was selected without any action on his part to enter the contest or proceeding;
>
> (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award; and
>
> (3) the prize or award is transferred by the payor to a governmental unit or [charitable] organization . . . pursuant to a designation made by the recipient.

Questions re Prizes

9. [True story:] In October 2007, former Vice President Al Gore was awarded the Nobel Peace Prize for his work on the effects of climate change. He shared the award, and the $1.5 million that goes to the winner, with the Intergovernmental Panel on Climate Change. Immediately upon being informed that he had won the Prize, Gore announced that he would donate his half of the $1.5 million to a nonprofit organization he founded the year before called the Alliance for Climate Protection. Was his half of the $1.5 income to him?

    a. Yes.

    b. Not if he advised the Nobel Prize committee to pay the money directly to the Alliance for Climate Protection.

    c. No, because he didn't render any services to the Nobel Prize committee in order to win the money.

    d. No; and it wouldn't have been income to him under any circumstances.

Interest

Read (in Posin & Tobin) re Interest

Pages 79 – 83

Internal Revenue Code provisions re Interest

§ 61. Gross income defined

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .

(4) Interest;

§ 103. Interest on State and local bonds

(a) Exclusion. Except as provided in subsection (b), gross income does not include interest on any State or local bond.

(b) Exceptions. Subsection (a) shall not apply to - . . .

(2) Any arbitrage bond (within the meaning of section 148).

(c) Definitions. For purposes of this section. . . -

(1) State or local bond. The term "State or local bond" means an obligation of a State or political subdivision thereof.

(2) State. The term ''State'' includes the District of Columbia and any possession of the United States.

§ 148. Arbitrage

(a) Arbitrage bond defined. – For purposes of section 103, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly-

(1) to acquire higher yielding investments, or

(2) to replace funds which were used directly or indirectly to acquire higher yielding investments.

(b) Higher yielding investments. – For purposes of this section–

(1) In general. – The term "higher yielding investments" means any investment property which produces a yield over the term of the issue which is materially higher than the yield on the issue.

Questions re Interest

1. Tabatha Taxpayer loaned her brother Bubba $1,000, at 10% interest, for one year, so he could buy a computer. One year later, Bubba repaid the loan in full, with interest, by paying her $1,100. How much income, if any, did Tabatha have in the year in which Bubba repaid her?

   a. None. It was just a loan repayment, within the family.

   b. $100.

   c. $1,000.

   d. $1,100.

2. Tabatha Taxpayer loaned her brother Bubba $100,000, at 10% interest per year, for 10 years, so he could make a down payment on a condo. The loan agreement (i.e., the promissory note) signed by Bubba provided that he would repay Tabatha $10,000 per year for nine years, and $10,000 plus any balance still due in the 10th year. The loan agreement also provided that the payments made during the first nine years would be "interest only," not repayment of principal. How much income, if any, did Tabatha have during each of the first nine years, as Bubba repaid her $10,000 per year?
   a. None, because it was just a loan repayment, within the family.
   b. None, because for the first nine years, Bubba was simply giving Tabatha back her own money – i.e., was repaying principal.
   c. $10,000.
   d. None of the above.
3. Same facts as #2, with this exception: the loan agreement provided that the payments made during the first nine years would be "principal only," not interest; and that all interest would be paid, with the principal, in the 10th year.
   a. None, because it was just a loan repayment, within the family.
   b. None, because for the first nine years, Bubba was simply giving Tabatha back her own money – i.e., was repaying principal.
   c. $10,000.
   d. None of the above.
4. Tabatha Taxpayer bought a $100,000 bond issued by the State of California. It pays 10% interest and matures in 10 years. The bond is an "interest only" bond, so that when it matures in 10 years, the entire $100,000 will be repaid. How much income, if any, did Tabatha have during each of the first nine years, as the State of California repaid her $10,000 per year?
   a. None, because the payments were interest, and interest paid by states is exempt from tax.
   b. None, because for the first nine years, California was simply giving Tabatha back her own money – i.e., was repaying principal.
   c. $10,000.
   d. None of the above.

5. The State of California is facing a budget crisis, because its revenues are inadequate to cover its expenses. Could California increase its revenues by taking advantage of the fact that states do not have to pay income tax, and are able to issue bonds? That is, could California sell low-interest bonds to buyers who want tax-exempt income, and then invest the proceeds in high-interest corporate bonds, the interest from which would be used to pay the interest owed to buyers of the state bonds? If, for example, California bought corporate bonds paying 10% and sold state bonds paying tax-exempt interest at 6%, the state would be able to keep 4% (of the 10%) it received from the corporate bonds, and the state would not have to pay tax on that 4% (because states don't pay tax).
    a. Yes, this would work fine. I'm surprised no one has told Governor Schwarzenegger about this. He'd love it, and so would the state Legislature.
    b. Yes, this would work fine. In fact, I'm sure that California is doing this already.
    c. No, this wouldn't work, because although interest paid by states usually is exempt from tax, these bonds would be "arbitrage bonds" whose interest would be taxable.
    d. No, this wouldn't work, because corporate bonds are risky, and the state might lose money on the bonds it bought but still would be obligated to pay interest on the bonds it sold, so taxes would have to be raised to pay the interest, and the whole purpose of this scheme was to avoid raising taxes.

<u>Dividends</u>

Read (in Posin & Tobin) re Dividends

Pages 86 – 89

Internal Revenue Code provisions re Dividends

§ 61. Gross income defined

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .

    (7) Dividends;

§ 1. Tax imposed

(h) Maximum capital gains rate

    (1) [and (11)] In general. If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section [shall be taxed at capital gains rates which are lower than ordinary income rates, rather than at higher ordinary income rates].

Questions re Dividends

6. DigiGame Company, a profitable video game publisher, needs to raise $1 million dollars in order to finance the creation and marketing of its next game. DigiGame can do so by selling stocks that pay dividends or bonds that pay interest. Tyler Taxpayer is willing to provide DigiGame with the funds it needs. In return, Tyler wants his investment – whether in stock or bonds – to provide him with an after-tax income of $50,000 per year. From a tax point of view (which is not the only relevant point of view, but is the one on which this question focuses), would DigiGame have to pay Tyler more per year if he buys the company's stock or its bonds? (Disregard the cost to DigiGame of doing it one way or the other; focus on the amount DigiGame would have to pay Tyler.)

    a. DigiGame will have to pay Tyler the exact same amount, regardless of whether he buys stock or bonds.

    b. DigiGame will have to pay Tyler more if he buys bonds than if he buys stock.

    c. DigiGame will have to pay Tyler more if he buys stock than if he buys bonds.

    d. The answer depends on what tax bracket Tyler is in.

7. Boogle Inc. is one of the most successful website operators in the world. Its fantastic success has driven the price of its stock to $500 per share. As result of this high price, most of Boogle's shareholders are large institutions (mutual funds, insurance companies and the like) rather than the individuals who actually use Boogle's websites. In order to broaden its shareholder base, Boogle has decided to split each share of its stock into five shares, and to distribute four additional shares to each shareholder for each share they currently own. This will result in the price per share of Boogle's stock dropping from $500 to $100. But since shareholders will own five shares for every one they owned before, the total value of each shareholder's investment will remain the same, and each shareholder will continue to own the same percentage of the company that he or she owned before the split. What will the tax consequences be to Boogle's shareholders, when they receive their additional shares?

    a. They will have $100 in income for each new share they receive.

    b. They will have income equal to $400 times the number of shares they owned before the split.

    c. They will have income equal to $500 times the number of shares they owned before the split.

    d. They will have no income at all.

8. Maxisoft Corp. is one of the most successful software companies in the world. As a result of years of profitable operations, the company has millions of dollars in the bank, in addition to vast holdings of real estate and, of course, valuable intellectual property rights. Despite its success, the price of the company's stock has fallen to just $5 per share – from a one-time high of $50 – which means that the aggregate value of all Maxisoft stock is now not much more than the cash it has in the bank. To counteract this dangerous state of affairs, the company has decided to redeem 50% of its outstanding stock – in other words to buy back half of every shareholders' stock – for $5 per share in cash. After the redemption, shareholders will own only half the number of shares they owned before, but their percentage ownership in Maxisoft will remain the same. And they will have received cash for the shares that are redeemed. What will the tax consequences be to Maxisoft's shareholders, when their shares are redeemed?
   a. They will have $2.50 in income for each share that is redeemed.
   b. They will realize $5 for each share that is redeemed.
   c. They will have $10 in income for each share that is redeemed.
   d. They will have no income at all.

Rents

Read (in Posin & Tobin) re Rents

Page 89

Internal Revenue Code provisions re Rents

> **§ 61. Gross income defined**
> (a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .
> (5) Rents;

Questions re Rents

9. Twyla Taxpayer owns a duplex in Los Angeles and two cars. She lives upstairs in the duplex and drives one of the cars. Her daughter and son-in-law used to live downstairs and drive the other car. But they just moved to Nashville, where they hope to make it big in the country music business. As a result, Twyla rented the downstairs part of the duplex and the car to a Southwestern Law School student. Do the rental payments made by the student to Twyla constitute income to Twyla?
   a. Yes, rental payments are income to everyone who receives them.
   b. Yes, because rental payments received from professional school students are income; if Twyla's tenant had been an undergraduate at, say, UCLA, they wouldn't be income.
   c. No, because rental payments received from students are not income, though if Twyla's tenant had been a practicing lawyer, they would be income.
   d. No, because Twyla is not in the business of renting property or cars; she is simply making a little money from property she owns that once was used by her family.

Royalties

Read (in Posin & Tobin) re Royalties

Pages 89-92

Internal Revenue Code provisions re Royalties

> **§ 61. Gross income defined**
> (a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .
> (6) Royalties;

Questions re Royalties

10. Talasi Taxpayer is a law professor. She is the author of a casebook on Native American Indian law, and she receives royalties of 10% of the revenues collected by her publisher from sales of the book. Virtually all sales are to bookstores that resell the books to law students who are enrolled in courses on Native American Indian law. Are the royalties received by Talasi "income" to her?

    a. Yes, all royalties are income.

    b. Yes, because her book is ultimately sold to students enrolled in a professional school; if her book were sold to public school districts for use by high school students, the royalties would not be income to her.

    c. No, because her book is an educational book.

    d. No, because her book is protected by the First Amendment, and requiring authors to report royalties would discourage them from writing books.

11. Although Talasi Taxpayer is a law professor, she also writes novels in her spare time. Her novels are mysteries; they feature a Native American Indian detective, and they are very popular. Talasi's publisher has just offered her a $500,000 recoupable but non-refundable advance against royalties for publication rights to her next three novels. If she accepts this offer, will the advance be income to Talasi, and if so, when?

    a. Yes. All $500,000 will be income to her, the year she receives it.

    b. Yes. One-third of the $500,000 advance will be income to her when she turns in the manuscript of the first novel. Another third will be income when she turns in the manuscript to the second novel. And the final third will be income to her when she turns in the manuscript to the third novel.

    c. Yes. The $500,000 will become income to her, in year-to-year installments, as her publisher recoups the advance from sales of her books.

    d. No. The advance will not be income to her, ever, because even though her novels are mysteries, they are protected by the First Amendment, and requiring authors to report royalties would discourage them from writing books.

Life Insurance Proceeds

Read (in Posin & Tobin) re Proceeds from Life Insurance

Pages 92-96

Internal Revenue Code provisions re Proceeds from Life Insurance

> **§ 61. Gross income defined**
>
> (a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .
>
> (10) Income from life insurance and endowment contracts;
>
> **§ 101. Certain death benefits**
>
> (a) Proceeds of life insurance contracts payable by reason of death
>
> (1) General rule – Except as otherwise provided [in other paragraphs] gross income does not include amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.

Questions re Proceeds from Life Insurance

1. Tutti Taxpayer was the beneficiary of a life insurance policy owned by her widowed father. When Tutti's father passed away, the insurance company paid Tutti $100,000 which was the amount of the death benefit provided for in the policy. Is the $100,000 income to Tutti?

    a. Yes, but only to the extent of the "inside buildup" of interest on the premiums her father had paid on the policy.

    b. Yes, but only to the extent of "mortality gain" portion of the $100,000.

    c. Yes, the entire $100,000 is income to Tutti.

    d. No, none of the $100,000 is income to Tutti.

Gifts and Inheritances

Read (in Posin & Tobin) re Gifts and Inheritances

Pages 101 – 111

Internal Revenue Code provisions re Gifts and Inheritances

§ 102. Gifts and inheritances

(a) General rule.—Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

(b) Income.— Subsection (a) shall not exclude from gross income—

(1) the income from any property referred to in subsection (a); or

(2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

. . . .

(c) Employee gifts.—

(1) In general.—Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.

(2) Cross references

. . .

For provisions excluding certain de minimis fringes from gross income, see section 132(e).

Sec. 132. Certain fringe benefits

(a) Exclusion from gross income. Gross income shall not include any fringe benefit which qualifies as a -

. . .

(4) de minimis fringe

. . .

(e) De minimis fringe defined. For purposes of this section -

(1) In general. The term "de minimis fringe" means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

Questions re Gifts and Inheritances

2. Tasha Taxpayer is a 21-year-old first year law student. Just before her classes began in August, Tasha's parents gave her a new car that cost $25,000 plus $25,000 in cash for her apartment rent and other living expenses. Next April, when Tasha files a tax return for this year, how much will she have to report as income as a result of what her parents gave her?

    a. Nothing, because the car and the cash were gifts to her.

    b. The $25,000 in cash is income to her because her parents intended that she spend it on rent and living expenses, but the car is not income because it is a gift.

    c. The entire $50,000 is income to her, because the Internal Revenue Code specifies that "income means all income from whatever source derived."

    d. The amount she will have to report "this year" as income depends on the expected useful life of the car and on whether she spends the entire $25,000 in cash this year.

3. Talbot Tackspayir is a 21-year-old first year law student. Before he began law school, he worked for Tasha's mother – who is a lawyer – as her legal secretary. Just before his classes began in August, Tasha's mother gave Talbot a new car that cost $25,000 plus $25,000 in cash for his apartment rent and other living expenses. Next April, when Talbot files a tax return for this year, how much will he have to report as income as a result of what Tasha's mother gave him?

    a. Nothing, because the car and the cash were gifts to him.

    b. The $25,000 in cash is income to him because Tasha's mother intended that he spend it on rent and living expenses, but the car is not income because it is a gift.

    c. The entire $50,000 is income to him, because the Internal Revenue Code specifies that "income means all income from whatever source derived," and because Talbot was an employed by Tasha's mother.

    d. The amount he will have to report "this year" as income depends on the expected useful life of the car and on whether he spends the entire $25,000 in cash this year.

4. Tubby Taxpayer is the head football coach at an NCAA Division I college. Last year, his team was the National Champion. Though Tubby's contract did not entitle him to any performance bonus at all, let alone a new Escalade, the college was so delighted that his team was National Champ that it gave Tubby a brand-new Cadillac Escalade SUV, painted in the school's colors, "to express its affection for him." The car is worth $75,000. Is the value of the car income to Tubby?

    a. No, because the car was a gift.

    b. Yes, because the Internal Revenue Code specifies that "income means all income from whatever source derived," and because Tubby was an employed by the college.

    c. It depends on what the college's state of mind was.

    d. It depends on what Tubby's state of mind was.

5. Every Thanksgiving, Don's Markets gives each of its employees a turkey worth $20; and at Christmas, it gives each of them a ham worth $15. Do Don's employees have "income" as a result of the turkey and ham?

    a. No, because they are gifts.

    b. No, because even though they are employees, the turkey and ham are de minimis fringe benefits.

    c. Yes, because they are Don's employees.

    d. Yes, because if not, then Don's could give its employees all of the food they need in lieu of part of their salary, and the employees would thereby avoid paying tax on a portion of what they earned by working for Don's.

6. Tasha's parents own $500,000 in securities (i.e., bonds and preferred stock) that generate $25,000 in income every year. Suppose that instead of giving Tasha their own check for $25,000 (as in #13 above), her parents instructed their stock broker to pay the income from the securities directly to Tasha. Would the money Sasha received from the broker be income to her?
   a. No, because it would still be a gift.
   b. Yes, because it would be "income from property."
   c. Some of it would be income; the amount would depend on whether she spends the entire $25,000 this year.
   d. None of the above.
7. Same as #6, with this change: Instead of just giving Tasha the income from the securities, her parents told their broker to transfer ownership of the securities to Tasha, including the $25,000 in income the securities earned in the year of the transfer. Would Tasha have income as a result of this transaction? If so, how much?
   a. No, because all $525,000 ($500,000 in securities plus $25,000 in income) would be a gift.
   b. $500,000 would be a gift, but $25,000 would be income.
   c. $25,000 would be a gift, but $500,000 would be income.
   d. Some of it would be income; the amount would depend on how much she spends.
8. Which of the following would result in income to Samantha Secretary?
   a. Her boss gives her a $10,000 trip to Hawaii for two (i.e., Samantha and a guest of her choice) as a Christmas "gift" to thank her for a job well done during the year.
   b. Her boss spends $10,000 to take her to Hawaii with him, where, with her consent, they share a room and bed, though they had not previously dated or been romantically involved with one another, as a Christmas "gift" to thank her for a job well done during the year.
   c. After dating for three months, her boss spends $10,000 to take her to Hawaii with him, where, with her enthusiastic consent, they share a room and bed.
   d. After dating for six months, she and her boss get married, and he spends $10,000 to take her to Hawaii on their honeymoon, where of course they share a room and bed.
9. Ernest Esquire is a lawyer. Which of the following would be income to him?
   a. He inherits $100,000 from a favorite uncle.
   b. He inherits $100,000 from an uncle he had never met or talked with.
   c. He inherits $100,000 from a client who Ernest had always billed (and collected from) for services Ernest rendered to the client.
   d. He inherits $100,000 from a client who Ernest never billed (or collected from) for services Ernest rendered to the client, because Ernest and the client had agreed that Ernest would receive $100,000 when the client died rather than fees when Ernest rendered the services.

Discharge of Debt

Read (in Posin & Tobin) re Discharge of Indebtedness

Pages 121-122 (stop at the bottom of page 122)

Internal Revenue Code provisions re Discharge of Indebtedness

§ 61. Gross income defined

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .

(12) Income from discharge of indebtedness;

§ 108. Income from discharge of indebtedness

(a) Exclusion from gross income.—

(1) In general.—Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

(A) the discharge occurs in a title 11 case,

(B) the discharge occurs when the taxpayer is insolvent. . . .

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged . . . [between January 1, 2007 and January 1, 2010].

(d) Meaning of terms; special rules relating to certain provisions.—

(1) Indebtedness of taxpayer.—For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness-

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

(2) Title 11 case.—For purposes of this section, the term "title 11 case" means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

(3) Insolvent.—For purposes of this section, the term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

(h) Special Rules Relating to Qualified Principal Residence Indebtedness—. . .

(2) Qualified Principal Residence Indebtedness—For purposes of this section, the term "qualified principal residence indebtedness" means acquisition indebtedness [of as much as $2 million] with respect to the principal residence of the taxpayer.

(3) Exception for Certain Discharges Not Related to Taxpayer's Financial Condition—Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

[Note: § 108(a)(1)(E) and § 108(h) were added to the Internal Revenue Code on December 20, 2007 by the Mortgage Forgiveness Debt Relief Act of 2007.]

Questions re Discharge of Indebtedness

1. Two years ago, Billy Taxpayer borrowed $50,000 from his brother-in-law to buy a $50,000 boat. Billy didn't report the $50,000 on his income tax return. Should he have?
    a. Yes, because the Internal Revenue Code says that "income means all income from whatever source derived."
    b. Yes, because even though he spent the money immediately, he was wealthier after buying the buying.
    c. No, because borrowed money is not income.
    d. No, because once he bought the boat, he didn't have the money any more and thus couldn't pay tax on the $50,000 even if it were income.
2. Last year, Billy Taxpayer took his boat (the one he bought in Question 1) out for a sail despite Coast Guard storm warnings, and the boat sank. Billy was rescued, but he was so depressed about losing the boat (it wasn't insured!) that he couldn't bring himself to repay the loan. Billy wasn't insolvent; he owned a valuable condo and auto, free and clear. But at the urgings of Billy's sister (who always comes to his defense), Billy's brother-in-law cancelled the loan, which improved Billy's spirits quite a bit. Billy didn't report the loan cancellation as income. Should he have?
    a. Yes, because the Internal Revenue Code says that "income" includes "Income from discharge of indebtedness."
    b. Yes, because even though he spent the money and sank the boat, the loan cancellation improved his spirits so he got something valuable for the debt cancellation.
    c. No, because borrowed money is not income, so repayment of loans and loan cancellation aren't income either.
    d. No, because when the boat sank, he didn't have either the money or the boat and it would make no sense to tax him on his brother-in-law's generosity.
3. Herman and Hermione Homeowner were unable to make the mortgage payments on the $1 million loan they had taken out in order to buy their home, because both lost their jobs when the company for which they had been working went out of business. Eventually, Herman and Hermione got other jobs. But by then, they had fallen behind $50,000 on their payments, and their combined pay was not enough to get them caught up. They weren't insolvent, because the value of their other assets – such as cars, jewelry and art – exceeded their debts. But they didn't want to sell their other assets, so they offered to deed their home to the mortgage company that had made them the loan, and to vacate the house so the mortgage company could sell it to someone else. The mortgage company, however, declined their offer, and instead offered to cancel the $50,000 unpaid portion of the loan, if they would simply resume making payments again. Herman and Hermione were delighted to accept this offer. *If this happened in 2006*, did they have income as a result of the mortgage company's cancellation of $50,000 of debt?
    a. Yes.
    b. No, because no cash changed hands.
    c. No, because if they did have income, they'd have to pay tax on it; and that might put them in financial trouble again.
    d. None of the above.

4. Would your answer to the previous question be the same or different, if everything happened in 2007 or 2008?
    a. The same.
    b. Different.

Damages

Read (in Posin & Tobin) re Recovery of Damages

Pages 136-143

Internal Revenue Code provisions re Recovery of Damages

> **§ 104. Compensation for injuries or sickness**
> (a) In general.—. . . gross income does not include—
> . . .
> (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;
> . . .
> . . . For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care. . . attributable to emotional distress.

Note concerning emotional distress damages:

Take a look at the second full paragraph on page 137 of the Posin/Tobin book. It says: ". . . although damages from emotional distress are generally not excluded from income, they are excluded *if they are on account of the physical injury*." (Emphasis added.) In other words, the book seems to say that emotional distress damages may be excluded from income if – but only if – they are on account of physical injury. The question is whether this is so.

You will be amused (I hope) to learn that the IRS apparently thinks that the meaning the last two sentences of § 104(a)(2) is perfectly clear. I say this, because the Regulations concerning § 104 say a fair amount about the tax treatment of compensation for injuries and sickness – but not a single word about the treatment of damages for emotional distress!

As it happens, the law permits taxpayers to exclude emotional distress damages from income *even if* the distress was *not* on account of physical injury, though only up to the amount spent on medical care for emotional distress. What's more, what the book says on page 137 is *not* to the contrary, though the book doesn't state the law for all possible cases.

Here's why:

There are three ways the taxation-of-emotional-distress-damages question can arise:

1. *Emotional distress may be caused by a physical injury.*

See, e.g., http://www.towson.edu/counseling/emotionaldistress.asp: "Common Causes of Emotional Distress . . . • serious illness or injury. . . ."

In this circumstance, damages for emotional distress would be excluded from gross income by the first part of § 104(a)(a)(2). The last two sentences of that section wouldn't come into play, because the taxpayer would not be seeking to treat emotional distress "as" an injury; the distress would have resulted *from* the injury. So, the damages would be for the physical injury.

This circumstance illustrates what the book is referring to when (on page 137) it says : ". . . damages from emotional distress . . . are excluded if they are on account of the physical injury."

2. *Physical injuries and illness may be caused by emotional distress.*

See, e.g., http://www.helpguide.org/mental/stress_signs.htm: "Physical Symptoms [of stress include] • Headaches or backaches • Diarrhea or constipation • Nausea, dizziness • Chest pain, rapid heartbeat • Skin breakouts (hives, eczema). . . ."

In this circumstance too, damages for emotional distress would be excluded from gross income by the first part of § 104(a)(a)(2). The last two sentences of that section wouldn't come into play, because the taxpayer would not be seeking to treat emotional distress "as" an injury or illness; the distress would have caused an actual physical injury or illness. So, the damages would be for the physical injury or illness.

This circumstance also illustrates what the book is referring to when (on page 137) it says : ". . . damages from emotional distress . . . are excluded if they are on account of the physical injury."

3. *Emotional distress may be caused by factors other than physical injury or illness; and emotional distress may not result in physical injury or illness.*

An example of this would be emotional distress resulting from defamation or invasion of privacy, in cases where the distress does not result in a physical injury or illness.

If damages were awarded for emotional distress of this kind, the second to last sentence in § 104(a)(a)(2) would prevent the taxpayer from arguing (successfully) that his or her emotional distress was one type of "physical injury" or "illness." So this sentence, *by itself*, would preclude the taxpayer from excluding the emotional distress damages from income, or – to say it in plain English – would require the taxpayer to include the emotional distress damages in his or her gross income. This is an illustration of the book's statement (on page 137) that ". . . damages from emotional distress are generally not excluded from income. . . ."

This brings us, at last, to the last sentence of § 104(a)(a)(2), which says that the second to last sentence does not apply to damages up to ("not in excess of") the amount paid by the taxpayer for medical care for the emotional distress. Since the second to last sentence does not apply, this means that it's OK for the taxpayer to treat emotional distress as a physical injury or illness, and thus exclude the emotional illness damages from income, though only up to the amount spent by the taxpayer on medical treatment for that emotional illness. This limited-in-amount *exception* to the usual rule that emotional distress damages must be included in gross income is not mentioned at page 137 of the book, because (I'm assuming) the authors decided they couldn't explicitly mention every exception to every general rule without turning their book into a 1500-page monster.

Questions re Recovery of Damages

5. Tildy Taxpayer was bitten by her neighbor's dog. She suffered severe physical injuries that required surgery costing $100,000. Tildy sued her neighbor. Her lawsuit went to trial, and the jury awarded Tildy $250,000, broken down this way: $100,000 for her medical expenses; $100,000 for pain and suffering; and $50,000 in punitive damages. How much income, if any, did Tildy have when the neighbor's insurance company paid the judgment in full?

    a. $50,000

    b. $100,000.

    c. $200,000.

    d. $250,000.

6. Same as #5, with this change: The jury's verdict was broken down this way: $100,000 for Tildy's medical expenses; $50,000 for wages that Tildy lost while recovering from surgery; $50,000 for pain and suffering; and $50,000 in punitive damages. How much income, if any, did Tildy have when the neighbor's insurance company paid the judgment in full?

    a. $50,000

    b. $100,000

    c. $200,000.

    d. $250,000.

7. Tildy's neighbor was so angry about the result in Tildy's lawsuit that the neighbor played a prank on Tildy. The neighbor installed an invisible, underground dog "fence" in his front yard, so his dog could roam freely in his front yard without the dog being able to leave the yard. (See, e.g., http://www.radiofence.com/dog-fences/index.htm for details about this technology.) Then, one day when Tildy was unloading groceries from her car in the driveway that separated their properties, the neighbor let the dog out of his house into his invisibly-fenced front yard. The dog barked at Tildy and frightened her so badly that she became emotionally ill. As a result, Tildy needed $50,000 in medical treatments for her emotional illness. Tildy sued her neighbor again. This time, the neighbor's insurance company settled immediately for $25,000 (and cancelled the neighbor's policy). How much income, if any, did Tildy have as a result of the settlement?

    a. None.

    b. $25,000; but she wouldn't have had any income if she had gone to trial and gotten a judgment.

    c. $25,000, which is the amount of income she would have had, whether she settled or got a judgment.

    d. $50,000.

8. University basketball coach Robert Nite has a surprisingly violent temper, for someone whose career involves working with young men. When he becomes angry, which is often, Nite shouts at his players, slaps them, and even throws chairs onto the basketball court. On one occasion, Nite threw a chair that hit one his players, injuring the player slightly. The player sued Nite for $100,000 in actual damages and $1 million in punitive damages. Nite quickly settled the case for $50,000, without acknowledging liability or even the player's injuries. How much income, if any, did the player have?
   a. None.
   b. $45,455 which is 10/11th of the settlement, the same percentage of the settlement as the punitive damage claim was to the total claim (i.e., $1,000,000/$1,100,000 = 10/11th).
   c. $50,000.
   d. Maybe "a" or maybe "b".
9. Alpha Shoes and Zeta Shoes are competing shoe stores, located across the street from one another. The store's owners, Andy Alpha and Zubin Zeta, are fierce business rivals and personal enemies. One day, when relations between them were particularly strained, Andy got drunk and set fire to Zubin's store, burning it to the ground. It took Zubin more than six months to rebuild and reopen his store, during which time Zubin lost $100,000 in *profits* (not just gross revenues). Zubin sued Andy, and won $100,000. (The cost of rebuilding the store was covered by insurance.) How much income, if any, did Zubin have?
   a. None.
   b. $100,000.
   c. Some other amount entirely.
   d. None of the above.

<u>Assignment of Income</u>

Read (in Posin & Tobin) re Assignment of Income

Pages 329 – 336

Internal Revenue Code provisions re Assignment of Income

Note that there are no Code provisions that address the assignment of income in a general way. There are a handful of Code provisions that deal with income assignments in very specific contexts, like the assignment of "mineral production payments," that we will not be covering in this course. Instead, tax law concerning the assignment of income is largely made up of the judicial decisions discussed in the assigned pages of the Posin/Tobin book. The following questions are intended to be certain that you understand the doctrines that these decisions have produced.

Questions re Assignment of Income

10. Which of the following is the best explanation for why tax law includes "assignment of income" doctrines?

    a. It is important, as a matter of principle, that those who earn income be the ones who pay the tax on that income, regardless of whether the amount of tax they pay would be more or less than the amount of tax that would be paid by those to whom the income was assigned.

    b. Because tax rates are progressive, high-bracket taxpayers sometimes assign some of their income to low-bracket family members, in an effort to reduce the amount of tax that is actually paid on that income.

11. Recall that earlier we discussed questions concerning Tasha Taxpayer, a first-year law student whose parents gave her a variety of gifts. Those questions were designed to illustrate the workings of Code § 102(a), (b)(1) and (b)(2). You will recall that those paragraphs of § 102 provide that as a general rule, gifts are *not* income to the recipient; but *income from* a gift of property (i.e., income generated by property that has been received as a gift) is income to the recipient, and a gift *of income* (generated by property retained by the donor) is income to the recipient as well. One of those questions illustrated the very last of these principles (i.e., a gift *of income* is income to the recipient). Here, again, is that question, and the answer that was *then* the best, because we hadn't yet covered the "assignment of income" doctrine:

    > Tasha's parents own $500,000 in securities (i.e., bonds and preferred stock) that generate $25,000 in income every year. Suppose . . . [Tasha's] parents instructed their stock broker to pay the *income* from the securities directly to Tasha [though they retained ownership of the securities themselves]. Would the money Tasha received from the broker be income to her?
    >
    > b. Yes, because it would be "income from property."

    Insofar as § 102(b)(2) is concerned, this is the correct answer. Now, though, you have studied the judicially-created "assignment of income" doctrine; so let's rephrase the question and the answers just a bit:

    Tasha's parents own $500,000 in securities (i.e., bonds and preferred stock) that generate $25,000 in income every year. Suppose . . . [Tasha's] parents instructed their stock broker to pay the *income* from the securities directly to Tasha [though they retained ownership of the securities themselves]. To whom would that income be taxed?

    a. Tasha, because that's exactly what § 102(b)(2) says.

    b. Tasha's parents, because of the judicially-created "assignment of income" doctrine.

    c. To whichever of them was in the highest tax bracket.

    d. To whichever of them was in the lowest tax bracket.

12. Here again is another question about Tasha, and the answer that was then the best, because we hadn't yet covered the "assignment of income" doctrine:

    Instead of just giving Tasha the income from the securities, her parents told their broker to transfer ownership of the securities to Tasha, including the $25,000 in income the securities earned in the year of the transfer. Would Tasha have income from this transaction? If so, how much?

    b. $500,000 would be a gift, but $25,000 would be income.

    Insofar as §§ 102(a) and (b)(1) are concerned, this is the correct answer. Now, though, that you have studied the "assignment of income" doctrine, would your answer be the same?

    a. Yes, it would be the same, because Tasha's parents gave her the "tree" (i.e., the securities) as well as the "fruit" (i.e., the income), and thus the income is income to Tasha, not to her parents. The securities themselves still are not income to Tasha, because they remain a gift.

    b. No, now that I've studied the assignment of income doctrine, I know that both the securities and the income would be income to Tasha.

    c. No, now that I've studied the assignment of income doctrine, I know that the income from the securities would be income to Tasha's *parents*, not to Tasha; though the securities themselves still wouldn't be income to Tasha.

    d. In order to answer this question, it's necessary to know what tax brackets Tasha and her parents are in, because the income will be taxed to whichever of them is in the higher bracket.

13. Lucy Taxpayer is a lawyer. She is outside counsel for a large chain of rest homes which pays her a $5,000 per month retainer towards services she renders at $250 per hour. Lucy's elderly mother recently fell and broke her hip, and will require several months of care in a rest home – care for which Lucy's client ordinarily charges $5,000 per month. Lucy is in a much higher tax bracket than her mother. So Lucy instructed her client to "pay" Lucy's $5,000 monthly retainer directly to Lucy's mother, who will then use it to pay the monthly charge for her care in the rest home. Which of the following is true?

    a. Lucy will not have to include the $5,000 in her income, because she is no longer receiving it. And Lucy's mother won't have to include it in her income either, because it was a gift from Lucy.

    b. Lucy will not have to include the $5,000 in her income, because she is no longer receiving it. But Lucy's mother will have to include it in her income, because it was a gift of income from Lucy.

    c. Lucy will have to include the $5,000 in her income, because she earned it and decided what her client should do with it; but Lucy's mother will not have to include it in her income, even though it was a gift of income.

    d. Lucy will have to include the $5,000 in her income, because she earned it and decided what her client should do with it; and Lucy's mother will have to include it in her income too, because it was a gift of income!

DEDUCTIONS

<u>Structural Issues</u>

Read (in Posin & Tobin) re Structural Issues

Pages 354 – 362

Introduction

The chart on page 354 looks less helpful than it is, simply because it is squeezed onto a single small page. If this same chart were printed on wider paper, you'd see that the chart is *not* a flowchart. The text printed in boxes explains the meaning of the short phrases that are not in boxes. The arrows that connect the boxes to the short phrases do not indicate flow; they simply direct the reader's eye to the phrase that is explained by the box. So, if you created a table having two columns and several rows, and you copied the unboxed phrases into the cells in the left column (each phrase in its own cell) and the boxed text into the corresponding cells in the right column, you'd clearly see what the chart is intended to explain.

The text on pages 354 through 357 is what attracted me to the Posin/Tobin book in the first place, so read and – I hope – enjoy it. It explains that the Internal Revenue Code is long and complex because it has to be; anyone who says otherwise does not understand the fundamentals of income taxation.

Questions re Structural Issues

The following questions are designed to make sure that you understand some terms that will be used throughout the lessons concerning deductions. When answering them, assume that the "taxpayers" referred to in the questions actually incurred deductible expenses.

1. The Internal Revenue Code makes a distinction between "above the line" deductions and "below the line" deductions. Which of the following statements about these two categories of deductions is true?
    a. Above the line deductions save taxpayers more money than below the line deductions.
    b. Below the line deductions save taxpayers more money than above the line deductions.
    c. Above the line and below the line deductions save taxpayers the same amount of money; they are referred to as "above the line" and "below the line" deductions, only because the lines on which they are claimed are printed in different places on the tax return form.
    d. Whether above the line deductions save taxpayers more than below the line deductions, or visa versa, depends on the taxpayer's tax bracket.
2. The Internal Revenue Code also makes a distinction between "itemized deductions" and the "standard deduction." Which of the following statements is true about "itemized deductions"?
    a. Itemized deductions are above the line deductions.
    b. Itemized deductions are below the line deductions.
    c. Itemized deductions are taken by all taxpayers.
    d. Itemized deductions are taken only by those taxpayers who don't qualify for the standard deduction.

3. Which of the following statements is true about the “standard deduction.”
    a. Taxpayers take a standard deduction if the total of their above the line deductions is less than the standard deduction.
    b. Taxpayers take a standard deduction if the total of their itemized deductions is less than the standard deduction.
    c. Taxpayers take a standard deduction in addition to their above the line and itemized deductions, not in lieu of one or the other.
    d. Taxpayers take a standard deduction if the total of their above the line and itemized deductions is less than the standard deduction.
4. Which of the following is true?
    a. All taxpayers are entitled to take above the line deductions, even if they take a standard deduction.
    b. All taxpayers are entitled to take above the line deductions, even if they take itemized deductions.
    c. Both “a” and “b”.
    d. Neither “a” nor “b”.
5. Which of the following types of deductions may be taken even by those taxpayers who have *not* incurred any actual expenses?
    a. Above the line deductions.
    b. Itemized deductions.
    c. Standard deduction.
    d. None of the above. Every type of deduction requires taxpayers to actually have incurred expenses of the type the Code allows to be deducted.

<u>Ordinary and Necessary Business Expenses</u>

Read (in Posin & Tobin) re Ordinary and Necessary Business Expenses

Pages 362 – 364 (stop at the bottom of page 364)

Internal Revenue Code provisions re Ordinary and Necessary Business Expenses

§ 62. Adjusted gross income defined

(a) General rule.—For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions.—The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

A note about the importance of § 62(a)(1)

Section 62 is important, because it provides that "trade and business" expenses are deductible from "gross income" in order to calculate "adjusted gross income" – "*if*" the taxpayer's "trade or business" is "*not* . . . the performance of services . . . as an employee." So, if a taxpayer incurs trade or business expenses *other than* as an employee – for example, as an independent contractor or as the owner of his or her own business (which are really the same thing) – those expenses are "above the line" deductions, which, as you now know, are more valuable to taxpayers than "below the line" deductions.

Note that performing services as an employee *is* a "trade or business." But if an *employee* incurs trade or business expenses, those expenses are not "above the line" deductions; they are "below the line" deductions, and thus are less valuable to the taxpayer.

The expenses covered below all may be "trade or business" expenses. Keep in mind, though, that whether the following expenses are deductible above or below the line depends on whether the taxpayer incurred these expenses in connection with his or her own business (above the line), or incurred them as someone else's employee (below the line).

§ 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including -

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered. . . .

Questions re Ordinary and Necessary Business Expenses

1. Deductions for salaries paid by taxpayers to their employees are what kinds of deductions?
    a. Above the line.
    b. Below the line.
    c. Itemized.
    d. Standard.
2. Danielle Taxpayer is a dentist. She has her own practice which she operates as a sole proprietor. Danielle has three employees: a dental technician, a receptionist and a bookkeeper, none of whom is related to Danielle by blood or marriage. Each of the three employees has worked for Danielle for many years, and though she could replace them if she had to, she doesn't want to. So Danielle pays each of them a salary that is 25% more than they would be likely to be paid, if they took similar jobs working for another dentist. Which of the following is most likely to be true?
    a. Danielle will not be able to deduct any of the salaries she pays her employees, because all of them are paid more than is ordinary and necessary.
    b. Danielle will be able to deduct only that portion of their salaries that is equivalent to what they would be likely to be paid if they took similar jobs working for another dentist. The 25% excess will not be deductible by Danielle, though it will be income to her employees.
    c. Danielle will be able to deduct only that portion of their salaries that is equivalent to what they would be likely to be paid if they took similar jobs working for another dentist. The 25% excess will not be deductible by Danielle, and thus it will not be income to her employees.
    d. Danielle will be able to deduct all of the salaries she pays her employees, even though she pays them 25% more than they are likely to be paid if they took similar jobs working for another dentist.

3. Danielle Taxpayer has a 10-year-old daughter. Danielle pays her daughter $25,000 a year for services as a "dental practice office assistant," though the daughter does not actually provide any services in the office. Danielle's daughter files a tax return in which she reports the $25,000 she is paid by Danielle; and the daughter pays tax on that income. Danielle began paying her daughter as an "office assistant" after several of Danielle's professional colleagues (also dentists) told her that they did this very thing. May Danielle deduct the $25,000 salary to her daughter from Danielle's own dental practice income?

    a. No, because because Danielle's daughter isn't actually providing personal services.

    b. No, but only because Danielle's daughter does not actually provide any services. If the daughter actually came into the office with Danielle – say, on Saturdays – and greeted Danielle's patients as they arrived, or if the daughter emptied the wastepaper baskets at the end of the day, then Danielle could deduct the $25,000 a year she pays her daughter, because the daughter actually would be rendering services in return for that pay.

    c. Yes, but only because Danielle's daughter actually files a tax return, so someone paid tax on $25,000 of income.

    d. Yes, because this is a legitimate and IRS-accepted way to assign income within a family, from a high-bracket taxpayer to a low-bracket taxpayer.

<u>Rental Expenses</u>

Internal Revenue Code provisions re Rental Expenses

§ 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including –

. . .

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Questions re Rental Expenses

4. Tabitha Taxpayer owns her own limousine business. Her one and only limo is a stretch Hummer, the cost of which reached comfortably into six figures. Rather than buy the car, she leases it, and makes monthly payments to the leasing company. The car is huge and very expensive to operate, so she never uses it for personal transportation. She only uses it to transport her clients. Which of the following is true?

    a. Tabitha may deduct her monthly lease payments, because she uses the limo in her business and doesn't use it for personal transportation.

    b. Tabitha may deduct her monthly lease payments, and would be able to do so, even if she used the limo for personal transportation as well as in her business, because auto lease payments always are deductible.

    c. Tabitha may not deduct her monthly payments even though she uses the limo in her business, because a limo is not "property" and § 162(a)(3) only permits the deduction of rental payments made for "property."

    d. Tabitha may not deduct her monthly lease payments even though she uses the limo in her business, because auto lease payments are never deductible.

5. Because Tabitha Taxpayer's stretch Hummer is too big to use for personal transportation, she needed a personal-use car too. The dealer from which she got the Hummer also carries Mini Coopers. (The dealer's slogan: "From the Biggest to the Smallest: We Have 'em All!) The Mini Cooper was affordable, and Tabitha was going to pay cash for it. But the car salesman told her she should lease the Mini Cooper too, because auto lease payments are deductible. Was this accurate advice?

    a. Yes, the Mini Cooper lease payments would be deductible, even if Tabitha uses the car solely for personal transportation.

    b. Yes, Tabitha's Mini Cooper lease payments would be deductible, because she leased that car in order to be certain that she uses the Hummer for business purposes only, so her Mini Cooper lease serves a business-related purpose too.

    c. No, the Mini Cooper lease payments would not be deductible, because Tabitha will not be using that car for business purposes.

    d. No, the Mini Cooper lease payments would not deductible, because Tabitha was willing to buy the car for cash, so if she leased it, it would be solely for tax purposes without any underlying business purpose.

<u>Bribes and Penalties</u>

Read (in Posin & Tobin) re Public Policy Limits: Bribes, Kickbacks, Fines and Penalties

Pages 472 –475

Internal Revenue Code provisions re Public Policy Limits: Bribes, Kickbacks, Fines and Penalties

§ 162. Trade or business expenses

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . .

(c) Illegal bribes, kickbacks, and other payments.—

(1) Illegal payments to government officials or employees.—No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act. . . .

(2) Other illegal payments.—No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. . . .

(3) Kickbacks, rebates, and bribes under medicare and medicaid.—No deduction shall be allowed under subsection (a) for any kickback, rebate, or bribe made by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, or in whole or in part out of Federal funds under a State plan approved under such Act, if such kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receipt of such payments. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

. . .

(f) Fines and penalties.—No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.

(g) Treble damage payments under the antitrust laws.—If in a criminal proceeding a taxpayer is convicted of a violation of the antitrust laws, or his plea of guilty or nolo contendere to an indictment or information charging such a violation is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) for two-thirds of any amount paid or incurred—

(1) on any judgment for damages entered against the taxpayer under section 4 of the Act . . . (commonly known as the Clayton Act) . . . or

(2) in settlement of any action brought under such section 4. . . .

Questions re Public Policy Limits: Bribes, Kickbacks, Fines and Penalties

6. Lunkhead Taxpayer is a personal injury lawyer, and not a very good one at that. Among other things, he's careless and doesn't pay attention to important details. Last year, Lunkhead missed the statute of limitations on a client's claim. In an effort to "cure" his mistake, Lunkhead paid $5,000 to bribe a clerk at the courthouse to backdate the filing date of a complaint a few days, so that it appeared to have been filed on time. The bribe was, of course, a violation of state law, and it also was grounds for Lunkhead to be disbarred. Alas, poor Lunkhead was not only careless and dishonest, he also was unlucky. The court clerk accidentally backdated the filing date to a Sunday – a day when the courthouse wasn't even open. As a result, Lunkhead's scheme was detected, and he was prosecuted – as lawyers who do this always are, in Lunkhead's state. He was convicted and also disbarred. When Lunkhead prepared last year's tax return, he deducted the $5,000 bribe payment. Was that a proper deduction?

    a. Yes. The bribe payment was an ordinary (it's been done before by many lawyers) and necessary (otherwise, his client's case wouldn't have been heard) business expense.

    b. Yes. Even though kickbacks are not deductible, the illegal bribe was not a kickback to the court clerk.

    c. No. Illegal bribes are not deductible.

    d. Not unless he settled his client's case for more than $5,000, because the amount a lawyer may deduct in connection with any one case is limited by the amount of gross income the lawyer has from that case.

7. When Lunkhead prepared last year's tax return, he also deducted $25,000 he paid to the criminal lawyer who represented him, unsuccessfully, in the criminal prosecution, and he deducted an additional $25,000 that he paid to another lawyer who represented him, unsuccessfully, in the state disbarment proceeding. Were these proper deductions?

    a. Yes. The lawyers' fees were ordinary and necessary business expenses, and were not disallowed because they weren't illegal payments, bribes or kickbacks.

    b. Yes. Attorneys' fees are always deductible, by anyone who incurs them.

    c. No. The lawyers' fees were not deductible, because they were incurred only as a result of criminal activity.

    d. No, because Lunkhead lost both the criminal case and the disbarment proceeding. If he had won, he could have deducted the fees he paid to win.

8. Danni Taxpayer owns a motorcycle delivery business. Most of her customers (clients?) are located in downtown Los Angeles; and they pay her to deliver documents and other small packages to businesses that also are in downtown Los Angeles. Often, there is no place for Danni to park her motorcycle legally, so she parks it no-parking zones because it only takes her a few minutes to make her deliveries. Most of the time, she gets away with this. But once a week or so, she gets a pretty expensive parking ticket. Parking delivery vehicles in a no-parking zone is a common practice; UPS and FedEx park their trucks in no-parking zones all the time, and the U.S. Postal Service does too. They, and Danni, do it because, as a practical matter, it's necessary; finding a parking lot with available space would take too long and be too expensive. And although Danni delivers small packages, UPS and FedEx often deliver packages that would be too big for drivers to carry any significant distance. May Danni deduct the cost of paying the parking tickets?

    a. Yes, because the cost of her parking tickets is an ordinary and necessary expense of her business.

    b. It would be if she delivered big and heavy packages, the way UPS and FedEx do; but since she delivers documents and small packages, she can't because the parking tickets are fines for violating the law.

    c. No; and she wouldn't be able to deduct the parking tickets even if she delivered big and heavy packages, because the parking tickets are fines for violating the law.

    d. No, because she parks in no-parking zones on purpose, and thus knows she's violating the law before she does it. If she could prove to the IRS that she didn't realize she was parking in no-parking zones, or that doing so was a violation of law, then she would be able to deduct them.

<u>**Lobbying and Political Expenses**</u>

Read (in Posin & Tobin) re Public Policy Limits: Lobbying and Political Expenses

Pages 475 –476

Internal Revenue Code provisions re Public Policy Limits: Lobbying and Political Expenses

> **§ 162. Trade or business expenses**
> (a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . .
> (e) Denial of deduction for certain lobbying and political expenditures.—
> (1) In general.—No deduction shall be allowed under subsection (a) for any amount paid or incurred in connection with—
> (A) influencing legislation,
> (B) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office,
> (C) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or
> (D) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official.
> (2) Exception for local legislation.—In the case of any legislation of any local council or similar governing body—
> (A) paragraph (1)(A) shall not apply. . . .

§ 276. Certain indirect contributions to political parties

(a) Disallowance of deduction. No deduction otherwise allowable under this chapter shall be allowed for any amount paid or incurred for -

(1) advertising in a convention program of a political party, or in any other publication if any part of the proceeds of such publication directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate,

(2) admission to any dinner or program, if any part of the proceeds of such dinner or program directly or indirectly inures (or is intended to inure) to or for the use of a political party or a political candidate, or

(3) admission to an inaugural ball, inaugural gala, inaugural parade, or inaugural concert, or to any similar event which is identified with a political party or a political candidate.

Questions re Public Policy Limits: Lobbying and Political Expenses

9. Regardless of how *you* answered Question 8, Danni Taxpayer thought she couldn't deduct the cost of her parking tickets, and this made her angry enough to do something about it. She urged her Representative in Congress to introduce an amendment to the Internal Revenue Code that would permit "delivery companies that make deliveries in densely-developed urban areas that do not have adequate affordable parking to deduct the cost of parking tickets they may receive for parking in no-parking zones." And she hired a Washington D.C. lobbying firm to lobby her Representative and others to enact such legislation. She paid the lobbying firm $5,000 for its as-yet unsuccessful efforts on her behalf. May she deduct the $5,000 she paid the lobbying firm?

    a. Yes, because business people frequently lobby their representatives to enact new laws or amend old ones; and thus the fee she paid the lobbying firm was an ordinary and necessary business expense for her.

    b. She can't deduct the lobbying firm's fee yet, though she will be able to do so if and when the lobbying firm is successful on her behalf and the Code is amended.

    c. No, because lobbying fees are never deductible.

    d. No, because lobbying fees to influence federal legislation are not deductible.

10. The lobbying firm that Danni is using is bi-coastal and has an office in Los Angeles as well as in Washington. In addition to the lobbying work being done for Danni in Washington, the lobbying firm also is attempting to persuade the Los Angeles City Council to amend the city's parking ordinance so that delivery companies will not be ticketed for parking in no-parking zones while they are "making deliveries in densely-developed areas of the city that do not have adequate affordable parking." Danni is paying the lobbying firm an additional $2,500 for this work. May she deduct it?

    a. No, because lobbying fees are never deductible.

    b. She can't deduct the lobbying firm's fee yet, though she will be able to do so when and if the lobbying firm is successful on her behalf and the Code is amended.

    c. Yes, because business people frequently lobby their representatives to enact new laws or amend old ones; and thus the fee she paid the lobbying firm was an ordinary and necessary business expense for her.

    d. Answer "c" is correct, as far as it goes. But it would have been a better answer if it explained that lobbying fees paid to influence *local* legislation are deductible, assuming of course that the legislation affects the taxpayer's trade or business, as Danni's proposed parking legislation does.

11. Lucy and Larry Taxpayer are the young, politically active Los Angeles lawyers. They just moved to Washington D.C. so that Lucy can work for President Obama. They attended the Presidential Inaugural Ball in January. The tickets for the Ball were expensive. Larry bought the tickets, because attending the Ball was a "business expense" for him because he's in private law practice in D.C., and rubbing shoulders with folks in the new administration will be good for his law practice. Will the cost of the tickets be deductible?

    a. No, because Inaugural Ball tickets are purely personal expenses, even for lawyers who attend only for reasons related to their law practices.

    b. No, because even if attending the Ball is a business matter, the cost of the tickets is not deductible because the code specifically provides that no deduction may be taken for this kind of expense.

    c. Yes, because attending the Ball will be a business expense for one of them.

    d. Yes, because Congress wants to encourage citizens to attend things like the Inaugural Ball.

<u>Moving Expenses</u>

Read (in Posin & Tobin) re Moving Expenses

Pages 406 - 407

Internal Revenue Code provisions re Moving Expenses

§ 217. Moving expenses

(a) Deduction allowed. There shall be allowed as a deduction moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work.

(b) Definition of moving expenses

(1) In general. For purposes of this section, the term "moving expenses" means only the reasonable expenses -

(A) of moving household goods and personal effects from the former residence to the new residence, and

(B) of traveling (including lodging) from the former residence to the new place of residence.

Such term shall not include any expenses for meals.

. . .

(c) Conditions for allowance. No deduction shall be allowed under this section unless -

(1) the taxpayer's new principal place of work -

(A) is at least 50 miles farther from his former residence than was his former principal place of work, or

(B) if he had no former principal place of work, is at least 50 miles from his former residence, and

(2) either -

(A) during the 12-month period immediately following his arrival in the general location of his new principal place of work, the taxpayer is a full-time employee, in such general location, during at least 39 weeks, or

(B) during the 24-month period immediately following his arrival in the general location of his new principal place of work, the taxpayer is a full-time employee or performs services as a self-employed individual on a full-time basis, in such general location, during at least 78 weeks, of which not less than 39 weeks are during the 12-month period referred to in subparagraph (A).

For purposes of paragraph (1), the distance between two points shall be the shortest of the more commonly traveled routes between such two points.

Questions re Moving Expenses

12. Arlene and Zoe were college roommates as undergrads at the University of Texas in Austin, where they were born, grew up and attended high school. Both decided they wanted to be lawyers. After getting their Bachelors Degrees, Arlene moved to San Francisco to attend the University of San Francisco School of Law; and Zoe moved to Boston to attend Boston College School of Law. After getting their JD degrees, both got jobs working for Google at its corporate headquarters in Mountain View, California. They also rented a lovely apartment together in the Avalon Towers in Mountain View, in order to be close to work. Mountain View is 35 miles from San Francisco and 3,000 miles from Boston. Arlene and Zoe both incurred moving expenses to move to Mountain View. May they deduct their expenses?

    a. No, because neither moved from one *job* to another; both moved from school to a job.

    b. Yes, because both moved more than 50 miles: Zoe moved from Boston to Mountain View; and Arlene moved from Austin to Mountain View via San Francisco.

    c. Arlene may deduct her expenses, because she moved fewer than 50 miles, but Zoe may not because she moved more than 50 miles.

    d. Arlene may not deduct her expenses, because she moved fewer than 50 miles, but Zoe may deduct her moving expenses because she moved more than 50 miles.

<u>Capital Expenditures vs. Business Expenses</u>

Read (in Posin & Tobin) re Capital Expenditures vs. Business Expenses

Pages 457 (bottom) – 464 (top: thru first full paragraph only)

Internal Revenue Code provisions re Capital Expenditures vs. Business Expenses

§ 263. Capital expenditures

(a) General rule. No deduction shall be allowed for -

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. . . .

(2) Any amount expended in restoring property . . . .

Reg. § 1.263(a)-1 Capital expenditures; In general

(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for:

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or

(2) Any amount expended in restoring property. . . .

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred

(1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or

(2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph. . . .

Reg. § 1.263(a)-2 Examples of capital expenditures.

The following paragraphs of this section include examples of capital expenditures:

(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Earlier, we saw that if Tabitha Taxpayer – the limousine business owner – *leased* her limo, she would be able to deduct her monthly lease payments in the year in which she made them. If she *bought* the limo, though, she wouldn't be able to deduct its *full* cost in the year she paid for it. Instead, she would have to deduct just a portion of its cost each year over several years – taking deductions for what tax law calls "depreciation."

The reason she wouldn't be able to deduct the full cost of the limo in the year she bought it is that section 162(a) of the Code permits deductions for "*expenses* paid . . . during the taxable year." But the law makes a distinction between "expenses" and "capital expenditures": *expenses* may be deducted in the year in which they are paid, but *capital expenditures* must be depreciated over a period of years.

The trick is being able to distinguish between "expenses" and "capital expenditures." In Tabitha's case, it was an easy distinction to make: cars are capital assets, and money spent to buy them are capital expenditures. In fact, the IRS itself uses cars to illustrate the difference:

> **Publication 535 (2007), Business Expenses**
> http://www.irs.gov/publications/p535/ch01.html#d0e511
>
> *Capital versus Deductible Expenses*
>
> To help you distinguish between capital and deductible expenses, different examples are given below.
>
> *Motor vehicles.*
>
> You usually capitalize the cost of a motor vehicle you use in your business. You can recover its cost through annual deductions for depreciation. . . .
>
> Generally, repairs you make to your business vehicle are currently deductible. However, amounts you pay to recondition and overhaul a business vehicle are capital expenses and are recovered through depreciation.

Notice that the IRS not only distinguishes between the cost of

- *buying* a car, which is a capital expenditure that must be *depreciated* over time, and
- *repairing* it, which is a *deductible expense* in the year paid,

but also between the cost of

- *reconditioning and overhauling* the car, which is a capital expense that must be *depreciated* over time, and
- *repairing* it which is a *deductible expense* in the year paid.

Requiring business owners to depreciate the cost of reconditioning and overhauling their cars – rather than allowing them to deduct those costs in the year they are incurred – may not make much of a bottom-line difference to some business owners. (I suppose it would depend on how many cars they have and how many of those cars require reconditioning rather than just repair.) However, in the real estate business, the difference between "repairs" that may be deducted in the year incurred and "reconditioning expenses" that must be depreciated over time can make a very significant difference in the taxpayer's taxable income for the year in which repair or reconditioning was done.

Because the distinction between deductible expenses and capital expenditures can be so significant, and because the IRS considered the cost of a new (business-use) car to be an obvious example of a capital expenditure, you might have supposed that the Code contains a section that spells out why the cost of a car (or other item of business equipment) is a capital asset that must be depreciated. I supposed so; but there is isn't.

Section 263 (above) talks about "buildings" and "permanent improvements" – but says nothing at all about cars or any other type of business-use personal property. Apparently, the IRS considered this omission to be a mere (and slight) oversight, because the IRS itself filled the gap in Regulation § 1.263(a)-1 and §1.263(a)-2 (above). Those Regulation sections make it clear that the costs of "equipment" and "furniture" also are "capital expenditures."

What's more, the Regulations also give us a rule of thumb for distinguishing between items whose costs are deductible expenses and those whose costs are capital expenditures. As important as this rule of thumb is, the IRS buried it at the tail end of the sentence that is paragraph (a) of Regulation § 1.263(a)-2: the cost of "property having a useful life substantially beyond the taxable year" is a capital expenditure rather than a deductible expense. And that's why the cost of a business-use car is a capital expenditure: cars last longer than a year.

With this one-year useful-life rule of thumb in mind, a number of common expenses become easy to classify:

- The cost of buying a photocopy machine is a capital expenditure that must be depreciated over a term of years, because photocopy machines have a useful life of more than a year. On the other hand, the cost of photocopy paper and toner may be deducted in the year they are purchased, because photocopy paper and toner have a useful life of less than a year.
- The cost of buying a business jet is a capital expenditure that must be depreciated over a term of years, because business jets have a useful life of more than a year. On the other hand, the cost of jet fuel may be deducted in the year it's purchased because jet fuel has a useful life of less than a year.

If you find this topic to be particularly interesting, questions may have occurred to you concerning the proper classification of the cost of an entire carton of photocopy toner that may last more than a year, or the cost of overhauling a jet engine which has to be done only once every few years. I am confident that the IRS would not expect taxpayers to capitalize and depreciate photocopy toner (no matter how long it lasted). The jet engine example is not as easy; FedEx once had a case against the IRS about whether FedEx could "expense" the cost of reconditioning its jet engines or whether it had to capitalize and depreciate those costs instead. The gray area between business expenses and capital expenditures has provoked many cases like FedEx's, a few of which were the subject of the assigned reading in Posin & Tobin.

Although the useful life of an asset is a prime factor, it's not the only one. As you read the Code and Regulation sections, you noticed (I hope) that if an expenditure

- increases the value of property, or
- substantially prolongs its useful life,

that expenditure is likely to be a capital expenditure that will have to be depreciated, rather than a business expenses that can be deducted in the year paid.

Questions re Tangible Asset Costs: Capital Expenditures vs. Business Expenses

1. Kimberly Taxpayer breeds and sell dogs. She used to run her business out of her home, but recently she became the owner of a retail pet store. Her store is, quite literally, a brick-and-mortar storefront. Most pet store owners rent their premises from landlords. But Kimberly is no fool. She knows that in the long run – not necessarily this year, but in the long run – there's more money to be made in real estate than in selling dogs and cats. As a result, Kimberly bought the building in which her store is located. Which of the following is true?

   a. She can deduct the full amount she paid for the building in the year she bought it, because the cost of the building is a "business expense."

   b. She will not be able to deduct the full cost of the building in the year she bought it, because even though she's using the building for her business, the cost of the building is a "capital expenditure" that she will have to depreciate over a period of years.

   c. She will not be able to deduct the full cost of the building in the year she bought it, because even though she's using the building for her business, the cost of the building is a "capital expenditure." But since her basis in the building is its cost, when she eventually sells the building, her gain on the sale will be less than what she gets for it, because she then will be permitted to subtract her basis in order to calculate her gain.

   d. She will have the option to treat the cost of the building, for tax purposes, in any one of the ways described in "a," "b" and "c." The choice that she makes among those three ways will depend on *when* she thinks she can make best use of the tax benefit: immediately; over time; or later when she sells.

2. Shortly after Kimberly opened her store, a heavy rain storm caused an unexpected leak in the building's roof, and a car skidded through a plate glass window at the front of the building. The costs of repairing the roof and window were substantial. Which of the following is true?

   a. She can deduct the full cost of the repairs in the year she paid for them, because they are a "business expense" deductible under section 162(a) of the Code.

   b. She will not be able to deduct full cost of the repairs in the year she paid for them, because even though she's using the building for her business, the cost of repairing the building is a "capital expenditure" that she will have to depreciate over a period of years.

   c. She will not be able to deduct the full cost of the repairs in the year she for them, because even though she's using the building for her business, the cost of repairing the building is a "capital expenditure." Nor will she be able to depreciate the repair costs. But she can add the repair costs to her basis in the building when she eventually sells it, so her gain on the sale will be less than what she gets for it, because she then will be permitted to subtract her basis in order to calculate her gain.

   d. She will have the option to treat the repair costs, for tax purposes, in any one of the ways described in "a," "b" and "c." The choice that she makes among those three ways will depend on *when* she thinks she can make best use of the tax benefit: immediately; over time; or later when she sells.

3. [This is a different version of the previous question.] Shortly after Kimberly opened her store, a heavy rain storm caused a leak in the building's roof. The leak was not unexpected, because Kimberly knew the roof was bad and would soon need to be repaired, even before she bought the store. The cost of repairing the roof was substantial. Which of the following is true?

    a. She can deduct the full cost of the roof repair in the year she paid for it, because it is a "business expense" deductible under section 162(a) of the Code.

    b. She will not be able to deduct full cost of the roof repair in the year she paid for it, because even though she's using the building for her business, the cost of repairing the roof is a "capital expenditure" that she will have to depreciate over a period of years.

    c. She will not be able to deduct the full cost of the roof repair in the year she for it, because even though she's using the building for her business, the cost of repairing the roof is a "capital expenditure." But she can add the repair cost to her basis in the building when she eventually sells it, so her gain on the sale will be less than what she gets for it, because she then will be permitted to subtract her basis in order to calculate her gain.

    d. She will have the option to treat the roof repair cost, for tax purposes, in any one of the ways described in "a," "b" and "c." The choice that she makes among those three ways will depend on *when* she thinks she can make best use of the tax benefit: immediately; over time; or later when she sells.

Depreciation

The Code includes several different formulas for calculating how much depreciation taxpayers may deduct. The Posin/Tobin book and the Code sections below focus on the three most commonly used of these formulas: "straight line depreciation"; "200% declining balance depreciation" (commonly referred to by its nickname: "double-declining balance depreciation"); and "150% declining balance depreciation." The Code includes other depreciation formulas too, some of them industry-specific, like the formula used by movie producers to deduct the costs they incur in the production of motion pictures.

We could spend a lot of class time exploring the workings of these various formulas; but we won't. *The only formula I want you to be certain you understand is the "straight line depreciation formula,"* and it's an easy one (even for those who don't like arithmetic).

Double declining balance depreciation and 150% declining balance depreciation are called "accelerated depreciation" because they allow taxpayers to take depreciation deductions faster than straight line depreciation would. Accelerated depreciation results in larger early-year deductions (and thus less taxable income during those years) than does straight line depreciation. *And that's the key thing I want you to know about double declining balance and 150% declining balance depreciation: they result in bigger early-year deductions.* For this course, you do not have to be able to do the arithmetic for those forms of depreciation. So, when allocating your study time, feel free to read the descriptions of the accelerated depreciation formulas just once, without highlighting or fussing over their details.

Some of the assigned reading concerning depreciation is Posin and Tobin's explanation for why the formulas in the Code do not reflect economic realties (a reoccurring theme in the book). Posin and Tobin also address a somewhat more interesting point: whether accelerated depreciation actually produces the result that Congress had in mind when it enacted accelerated depreciation provisions in the first place. That purpose was to encourage businesses to invest in new plant and equipment, in order to boost the economy. As you'll see, Posin and Tobin don't think that accelerated depreciation has that effect at all, and they've got formulas of their own to show why not. They do, however, acknowledge that others disagree with them on this point (and I'm one of them, for reasons I'll explain in class). Feel free to quickly read the pages that make these points, without fussing over their details either.

In order to understand how depreciation relates to other deductions we've studied already, recall the question concerning Tabitha Taxpayer who owns her own limousine business. Tabitha, you'll recall, *leased* her stretch Hummer limo; she didn't buy it. She leased it, because we were then looking at the deductibility of *rental* payments made by taxpayers to acquire property they use in business. Suppose, though, that Tabitha didn't lease her limo; supposed she *bought* it. If she bought it, she wouldn't have lease payments to deduct; but she would be permitted to deduct the purchase price of the limo. If she bought the limo, the deduction would be a "depreciation" deduction. She wouldn't necessarily be able to deduct the full cost of the limo *in the year she bought it* (nor would she necessarily want to, for reasons we'll discuss in class). She might have to deduct the limo's cost over a period of years (as she may well prefer to do). But whether she has to deduct the cost over time, or can deduct the full cost in the year she bought the limo, the deduction is "depreciation."

Read (in Posin & Tobin) re Depreciation

Pages 422 – 435 (stop before "Other Limits…")

Internal Revenue Code provisions re Depreciation

§ 167. Depreciation

(a) General rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) -
  (1) of property used in the trade or business, or
  (2) of property held for the production of income.

. . .

(c) Basis for depreciation
  (1) In general. The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011, for the purpose of determining the gain on the sale or other disposition of such property.

§ 1011. Adjusted basis for determining gain or loss

(a) General rule.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 . . .). . . .

§ 1012. Basis of property—cost

The basis of property shall be the cost of such property. . . .

§ 168. Accelerated cost recovery system

(a) General rule.—Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using—

(1) the applicable depreciation method,

(2) the applicable recovery period . . .

. . .

(b) Applicable depreciation method.—For purposes of this section—

(1) In general.—Except as provided in paragraphs (2) and (3), the applicable depreciation method is—

(A) the 200 percent declining balance method,

. . .

(2) 150 percent declining balance method in certain cases.— . . . .

(3) Property to which straight line method applies.—The applicable depreciation method shall be the straight line method in the case of [certain types of] property [including property taxpayers elect to depreciate using the straight line method, even though the property qualifies for accelerated depreciation using the 200% or 150% declining balance method. . . .]

(c) Applicable recovery period.—For purposes of this section, the applicable recovery period shall be determined in accordance with the following table:

In the case of:	The applicable recovery period is:
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
Water utility property	25 years
Residential rental property	27.5 years
Nonresidential real property	39 years
Any railroad grading or tunnel bore	50 years

. . .

(e) Classification of property.—For purposes of this section-

(1) In general.—Except as otherwise provided in this subsection, property shall be classified under the following table:

Property shall be treated as:	If such property has a class life (in years) of:
3-year property	4 or less
5-year property	More than 4 but less than 10
7-year property	10 or more but less than 16
10-year property	16 or more but less than 20
15-year property	20 or more but less than 25
20-year property	25 or more.

. . .

(3) Classification of certain property

. . .

(B) 5-year property. The term “5-year property” includes -

(i) any automobile or light general purpose truck. . . .

§ 179. Election to expense certain depreciable business assets

(a) Treatment as expenses.—A taxpayer may elect to treat the cost of any section 179 property as an expense. . . . Any cost so treated shall be allowed as a deduction for the taxable year in which the section 179 property is placed in service.

(b) Limitations.—

(1) Dollar limitation.—The aggregate cost which may be taken into account under subsection (a) for any taxable year shall not exceed $25,000 ($125,000 in the case of taxable years beginning after 2006 and before 2011).

(2) Reduction in limitation.—The limitation under paragraph (1) for any taxable year shall be reduced (but not below zero) by the amount by which the cost of section 179 property placed in service during such taxable year exceeds $200,000 ($500,000 in the case of taxable years beginning after 2006 and before 2011).

. . .

(7) Increase in limitations for 2008. – In the case of any taxable year beginning in 2008 —

(A) the dollar limitation under paragraph (1) shall be $250,000,

(B) the dollar limitation under paragraph (2) shall be $800,000. . . .

§ 197. Amortization of goodwill and certain other intangibles

(a) General rule.—A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired

. . .

(c) Amortizable section 197 intangible.—For purposes of this section—

(1) In general.—Except as otherwise provided in this section, the term "amortizable section 197 intangible" means any section 197 intangible— . . .

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

. . .

(d) Section 197 intangible.—For purposes of this section—

(1) In general.—Except as otherwise provided in this section, the term "section 197 intangible" means—

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment . . .

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and
(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

(e) Exceptions.—For purposes of this section, the term "section 197 intangible" shall not include [several kinds of intangibles described in this paragraph (e)].

Questions re Depreciation

4. Tabitha Taxpayer owns her own limousine business. Her one and only limo is an 18-passenger stretch Hummer, which cost $200,000. Rather than lease the limo, she bought it, for cash, using money she inherited from her grandfather. The car is huge and very expensive to operate, so she never uses it for personal transportation. She only uses it to transport her clients. In answering this question, pay particular attention to §168(b)(3), §168(e)(3)(B)(i) and §179, which are reproduced above. Which of the following is true?
   a. Tabitha may deduct $40,000 a year in limo depreciation for 5 years.
   b. Tabitha may deduct $200,000 in depreciation deductions the year she bought the limo.
   c. Either "a" or "b" is correct. Tabitha may elect whichever one she prefers.
   d. Tabitha may not deduct anything for depreciation. She should have leased the limo so she could deduct her monthly lease payments.

5. Tabitha didn't start her limousine business from scratch; she bought it from its prior owner, Sam. She paid Sam just $15,000 for the business, because Sam had totaled his limo in an accident. That's why Sam decided to sell the business and why Tabitha had to buy a new limo. For her $15,000, Tabitha got Sam's business name, his customer list, his business telephone number, his limo business license, and Sam's agreement not go back into the limo business (in the same town) for at least 5 years. May Tabitha deduct any part of the $15,000 she paid for the business?
   a. She may take a $1,000 per year amortization deduction.
   b. She may elect to take a one-time $15,000 amortization deduction.
   c. She may deduct, in equal installments over five years, the amount allocated to Sam's non-compete agreement. But she can't deduct the amount allocated to the business name, customer list, the phone number, or the limo business license.
   d. She can't deduct any of it.

Itemized Deductions

Read (in Posin & Tobin) re Itemized Deductions in General

Pages 487 – 489

Internal Revenue Code provisions re Itemized Deductions in General

> **§ 62. Adjusted gross income defined**
>
> (a) General rule.—For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions. . . .

The portion of § 62(a) quoted above is followed by 21 separately-numbered subparagraphs which list specific deductions that are authorized by *other* sections of the Code. Section 62(a) itself doesn't authorize deductions. It simply turns the listed deductions into "above the line" deductions, because § 62(a) allows them to be deducted from gross income when calculating "adjusted gross income." Business expenses – deductions which are authorized by § 162(a) – are listed in § 62(a)(1) as among those that may be deducted in calculating adjusted gross income, so business expenses are *above* the line deductions.

Deductions authorized by the Code, but not listed in § 62(a), all are "below the line" deductions, simply because they are *not* listed in § 62(a). Investment expenses – deductions for which are authorized by § 212(1) [below] – are *not* among those listed in § 62(a). So investment expenses are *below* the line deductions.

Section 68 of the Code is one of several sections that illustrate the significance of "adjusted gross income" in determining how much in *other* deductions – called "itemized deductions" – actually may be deducted. (The italics in what follows were added.)

> **§ 68. Overall limitation on itemized deductions**
>
> (a) General rule.—In the case of an individual whose *adjusted gross income* exceeds the applicable amount, the amount of the itemized deductions otherwise allowable for the taxable year shall be *reduced* by . . .
>
> (1) 3 percent of the excess of *adjusted gross income* over the applicable amount . . .
>
> (b) Applicable amount.
>
> (1) In general.—For purposes of this section, the term "applicable amount" means $100,000. . . .
>
> (2) Inflation adjustments.—In the case of any taxable year beginning in a calendar year after 1991, each dollar amount contained in paragraph (1) shall be increased by [a cost of living formula].
>
> (c) Exception for certain itemized deductions.—For purposes of this section, the term "itemized deductions" does not include [deductions for medical expenses, investment interest, casualty losses or gambling losses, all of which have their own limits].
>
> . . .
>
> (f) Phaseout of limitation.— [The amount of the itemized deduction reduction is itself reduced – i.e., the amount that may be deducted is increased – in accordance with a formula in this subparagraph, in the manner described in the Postin & Tobin book at pages 488-489.]

<u>Tax Advice and Attorney's Fees</u>

Read (in Posin & Tobin) re Tax Advice and Attorney's Fees

Pages 489 – 490

Internal Revenue Code provisions re Tax Advice and Attorney's Fees

§ 262. Personal, living, and family expenses

(a) General rule. Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

§ 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .

§ 212. Expenses for production of income

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

. . .

(3) in connection with the determination, collection, or refund of any tax.

§ 62. Adjusted gross income defined

(a) General rule. — For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions. . .

(20) Costs involving discrimination suits, etc. — Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination. . . . The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

(21) Attorneys fees relating to awards to whistleblowers. — Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award under section 7623(b) (relating to awards to whistleblowers). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

Questions re Tax Advice and Attorney's Fees

1. Clive Taxpayer is a client of Linda Lawyer. Clive is a professional photographer. This year, Linda: negotiated Clive's lease for his photo studio; gave him tax advice concerning his decision to lease (rather than buy) his photo studio; prepared and filed Copyright Registrations for his photos; and represented him in a dispute with one of Clive's former clients over payment of his fees for shooting the client's wedding. Linda billed Clive on a hourly basis for the legal services she rendered, and he paid her immediately. Will Clive be able to deduct the amount he paid Linda?

    a. Yes, Clive will be able to take a deduction for the full amount of the fees he paid Linda.

    b. Yes, Clive will be able to take a deduction for the fees he paid Linda, but he will be able to deduct the amount he paid her in connection with the dispute only up to the amount he recovered in that dispute.

    c. Yes, Clive will be able to take a deduction for the fees he paid Linda, but only for the fees he paid for tax advice – not the fees he paid for the other matters.

    d. No, Clive will not be able to deduct the fees he paid Linda.

2. If Clive is able to deduct the attorney's fees he paid Linda, will they be an above or below the line deduction?

    a. Above the line.

    b. Below the line.

3. Clive also got divorced this year. Linda represented him in connection with that matter too. It was a complicated divorce that involved child custody and support, spousal support, and division of separate and community property. Some of these issues had tax ramifications, and Linda's work included her analysis of the tax consequences of proposals made by Clive's wife's lawyer, as well as the tax consequences of counter-proposals Linda made on Clive's behalf. Linda billed Clive on an hourly basis for the work she did; and her statement indicated how many hours she devoted to each task, including the amount of time she devoted to the tax aspects of the divorce. Clive paid Linda's statement immediately. May he deduct all or any part of what he paid her?

    a. No, Clive's legal fees for his divorce were a non-deductible personal or family expense.

    b. The amount that Linda charged Clive for tax advice is deductible by him, but not the rest.

    c. Clive may deduct all of Linda's legal fees.

    d. Clive may deduct all of Linda's legal fees, but only if he paid them using his business checkbook so he could characterize them as business expenses.

4. Before Clive started his own photography business, he was employed by an auto insurance company to take photographs of accident sites for use in trials. Clive has a disability. His disability did not prevent him from doing his job, but it did require the insurance company to make certain accommodations for him (of the kind required by the Americans with Disabilities Act). For some reason that Clive never understood, the company suddenly became unwilling to continue the accommodation, and it fired him. Clive responded by filing a discrimination lawsuit against the company. Clive's lawsuit asserted the kind of claim listed in §62(a)(20) of the Code. Linda represented him in that lawsuit, on a contingent fee basis. Before trial, the insurance company settled with Clive for $1 million. Linda's contingency fee was 1/3 of his recovery, or $333,333, which Clive paid immediately, leaving him with $666,667. Was the $1 million recovery "gross income" to Clive? If it was income to him, was he able to deduct the attorney's fees he paid Linda? If he was able to deduct them, was the deduction above or below the line?

    a. No, Clive's recovery was not income to him, and thus the fee he paid Linda was not deductible.

    b. Yes, Clive's recovery was income to him, and the fee he paid Linda was deductible by him, above the line.

    c. Yes, Clive's recovery was income to him, and the fee he paid Linda was deductible by him, below the line.

    d. Yes, Clive's recovery was income to him, but the fee he paid Linda was not deductible by him.

5. [This is an alternate version of Question 4.] Before Clive started his own photography business, he was employed by an auto insurance company to take photographs of accident sites for use in trials. Clive had a written employment agreement with the insurance company (because the company wanted his photos to be works-made-for-hire under the Copyright Act, so it would own the copyrights to the photos rather than he). For some reason that Clive never understood, the company fired him before the end of the term of his employment contract. Clive responded by filing a breach of contract lawsuit against the company. Linda represented him in that lawsuit, on a contingent fee basis. Before trial, the insurance company settled with Clive for $60,000. Linda's contingency fee was 1/3 of his recovery, or $20,000, which Clive paid immediately, leaving him with $40,000. Was the $60,000 recovery "gross income" to Clive? If it was income to him, was he able to deduct the attorney's fees he paid Linda? If he was able to deduct them, was the deduction above or below the line?

    a. No, Clive's recovery was not income to him, and thus the fee he paid Linda was not deductible.

    b. Yes, Clive's recovery was income to him, and the fee he paid Linda was deductible by him, above the line.

    c. Yes, Clive's recovery was income to him, and the fee he paid Linda was deductible by him, below the line.

    d. Yes, Clive's recovery was income to him, but the fee he paid Linda was not deductible by him.

<u>Taxes (as a Deduction)</u>

Read (in Posin & Tobin) re Taxes

Pages 498 – 500

Internal Revenue Code provisions re Taxes

> **§ 164. Taxes**
>
> (a) General rule. Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
>
> (3) State and local, and foreign, income . . . profits taxes.

6. Clive (the photographer) is having a very good year, this year. His taxable income is going to be substantial, and his California taxes are going to be huge (which is good for California, because it's in serious financial difficulty right now). As a general rule, Clive doesn't like to pay taxes; and the thought of paying huge state income taxes caused him to contemplate a number of crazy things (like join the Howard Jarvis Taxpayers Association, or even move to Nevada which doesn't, yet, have a state income tax). However, before Clive did anything crazy, Linda Lawyer assured him that his California taxes wouldn't really be as expensive as he thinks, because he'll be able to take a deduction for the amount he pays in California income tax when he calculates his taxable income for federal tax purposes. Was Linda right?

   a. Yes.

   b. No.

   c. It depends on how much taxable income Clive has, for California income tax purposes. That is, Clive will be able to deduct, for federal tax purposes, the California tax he pays on $1 million in income, but not California tax on any income greater than $1 million.

   d. The question is irrelevant to whether Clive should join the Howard Jarvis Taxpayers Association or move to Nevada. What matters is whether Clive has to pay tax to California – as well as to the federal government! – not whether the tax he has to pay to California is a little or a lot.

7. When Linda explained to Clive that he'd be able to deduct his California taxes when calculating his taxable income for federal tax purposes, Clive became very excited because he reasoned that if California taxes are deductible, federal taxes must be too, and Clive's federal taxes are going to be even greater than his California taxes. Will Clive be able to deduct the federal income taxes he pays when he calculates his taxable income for federal income tax purposes?

    a. Yes, of course. Taxes are taxes. Section 164 of the Code doesn't distinguish between taxes paid to state and local government, and taxes paid to the federal government.

    b. Yes, but only if Clive can persuasively take the position that the United States is a "foreign" country, so income taxes paid to the federal government are "foreign" income taxes, deductible under § 164(a)(3).

    c. No, and this is odd. Why would state taxes be deductible, but not federal taxes?

    d. No, and there's nothing odd about this. First of all, if federal taxes were deductible in determining how much in federal taxes must be paid, the deduction would evaporate, because each iteration of the calculation would reduce the amount of tax that had to be paid which in turn would reduce the amount of the deduction. Second, there's a good reason for the state and local income tax deduction. It is a method by which the federal government transfers taxing power to state and local governments; it's like a grant from the federal government to state and local governments.

<u>Interest</u>

Read (in Posin & Tobin) re Interest

Pages 490 – 498

Internal Revenue Code provisions re Interest

§ 163. Interest

(a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

. . .

(d) Limitation on investment interest

(1) In general. In the case of a taxpayer other than a corporation, the amount allowed as a deduction under this chapter for investment interest for any taxable year shall not exceed the net investment income of the taxpayer for the taxable year.

. . .

(h) Disallowance of deduction for personal interest

(1) In general. In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

(2) Personal interest. For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than -

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

. . .

(D) any qualified residence interest (within the meaning of paragraph (3)),

. . .

§ 62. Adjusted gross income defined

(a) General rule.—For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions.—The deductions allowed by this chapter . . . which are attributable to a trade or business carried on by the taxpayer, *if such trade or business does not consist of the performance of services by the taxpayer as an employee*. [Emphasis added]

Questions re Interest

8. When Clive (the photographer) was employed by the insurance company, he bought some expensive photography equipment. The company did not reimburse him for the cost of the equipment, but he used it only in connection with his employment. He paid for the equipment using his credit card, and because it took him several months to pay off the purchase, the credit card company charged him interest, which he also paid. May Clive deduct the *interest*, and if so, will the deduction be above or below the line?

    a. No, he will not be able to deduct the interest, because of § 163(h)(1) and (2)(A).

    b. Yes, he will be able to deduct the interest, because of § 163(a), and it will be an above the line deduction because of § 62(a) and § 162(a).

    c. Yes, he will be able to deduct the interest, because of § 163(a), but it will be a below the line deduction because of § 163(h)(1) and (2)(A), and because that's what Posin & Tobin say on page 492, paragraph "1)".

    d. Yes, he will be able to deduct the interest, because all interest is deductible, regardless of why the money was borrowed, though in this case, it will be a below the line deduction because that's what Posin & Tobin say on page 492, paragraph "1)".

9. When Clive went into business for himself and opened his own photo studio, he bought more expensive photography equipment that he uses only in connection with his business. He paid for the equipment using his credit card, and because it took him several months to pay off the purchase, the credit card company charged him interest, which he also paid. May Clive deduct the *interest*, and if so, will the deduction be above or below the line?

    a. No, he will not be able to deduct the interest, because of § 163(h)(1) and (2)(A).

    b. Yes, he will be able to deduct the interest, because § 163(a) authorizes it and §163(h) does not disallow it (because of § 163(h)(2)(A)), and it will be an above the line deduction because of § 62(a) and § 162(a).

    c. Yes, he will be able to deduct the interest, because of § 163(a), but it will be a below the line deduction because of §§ 62(a)(1), 163(h)(1) and 163(h)(2)(A) [and see Posin & Tobin, page 492, paragraph "1"].

    d. Yes, he will be able to deduct the interest, because all interest is deductible, regardless of why the money was borrowed, though in this case, it will be an above the line deduction because that's what Posin & Tobin say on page 492, paragraph "1)".

10. Ida Taxpayer is an eager and aggressive investor. She buys stocks and bonds with cash; and when she finds an attractive investment for which she doesn't have enough cash, she borrows the money she needs to buy it. She usually does quite well in the market. Last year, for example, she made $25,000 in profits from her investments, calculated before taking into account her interest expenses. Last year, interest expenses ate into her profits quite a bit, because she borrowed so much money for investment purposes that she paid $30,000 in interest and $5,000 in loan processing fees and points. Was she able to deduct all or any part of the interest, loan processing fees and points?

    a. She was able to deduct all of the interest, fees and points.

    b. She was able to deduct all of the interest, but none of the fees and points.

    c. She was able to deduct $25,000 of the interest, fees and points, but not the remaining $10,000 (though she may be able to deduct the $10,000 this year, if she has investment income this year from which to take the deduction).

    d. She was not able to deduct any of the interest, fees or points.

<u>Casualty Losses</u>

Read (in Posin & Tobin) re Casualties

Pages 500 – 506

Internal Revenue Code provisions re Casualties

§ 165. Losses

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of deduction.—For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to

- (1) losses incurred in a trade or business;
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

. . .

(h) Treatment of casualty gains and losses.—

- (1) $100 limitation per casualty.—Any loss of an individual described in subsection (c)(3) shall be allowed only to the extent that the amount of the loss to such individual arising from each casualty, or from each theft, exceeds $100.
- (2) Net casualty loss allowed only to the extent it exceeds 10 percent of adjusted gross income.—
  - (A) In general.—If the personal casualty losses for any taxable year exceed the personal casualty gains for such taxable year, such losses shall be allowed for the taxable year only to the extent of the sum of-
    - (i) the amount of the personal casualty gains for the taxable year, plus
    - (ii) so much of such excess as exceeds 10 percent of the adjusted gross income of the individual.

Questions re Casualties

1. Victoria Taxpayer owned a home in the hills northeast of Pasadena which was destroyed in a fire. She paid $500,000 for her house several years ago. She had insurance for her house, and received $400,000 from her insurance company, though rebuilding her house will cost her $750,000. Will she be able to deduct her loss, and if so, how much of a deduction will she be able to take? Her adjusted gross income is $100,000.

    a. She will not be able to deduct her loss, because it is a personal loss, rather than a business or investment loss.

    b. She will be able to deduct a loss of $350,000 – that being the difference between the amount she received from her insurance company and the amount it will cost her to rebuild her house.

    c. She will be able to deduct a loss of $339,900, that being the difference between the amount she received from her insurance company and the amount it will cost her to rebuild her house, *less* $10,000 which is 10% of her adjusted gross income and less $100.

    d. She will be able to deduct a loss of $89,900, that being the difference between the amount she received from her insurance company and the amount she paid for her house when she first bought it, *less* $10,000 which is 10% of her adjusted gross income and *less* $100.

2. Suppose that Victoria had a "replacement cost" insurance policy on her house, so that she recovered $750,000 when the house for which she had paid $500,000 was destroyed by fire. Suppose too that in addition to her house, the fire also destroyed her car, for which she originally paid $25,000, and a boat for which she originally paid another $25,000. Suppose finally that her car and boat insurance policies were liability only policies (to protect her in case she injured someone else in an accident that was her fault), so that those policies didn't pay her anything at all as a result of the destruction of the car and boat by fire. Will she be able to deduct anything as a result of the fire, and if so, how much of a deduction will she be able to take? Her adjusted gross income is still $100,000.

    a. She doesn't have any loss to deduct as a result of the destruction of her house, because her house insurance will fully cover the cost of rebuilding it. But she will be able to deduct her $50,000 loss as a result of the destruction of her car and boat.

    b. She doesn't have any loss to deduct as a result of the destruction of her house, because her house insurance will fully cover the cost of rebuilding it. But she will be able to deduct $39,800 as a result of the destruction of her car and boat – that being her $50,000 loss less $10,000 which is 10% of her adjusted gross income and *less* $200 which is the $100 "deductible" for the car and a second $100 "deductible" for the boat, required by Code § 165(h)(1).

    c. She won't be able to deduct anything, because her $50,000 loss was more than offset by her $250,000 casualty gain from her house insurance which is the difference between the $500,000 she paid for the house and the $750,000 she received from the insurance company.

    d. She won't be able to deduct anything, because these were personal losses, rather than a business or investment losses.

<u>Charitable Contributions</u>

Read (in Posin & Tobin) re Charitable Contributions

Pages 519 – 527

Internal Revenue Code provisions Charitable Contributions

Section 170 of the Code, which authorizes deductions for charitable contributions, is surprisingly long and detailed. The excerpt that follows is the portion discussed in Posin & Tobin.

§ 170. Charitable, etc., contributions and gifts

(a) Allowance of deduction.—

(1) General rule.—There shall be allowed as a deduction any charitable contribution . . . .

(b) Percentage limitations.—

(1) Individuals.—In the case of an individual, the deduction provided in subsection (a) shall be limited as provided in the succeeding subparagraphs.

(A) General rule.—Any charitable contribution to—

(i) a church . . . ,

(ii) an educational organization . . . ,

(iii) an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research . . . ,

(v) a governmental unit . . .

shall be allowed to the extent that the aggregate of such contributions does not exceed 50 percent of the taxpayer's contribution base for the taxable year.

(B) Other contributions.—Any charitable contribution other than a charitable contribution to which subparagraph (A) applies shall be allowed to the extent that the aggregate of such contributions does not exceed the lesser of—

(i) 30 percent of the taxpayer's contribution base for the taxable year, or

(ii) the excess of 50 percent of the taxpayer's contribution base for the taxable year over the amount of charitable contributions allowable under subparagraph (A) (determined without regard to subparagraph (C)). . . .

(C) Special limitation with respect to contributions described in subparagraph (A) of certain capital gain property.—

(i) In the case of charitable contributions described in subparagraph (A) of capital gain property . . . the total amount of contributions of such property which may be taken into account under subsection (a) for any taxable year shall not exceed 30 percent of the taxpayer's contribution base for such year. . . .

(D) Special limitation with respect to contributions of capital gain property to organizations not described in subparagraph (A).—
(i) In general.—In the case of charitable contributions (other than charitable contributions to which subparagraph (A) applies) of capital gain property, the total amount of such contributions of such property taken into account under subsection (a) for any taxable year shall not exceed the lesser of—
(I) 20 percent of the taxpayer's contribution base for the taxable year, or
(II) the excess of 30 percent of the taxpayer's contribution base for the taxable year over the amount of the contributions of capital gain property to which subparagraph (C) applies. . . .
(G) Contribution base defined.—For purposes of this section, the term "contribution base" means adjusted gross income . . . .
(c) Charitable contribution defined.—For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of—
(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.
(2) A corporation, trust, or community chest, fund, or foundation—
(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;
(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;
(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and
(D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. . . .

Questions re Charitable Contributions

3. Recall that earlier in the semester, when we covered whether gross income includes prizes, we considered this question:

   > [True story:] In October 2007, former Vice President Al Gore was awarded the Nobel Peace Prize for his work on the effects of climate change. He shared the award, and the $1.5 million that goes to the winner, with the Intergovernmental Panel on Climate Change. Immediately upon being informed that he had won the Prize, Gore announced that he would donate his half of the $1.5 million to a nonprofit organization he founded the year before called the Alliance for Climate Protection. Was his half of the $1.5 income to him?

   The answer you'll recall was that it would *not* have been income to him *if* he advised the Nobel Prize committee to pay the money directly to the Alliance for Climate Protection. The Alliance is a charitable organization of the kind referred to in § 170(b)(a)(A). (See http://www.irs.gov/app/pub-78/.)

   Since Gore could have accepted the $750,000 that was his half of the Nobel Prize and then donated it to the Alliance, would it have made any difference to him at all if he did that rather than tell the Nobel Prize committee to pay the $750,000 directly to the Alliance?

   a. No, it would have made no difference whatsoever, insofar as his taxes were concerned, because a $750,000 deduction would be so much greater than a standard deduction that he certainly would have itemized his deductions and deducted the whole $750,000.

   b. If his adjusted gross income for 2007 (including the Nobel Prize money) was more than $1.5 million, it would not make a difference, because the limit on his charitable contribution deduction would have been at least the $750,000 he contributed. If, though, his adjusted gross income was less than $1.5 million, then he would not have been able to deduct the entire $750,000 deduction.

   c. It would make a significant difference, even if his adjusted gross income for 2007 were more than $1.5 million. Indeed, it would make a difference so long as his adjusted gross income was greater than $100,000 as adjusted for inflation since 1991, which by now is $159,950 (see Schedule A, Line 29). This is so, because if his adjusted gross income was greater than $159,950, the amount of itemized deductions he could take (including charitable deductions) would be reduced by a formula set forth in § 68 of the Code (above). So Gore saved taxes by telling the Nobel Prize committee to pay the $750,000 directly to the Alliance for Climate Protection rather than accept the money and then contribute it himself to the Alliance.

   d. I don't see why it should make a difference, for tax purposes, whether Gore told the Nobel Prize committee to send the money directly to the Alliance, or whether the money passed through his own checking account first, so long as the Alliance would up with the money at about the same time.

<u>Floor on Miscellaneous Itemized Deductions</u>

Read (in Posin & Tobin) re Floor on Miscellaneous Itemized Deductions

Pages 527 – 528

Internal Revenue Code provisions re Floor on Miscellaneous Itemized Deductions

> **§ 67. 2-percent floor on miscellaneous itemized deductions**
>
> (a) General rule. – In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.
>
> (b) Miscellaneous itemized deductions. – For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than–
>
> (1) the deduction under section 163 (relating to interest),
>
> (2) the deduction under section 164 (relating to taxes),
>
> (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
>
> (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),
>
> (5) the deduction under section 213 (relating to medical, dental, etc., expenses). . . .

Questions re Floor on Miscellaneous Itemized Deductions

4. Wynona Taxpayer is a successful lobbyist in Washington D.C., where she is employed by a firm that specializes in representing clients who want changes in the Internal Revenue Code. Her adjusted gross income last year was $125,000, and though she knows a great deal about income tax law (because of the lobbying work that she does), she doesn't prepare her own income tax returns. Wynona has an accountant who does that for her. Wynona itemizes her deductions, because last year she paid interest on her home mortgage, she paid property taxes, and she made charitable contributions. She didn't have any unreimbursed employee expenses (i.e., no union dues or travel expenses); nor did she have any investment expenses. However, her accountant did charge Wynona $2,500 to prepare her tax returns. You'll recall that §212(3) of the Code authorizes individuals to deduct the expenses they incur "in connection with the determination . . . of any tax." Was Wynona able to deduct the amount she paid her accountant to prepare her tax returns?

   a. Yes, she was able to deduct the amount she paid her accountant. The deduction is authorized by § 212(3), and § 212(3) is *not* among the exceptions listed in §67(b).

   b. No, she was not able to deduct the amount she paid her accountant. Although §212(3) authorizes the deduction of tax determination expenses, § 67(b) allows them to be deducted only to the extent they exceed 2% of a taxpayer's adjusted gross income. The $2,500 Wynona paid to have her tax returns prepared does not exceed 2% of her adjusted gross income (2% x $125,000 = $2,500). And §212(3) is *not* listed in § 67(b), so accounting fees are *not excluded* from the 2% floor.

5. If Wynona's accountant had charged her $3,000 to prepared Wynona's tax returns, would Wynona have been able to deduct those fees?

    a. Yes, she would have been able to deduct the amount she paid her accountant. The deduction is authorized by § 212(3), and § 212(3) is *not* among the exceptions listed in §67(b).

    b. Yes, now the accountant's fees exceed 2% of Wynona's adjusted gross income, so now they are fully deductible.

    c. Yes, now that the accountant's fees exceed 2% of Wynona's adjusted gross income by $500, Wynona may deduct $500 of the $3,000 she paid, though not the remaining $2,500.

    d. Although Wynona cannot deduct the $3,000 in fees she paid her accountant, she may exclude $3,000 from her gross income, which has the same effect as an above the line deduction, insofar as the amount of her taxable income is concerned.

<u>Standard Deduction</u>

Read (in Posin & Tobin) re the Standard Deduction

Pages 529 – 530

Internal Revenue Code provisions re the Standard Deduction

§ 63. Taxable income defined

. . .

(b) Individuals who do not itemize their deductions. – In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term "taxable income" means adjusted gross income, minus–

(1) the standard deduction, and

(2) the deduction for personal exemptions provided in section 151.

(c) Standard deduction. – For purposes of this subtitle–

(1) In general. – Except as otherwise provided in this subsection, the term "standard deduction" means the sum of–

(A) the basic standard deduction, and

(B) the additional standard deduction [for the aged and blind]. . . .

Questions re the Standard Deduction

6. Tara Taxpayer is a recent law school grad. She was a terrific student, and went through all of law school on full-ride scholarships. As a result, she has no student loans to repay, though she could well-afford to do so, if she had to, because she went straight from law school to the biggest law firm in town, where she is already earning enough to give her an adjusted gross income of $125,000. Tara still lives in the apartment she rented as a student, because she's been too busy to look for, let alone buy, a condo or house (even though she knows from her tax law class that she should). This means that she doesn't pay any property taxes or mortgage interest; and she doesn't have any other deductible expenses either. The dean of her law school just called Tara, and asked her to make a $5,000 contribution to the school's scholarship fund (the very fund from which she received her scholarships). In an effort to persuade Tara to do so, the dean told her that she'd be able to deduct the donation, and that in her tax bracket, she'd save a lot in taxes by doing so. Was the dean right?
    a. Yes, because $5,000 is much less than 50% or Tara's adjusted gross income, and her adjusted gross income is less than $156,400, so she'll be able to deduct the entire $5,000 contribution.
    b. Yes, sort of. That is, if Tara's adjusted gross income is $125,000, she'll only be able to deduct $2,500 of her $5,000 deduction, because the $5,000 contribution will exceed 2% of her AGI by only $2,500.
    c. Yes, because if she doesn't make this donation, she won't have any deductions at all; and she wind up paying taxes on her entire $125,000 adjusted gross income.
    d. No, because even though Tara doesn't have any deductible expenses, she can still take the Standard Deduction, which for 2007 was $5,350 (for unmarried taxpayers like Tara).

7. If you were a law school dean, or were in charge of fundraising for a charity, would you (in your professional capacity) favor an increase in the amount of the standard deduction?
    a. Yes, I would favor an increase in the amount of the standard deduction, so that taxpayers would pay less tax, and thus have more to donate.
    b. Yes, I would favor an increase in the amount of the standard deduction, so that people would donate more than they do now, in order to make it worth their while to itemize their deductions rather than take a standard deduction.
    c. No, I wouldn't favor an increase in the amount of the standard deduction, because that would reduce the number of people who itemize their deductions, and thus reduce the number of people who would get a tax benefit from making charitable contributions.
    d. No, I wouldn't favor an increase in the amount of the standard deduction, because that would increase the amount of tax that people would have to pay, and reduce the amount of money they would be able to donate.

INCOME & DEDUCTIONS, COMBINED: SALES AND EXCHANGES OF PROPERTY

Read (in Posin & Tobin) re Overview of Sales and Exchanges; and the Requirement of Realization

Pages 148-166

Don't be intimidated, or even put off, by the charts in the book at pages 148 and 150. Both are flowcharts that were intended to illustrate the order in which several steps of analysis are supposed to be done. In my opinion, the charts look more complicated than they are, because they are squeezed into columns that are only 7½ inches by 4¼ inches in size, and most of the boxes were placed where they *fit*, rather than where they would have been have been placed if the charts had been printed on larger sheets of paper. I usually find charts to be very helpful. But if these two charts don't help you, ignore them. The same information is in the text in what is (for me) a more easily understood format, namely, plain paragraphs.

Internal Revenue Code provisions re Overview and Realization in General

> **§ 61. Gross income defined**
> (a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .
> (3) Gains derived from dealings in property;

> **§ 109. Improvements by lessee on lessor's property**
> Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

> **§ 305. Distributions of stock and stock rights**
> (a) General rule
> Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.
> (b) Exceptions [of which there are many] . . .

Questions re Overview and Realization in General

1. Igor ("the Investor") Taxpayer purchased stock in PubCorp on January 2nd of last year, paying $10,000 for 100 shares (i.e., $100 per share). By December 31st of last year, PubCorp stock had increased in value to $150 per share, so he could have sold his shares on that date for $15,000. He didn't sell his shares though; he kept them. Insofar as the increase in the value of the PubCorp shares is concerned, Igor:
    a. had no income, because he didn't "realize" the gain.
    b. had income, because he could have sold his shares to get the increase in their value, which also would have given him cash to pay tax on their increased value.
    c. would have income if he would have had income from catching Barry Bond's record-setting homerun baseball; that is, the "rule" – whatever it is – is the same in the PubCorp situation as it is in the baseball case.
    d. none of the above.
2. Same as #1, with these additional facts: In the middle of last year, PubCorp paid a cash dividend to shareholders of $25 per share. Because Igor owned 100 shares, he received $2,500. Immediately after the dividend was paid, the value of PubCorp stock dropped to $75 per share, so Igor's stock was worth $7,500. Insofar as the cash dividend is concerned, Igor:
    a. had income – even though he wasn't any wealthier than when he started – because: the cash dividend was "severed from the capital"; Igor had "complete dominion" over it (recall the Glenshaw Glass decision, pg 54-55); and dividends are specifically listed as income in § 61(a)(7) of the Code (see the Study Guide for Class 3).
    b. had no income, because he didn't realize any increase in his wealth; that is, he paid $10,000 for stock that turned into $2,500 in cash plus stock worth $7,500.
    c. had no income, because even though he realized $2,500 in cash income, he also realized a $2,500 loss in the value of his stock, so his net income was zero.
    d. none of the above.
3. Same as #2, with this additional fact: Before PubCorp decided to pay a cash dividend, it also considered paying a stock dividend (rather than cash) that would have resulted in shareholders receiving 3.33 new shares of PubCorp for each share they already owned. If PubCorp had done that (instead of paying a cash dividend), the value of PubCorp shares would have dropped to $75 per share, just as it did when the cash dividend was paid. If PubCorp had paid a stock dividend, Igor would have:
    a. had income, even though he wasn't any wealthier than when he started, because he would have received 33.33 new shares worth $75 each.
    b. had no income, because he didn't "realize" any wealth; that is, he paid $10,000 for 100 shares of stock that turned into 133.33 shares of stock worth $10,000; and in any event, § 305(a) provides that stock distributions aren't income.
    c. had no income, because even though he received 33.33 shares worth $2,500, he also realized a $2,500 loss in the value of the 100 shares he already owned, so his net income was zero.
    d. none of the above.

4. Would your answer to question 3 be the same or different, if after the new shares were issued, the value of PubCorp stock didn't drop to $75, but dropped instead to $90, so that after the dividend, Igor's 133.33 shares were worth $12,000 (i.e., $2,000 more than he paid for his original 100 shares)? Remember: what these questions are driving at is "realization" of gain – not simply "gain."
   a. The same.
   b. Different.
5. The discussion in the Posin/Tobin book at pages 158 through 166 shows that:
   a. The tax treatment of certain transactions is not consistent with the economic reality of those transaction.
   b. The tax treatment of certain transactions is done for administrative ease, because in order to treat transactions in a way that reflected their economic reality, the Code would have to be even more complex than it already is.
   c. The tax treatment of certain transactions results in taxpayers paying less tax than they would have been required to pay, if the tax treatment of those transactions was consistent with their economic realities.
   d. All of the above.

Read (in Posin & Tobin) re Computation of Gain or Loss Realized

Pages 171-184 (top)

Internal Revenue Code provisions re Computation of Gain or Loss Realized

§ 1001. Determination of amount of and recognition of gain or loss

(a) Computation of gain or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. . . .

(c) Recognition of gain or loss.—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

§ 1011. Adjusted basis for determining gain or loss

(a) General rule.—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 . . .), adjusted as provided in section 1016.

§ 1012. Basis of property—cost

The basis of property shall be the cost of such property. . . .

§ 1016. Adjustments to basis

(a) General rule.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account . . .

(2) . . . for exhaustion, wear and tear, obsolescence, amortization, and depletion. . . .

Questions re Computation of Gain or Loss Realized

1. Igor Taxpayer purchased stock in PubliCo, a New York Stock Exchange company, on January 2nd of last year, paying $10,000 for 100 shares (i.e., $100 per share). On December 31st of last year, Igor sold all 100 shares for $15,000, so he'd have cash available in January to pay credit card bills for Christmas presents he bought for his family. (In a couple of weeks, when we get to Capital Gains, we'll consider whether Igor was a bit too eager to sell his stock, and whether he could have saved some money in taxes if he had waited just a few days, until, say, January 3rd of this year, to sell his stock. For now, though, disregard the capital gains issue.) Did Igor have income as a result of his sale of the stock, and if so, how much income?

    a. No, he didn't have any income.

    b. Yes, he had $5,000 in income.

    c. Yes, he had $10,000 in income.

    d. Yes, he had $15,000 in income.

2. Donald Taxpayer purchased an office building several years ago for $10 million, and he sold it this year for $15 million. During the years Donald owned the building, he took $2 million in deductions for exhaustion, wear and tear to the building (as permitted by the Internal Revenue Code, in ways we'll soon be studying). Did Donald have income as a result of his sale of the building, and if so, how much income?

   a. No, he didn't have any income.

   b. Yes, he had $5 million in income.

   c. Yes, he had $7 million in income.

   d. Yes, he had $15 million in income.

3. Same as #2, with this additional fact: While he owned the building, he spent $1 million building an adjoining parking structure for the building's tenants. (All other facts remain the same, including purchase price, deductions, and sale price.) Did Donald have income as a result of the sale of the building, and if so, how much income?

   a. No, he didn't have any income.

   b. Yes, he had $5 million in income.

   c. Yes, he had $6 million in income.

   d. Yes, he had $15 million in income.

4. Donald Taxpayer purchased a hotel last year for $10 million, and he sold it later that same year for $10 million in cash plus an office building with a fair market value of $5 million. Did Donald have income as a result of his sale of the hotel, and if so, how much income?

   a. No, he didn't have any income.

   b. Yes, he had $5 million in income, because that was the amount by which the cash and the fair market value of the building he received exceeded his basis in the hotel.

   c. Yes, he had $10 million in income, because that was the amount of the cash he received.

   d. Yes, he had $15 million in income, because that was the amount he received in cash and the fair market value of the building.

5. When Donald Taxpayer bought the hotel, he paid $2 million in cash from his own bank account, and he borrowed $8 million to cover the balance. Donald gave the lender a mortgage on the hotel, as collateral for the loan; and the loan provided that in event Donald defaulted on the loan, and the lender had to foreclose, Donald would be personally liable for any balance still due after the lender foreclosed and sold the hotel. In other words, Donald's loan was "with recourse." Does this fact change your answer to question 2?

   a. No, he still didn't have any income.

   b. Yes. Since he borrowed $8 million, his basis in the hotel, when he bought it, was only the $2 million he paid from his own money. So he realized a gain of $10 million, i.e., $10 million received, less his original $2 million basis reduced by the $2 million in deductions for exhaustion, wear and tear.

   c. No; the answer is the same. He still had $7 million in income, because his original basis was still $10 million, so his income was $15 million – ($10 million in original basis reduced by $2 million in deductions = an adjusted basis of $8 million) = $7 million gain.

   d. No; the answer is the same. He still had $15 million in income.

6. Same as #5, with this one change: the $8 million loan was a "non-recourse" loan, i.e., Donald would *not* be personally liable if he defaulted on the loan, even if there was an unpaid balance after the lender foreclosed and sold the hotel.

   a. If the loan was non-recourse, Donald's basis was just the $2 million of his own money he put into the hotel. So, after he took $2 million in deductions, his basis was $0. And therefore his gain was the $15 million he received when he sold the hotel.

   b. Even if the loan was non-recourse, Donald's basis was $10 million, so his income was $15 million – ($10 million original basis - $2 million deductions = $8 million adjusted basis) = $7 million.

   c. Even if the loan was non-recourse, he still didn't have any income.

   d. Even if the loan was non-recourse, his income is still $15 million.

7. The *Philadelphia Park Amusement* case (explained in the Posin/Tobin book at pages 174-175) appears to be more confusing than it needs to be, because:

   a. it involved a taxpayer that disposed of property (a bridge) in exchange for other property (a franchise extension), rather than for cash.

   b. the property the taxpayer received (a franchise extension) was worth much more than the property the taxpayer disposed of (a bridge), thereby making this a very unusual case, because most of the time, the value of things that are exchanged are the same.

   c. the issue in the case was not whether the taxpayer "realized" a gain or loss, or even how much of a gain or loss the taxpayer realized, but instead concerned the taxpayer's *basis in the property it received* (a franchise extension), because the taxpayer wanted to take deductions based on the high value of what the taxpayer received.

   d. All of the above.

8. The *Philadelphia Park Amusement* case *held* that the taxpayer's *basis* for what it *received* (the franchise extension) in exchange for property (the bridge) was:
    a. the fair market value of what it received at the time the taxpayer received it.
    b. the fair market value of the property that the taxpayer disposed of (the bridge).
    c. the taxpayer's basis in the property it disposed of (the bridge).
    d. None of the above.

9. The *Philadelphia Park Amusement* case *means* that if a taxpayer receives property having a fair market value of $1 million in exchange for property having a fair market value of $750,000, the taxpayer's basis in the property it received is:
    a. $1 million.
    b. $750,000.
    c. $875,000, i.e., the midpoint between $1 million and $750,000.
    d. another amount, which the facts don't provide, namely, the taxpayer's basis in the property the taxpayer disposed of.

10. The *Philadelphia Park Amusement* case *means* that if a taxpayer receives property having a fair market value of $1 million in exchange for property in which the taxpayer has a basis of $750,000, the taxpayer's basis in the property it received is:
    a. $1 million.
    b. $750,000.
    c. $875,000, i.e., the midpoint between $1 million and $750,000.
    d. another amount, which the facts don't provide, namely, the fair market value of the property the taxpayer disposed of.

11. The *Philadelphia Park Amusement* case *means* that if a taxpayer pays $750,000 in cash for property having a fair market value of $1 million, the taxpayer's basis in the property it received is:
    a. $1 million.
    b. $750,000.
    c. $875,000, i.e., the midpoint between $1 million and $750,000.
    d. none of the above.

Read (in Posin & Tobin) re Carryover Basis of Gifts

Pages 198 (beginning with § (c)) – 203 (end of page, but *not* 204)

Internal Revenue Code provisions and Regulations re Carryover Basis of Gifts

§ 1015. Basis of property acquired by gifts and transfers in trust

(a) Gifts . . . — If the property was acquired by gift . . . , the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner.

§ 1016. Adjustments to basis

(a) General rule.—Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account . . .

(2) . . . for exhaustion, wear and tear, obsolescence, amortization, and depletion. . . .

Reg. § 1.1015-1 Basis of property acquired by gift. . .

(2) The provisions of [§ 1015(a)] may be illustrated by the following example.

Example: A acquires by gift income-producing property which has an adjusted basis of $100,000 at the date of gift. The fair market value of the property at the date of gift is $90,000. A later sells the property for $95,000. In such case there is neither gain nor loss. The basis for determining loss is $90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is $100,000.

Here is an edited version of § 1015(a):

- If property is acquired by gift . . .
- the [recipient's] basis shall be the same as it would be in the hands of the donor . . . ,
- *except* . . .
- if such basis . . . is *greater* than the fair market value of the property *at the time of the gift*,
- then for the purpose of determining [the recipient's] *loss*
- the [recipient's] basis shall be such fair market value.

Questions re Carryover Basis of Gifts

1. Mama and Papa Bear bought a cabin on the shore of Big Bear Lake in 1980, for $25,000 when their daughter Tabatha was just a baby. Now of course the cabin is worth ten times as much as they paid for it – literally $250,000, as of last spring when Tabatha got married. Mama and Papa gave the cabin to Tabatha and her new husband as a wedding gift. But shortly after the wedding, Tabatha was offered and accepted a new job in Boston, as a professor at Harvard's Kennedy School of Government. As a result, Tabatha and her husband sold the cabin, for $250,000. How much income, if any, did Tabatha and her husband have as a result of the sale of the cabin?
    a. None, because the cabin was a gift.
    b. None, because they sold the cabin for the same amount as their basis, i.e., the $250,000 the cabin was worth when they received it as a gift.
    c. $225,000 – the difference between what they sold the cabin for, and her parents' $25,000 basis in the cabin.
    d. $250,000 – the difference between what they sold the cabin for and their basis, i.e., the $0 they paid for it.

2. Sally and Sam Spring bought a fancy condominium in Palm Springs a few years ago, for $500,000, thinking they would use it often because they like to play golf and swim. However, the traffic between their home in Los Angeles and Palm Springs was unbearable for them, so they hardly used the condo at all. This past spring, they thought about selling the condo; but as a result of the mortgage meltdown and overbuilding in Palm Springs, they discovered – much to their horror – that the condo was worth only $250,000, so they didn't sell it. Instead, they gave it to their daughter Thelma, as a law school graduation gift. Thelma lives in Los Angeles too, so, alas, the traffic was just as bad for her as it was for Sally and Sam. What's worse, Thelma is working such long hours as a lawyer that she had even less time to spend at the condo than they did. So Thelma sold the condo for $250,000. How much income, if any, did Thelma realize as a result of the sale of the condo?

   a. None, because the condo was a gift.

   b. None, because she sold the condo for the same amount as her basis, i.e., the $250,000 the condo was worth when she received it as a gift.

   c. She actually had a $250,000 *loss* on the sale – the difference between what she sold the condo for, and her parents' $500,000 basis in the condo.

   d. $250,000 – the difference between what she sold the condo for and her basis, i.e., the $0 she paid for it.

3. Same as #2, with these changes: Even though the condo had a fair market value of $250,000 when Sally and Sam gave it to Thelma, by the time Thelma sold it, its value had gone back up a bit; and she sold it for $300,000. How much income, if any, did Thelma realize as a result of the sale of the condo?

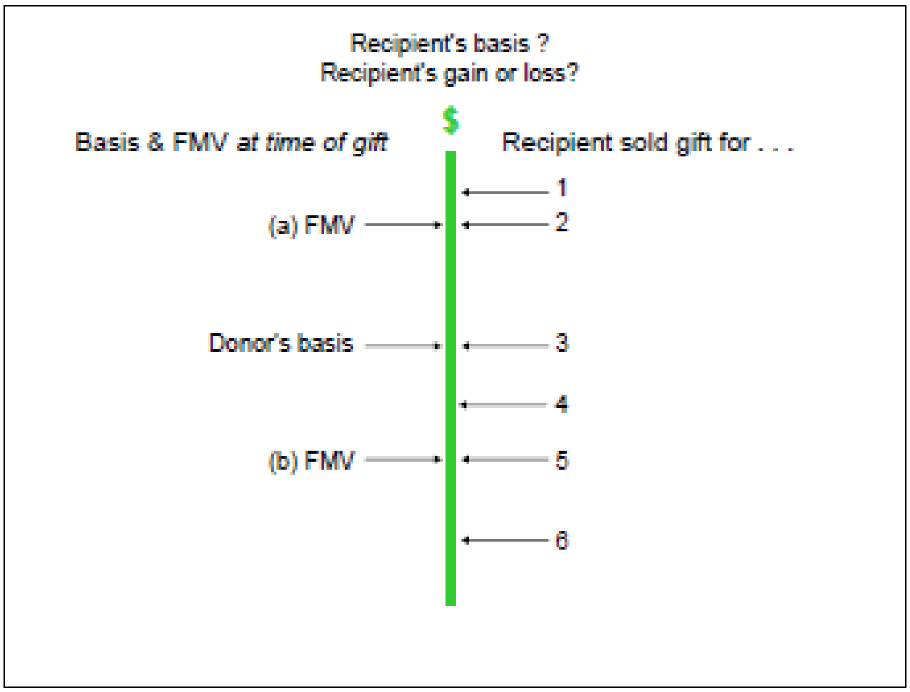
   a. None, because the condo was a gift.

   b. $50,000, because she sold the condo for $50,000 more than her basis, i.e., the $250,000 the condo was worth when she received it as a gift.

   c. She actually had a $200,000 *loss* on the sale – the difference between what she sold the condo for, and her parents' $500,000 basis in the condo.

   d. None, because the amount she received for the condo was more than what it was worth when she received it as a gift, and less than what her parents paid for it when they bought it, so this is a "notch" transaction and she has no gain or loss.

4. The following chart illustrates 12 possible scenarios: six possible sale prices, when the gift's fair market value at the time of the gift was greater than the Donor's basis; and six possible sale prices when the gift's fair market value at the time of the gift was less than the Donor's basis.
   - Which point on the chart ("Recipient sold gift for. . ." 1 through 6) illustrates Question 1 above?
   - Which point on the chart ("Recipient sold gift for. . ." 1 through 6) illustrates Question 2 above?
   - Which point on the chart ("Recipient sold gift for. . ." 1 through 6) illustrates Question 3 above?



Read (in Posin & Tobin) re Basis of Property Received from Decedents

Pages 205 (beginning with §(e)) – 209 (top)

Internal Revenue Code provisions re Basis of Property Received from Decedents

§ 1014. Basis of property acquired from a decedent

(a) In general.—Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall . . . be—

(1) the fair market value of the property at the date of the decedent's death....

. . .

(f) Termination.—This section shall not apply with respect to decedents dying after December 31, 2009.

§ 1022. Treatment of property acquired from a decedent dying after December 31, 2009

(a) In general. Except as otherwise provided in this section -

(1) property acquired from a decedent dying after December 31, 2009, shall be treated for purposes of this subtitle as transferred by gift, and

(2) the basis of the person acquiring property from such a decedent shall be the lesser of -

(A) the adjusted basis of the decedent, or

(B) the fair market value of the property at the date of the decedent's death.

(b) Basis increase for certain property

(1) In general. In the case of property to which this subsection applies, the basis of such property under subsection (a) shall be increased by its basis increase under this subsection.

(2) Basis increase. For purposes of this subsection -

(A) In general. The basis increase under this subsection for any property is the portion of the aggregate basis increase which is allocated to the property pursuant to this section.

(B) Aggregate basis increase. In the case of any estate, the aggregate basis increase under this subsection is $1,300,000.

Questions re Basis of Property Received from Decedents

5. Mama and Papa Bear bought a cabin on the shore of Big Bear Lake in 1980, for $25,000 when their daughter Tabatha was just a baby. Now of course the cabin is worth ten times as much as they paid for it – literally $250,000, as of last spring when Mama and Papa were killed in a tragic auto accident. Tabatha inherited the cabin from her parents and then immediately sold it for $250,000. How much income, if any, did Tabatha have as a result of the sale of the cabin?
    a. None, because the $225,000 increase in the value of the cabin will be income to her now deceased parents, which will be reported on the final income tax return filed on their behalf for this year.
    b. None, because she sold the cabin for the same amount as her basis, i.e., the $250,000 the cabin was worth when she received it by inheritance.
    c. $225,000 – the difference between what she sold the cabin for, and her parents' $25,000 basis in the cabin.
    d. $250,000 – the difference between what she sold the cabin for and her basis, i.e., the $0 she paid for it.
6. Same as #5, with this change: Mama and Papa Bear weren't killed this year. Instead, they will be killed in 2010. If the condo is worth $250,000 in 2010 and Tabatha sells it immediately after she inherits it, how much income, if any, will she have as a result of the sale of the cabin?
    a. None, because the $225,000 increase in the value of the cabin will be income to her deceased parents, which will be reported on the final income tax return filed on their behalf for 2010.
    b. None, because she will be selling the cabin for the same amount as her basis, i.e., her parents' $25,000 (as specified by section 1022(a)(2)(A)) increased to the $250,000 the cabin will be worth when she receives it by inheritance (as specified by section 1022(b)).
    c. $225,000 – the difference between what she will sell the cabin for, and her parents' $25,000 basis in the cabin.
    d. $250,000 – the difference between what she will sell the cabin for and her basis, i.e., the $0 she will pay for it.

Read (in Posin & Tobin) re Recognition of Gain or Loss

Pages 217 – 228 (top)

Internal Revenue Code provisions re Recognition of Gain or Loss

§ 1001. Determination of amount of and recognition of gain or loss

. . .

(c) Recognition of gain or loss.—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

§ 1031. Exchange of property held for productive use or investment

(a) Nonrecognition of gain or loss from exchanges solely in kind.—

(1) In general.—No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.

(2) Exception.—This subsection shall not apply to any exchange of—

(A) stock in trade or other property held primarily for sale,

(B) stocks, bonds, or notes,

. . .

(b) Gain from exchanges not solely in kind.—If an exchange would be within the provisions of subsection (a) . . . if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(c) Loss from exchanges not solely in kind.—If an exchange would be within the provisions of subsection (a). . . if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

(d) Basis.—If property was acquired on an exchange described in this section . . . then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section . . . to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. . . .

Questions re Recognition of Gain or Loss

Let's start with a question designed to be certain you correctly understanding some important terms:

1. What is the difference, if any, between "realizing" a gain or loss (as a result of a taxpayer's sale or exchange of property) and "recognizing" a gain or loss?

    a. There is no difference. The two terms are synonymous and the Internal Revenue Code uses them interchangeably.

    b. Taxpayers "realize" gains or losses when they sell or exchange property for more or less than their basis; and taxpayers "recognize" gains or losses when they include those gains or losses in their gross incomes.

    c. Taxpayers "recognize" gains or losses when they sell or exchange property for more or less than their basis; and taxpayers "realize" gains or losses when they include those gains or losses in their gross incomes.

    d. Taxpayers "recognize" gains or losses when they become aware that they've sold or exchanged property for more or less than their basis; and they "realize" gains or losses when they understand what the tax consequences of the transaction will be to them.

Here are a couple of questions intended to be certain you understand the essential features of § 1031:

2. Which of the following is the best explanation of Internal Revenue Code § 1031?

    a. Section 1031 means that if a taxpayer exchanges property (of any kind) for other property (of any kind), the taxpayer will not be required to *recognize* any gain (or be able to recognize any loss) that the taxpayer may have *realized* from the transaction – even though as a general rule, § 1001(c) the Internal Revenue Code requires the gains or losses on the exchange of property to be recognized.

    b. Section 1031 means that if a taxpayer exchanges *most* types of *business or investment* property for other property (of any kind), the taxpayer will not be required to *recognize* any gain (or be able to recognize any loss) that the taxpayer may have *realized* from the transaction – even though as a general rule, § 1001(c) the Internal Revenue Code requires the gains or losses on the exchange of property to be recognized.

    c. Section 1031 means that if a taxpayer exchanges *most* types of *business or investment* property for other property *of the same kind*, the taxpayer will not be required to *recognize* any gain (or be able to recognize any loss) that the taxpayer may have *realized* from the transaction – even though as a general rule, § 1001(c) the Internal Revenue Code requires the gains or losses on the exchange of property to be recognized.

    d. I have a better synopsis than any of these. (Write it down, so you can share it with the class.)

3. Which of the following is the best description of the effects of § 1031?
    a. If (because of § 1031) a taxpayer is not required to recognize a gain, the gain will be tax-free forever, because the taxpayer will never be required to recognized the gain. Likewise, if (because of § 1031), a taxpayer is not permitted to recognize a loss, the exchange will never result in a tax benefit to the taxpayer, because the taxpayer will never be permitted to recognize the loss.
    b. If (because of § 1031) a taxpayer is not required to recognize a gain, the gain isn't really tax-free, because eventually, when the taxpayer sells the acquired property, the taxpayer will have to recognize the gain realized as a result of the exchange of the first property. Likewise, if (because of § 1031), a taxpayer is not permitted to recognize a loss, eventually the exchange will result in a tax benefit to the taxpayer, because when the taxpayer sells the acquired property, the taxpayer will be permitted to recognize the loss realized as a result of the exchange of the first property.

Now answer these questions to be certain you understand how to apply § 1031:

4. Bobby used to own several acres of desert land on the outskirts of Palm Springs. He bought the land several years ago for $50,000 as an investment, because he thought Palm Springs would expand in the direction of his land and he'd eventually be able to sell it for more. In fact, he was right; and last year, he sold the land to Felicity for $250,000 in cash. Bobby knows a little about tax law, so he suggested to Felicity that their written agreement describe the transaction as an "exchange" of his land for her cash. Felicity didn't care what the agreement said, so long as she didn't have to pay any more than $250,000 and received a recordable deed and title insurance when the deal closed. Which of the following is true with respect to Bobby's suggestion?
    a. It was a good idea, because by describing the deal as a land-for-cash "exchange," Bobby will not have to recognize the $200,000 gain he realized on the deal.
    b. It was a silly idea, because gains realized on the "exchange" of property for cash must be recognized.
    c. We don't have enough information to know whether it was a good or silly idea, because we don't know what Bobby intends to do with the cash. If he intends to spend it, he'll have to recognize his gain. But if he intends to invest it, he won't.
    d. None of the above.

5. Same as question #4, with this change. Felicity didn't pay cash for the land. Instead, she gave Bobby a cherry red Ferrari worth $250,000, which Bobby drives for pleasure.
    a. Because the deal is a land-for-Ferrari exchange, Bobby will not have to recognize the $200,000 gain he realized on the deal.
    b. Even though the deal is a land-for-Ferrari "exchange," the gain Bobby realized on the exchange must be recognized because the land and the Ferrari are not the same kind of property.
    c. Even though the deal is a land-for-Ferrari "exchange," the gain Bobby realized on the exchange must be recognized, because the Ferrari is for his personal use rather than being investment or business property.
    d. Both "b" and "c".

6. Bobby used to own several acres of desert land on the outskirts of Palm Springs. He bought the land several years ago for $50,000 as an investment, because he thought Palm Springs would expand in the direction of his land and he'd eventually be able to sell it for more. In fact, he was right; and last year, he transferred his Palm Springs land to Felicity in exchange for a condo she owned in Mammoth Lakes worth $250,000, which she bought several years ago for $300,000, for investment purposes. That is, Felicity doesn't ski, fish or hike, so she didn't use the condo herself. Instead, she rented the condo year-round to skiers, fishermen and hikers. Bobby doesn't ski, fish or hike either, so he too rents the condo year-round to skiers, fishermen and hikers. What were the tax consequences of this deal to both Bobby and Felicity?

   a. Bobby realized a gain on the trade, but did not have to recognize it (because of § 1031). Felicity realized a loss on the trade, but was not able to recognize it (because of § 1031).

   b. Bobby realized a gain on the trade, and had to recognize it (because of § 1001(c)). Felicity realized a loss on the trade, and was able to recognize it (because of § 1001(c)).

   c. Bobby had to recognize his gain (because of § 1001(c)), but Felicity wasn't able to recognize her loss (because of § 1031).

   d. Bobby didn't have to recognize his gain (because of § 1031), but Felicity was able to recognize her loss (because of § 1001(c)).

7. Same as Question 6, with this change: Felicity did like to ski, fish and hike, so she used the condo for personal purposes; it was not an investment. Does this change in the facts affect whether Bobby and Felicity had to recognize a gain or were able to recognize a loss?

   a. No; this doesn't change anything. The answer as to whether Bobby had to recognize a gain, and whether Felicity was able to recognize a loss, remains the same.

   b. Yes; this changes everything. The answer as to whether Bobby had to recognize a gain, and whether Felicity was able to recognize a loss, is exactly the opposite (from what it was in Question 6) for each of them.

   c. This does not change the answer as to whether Bobby has to recognize his gain, but it does change the answer as to whether Felicity is able to recognize her loss.

   d. This changes the answer as to whether Bobby has to recognize his gain, but it does not change the answer as to whether Felicity is able to recognize her loss.

8. Bobby sold the condo this year for $300,000, and Felicity sold the land for $300,000. Bobby originally paid $50,000 for the land he transferred to Felicity, though when they did their exchange deal, the land and the condo were worth $250,000 each. What are the tax consequences to Bobby (we'll do Felicity in the next question), as a result of his sale of the condo?
   a. Bobby will not have to recognize any gain, because of § 1031.
   b. Bobby will have to recognize $50,000 in gain – the difference between the $300,000 he received when he sold the condo, and the $250,000 it was worth when he got it from Felicity in exchange for the land in Palm Springs.
   c. Bobby will have to recognize $250,000 in gain – the difference between the $300,000 he received when he sold the condo, and the $50,000 he paid for the land in Palm Springs that he transferred to Felicity in the exchange for the condo.
   d. Bobby will have to recognize $300,000 in gain – the amount that he received when he sold the condo.
9. What are the tax consequences to Felicity, as a result of her sale of the land in Palm Springs, if Felicity originally paid $300,000 for the condo she transferred to Bobby, though when they did their exchange deal last year, the land and the condo were worth $250,000 each; and Felicity held the condo for investment (not personal) purposes.
   a. Felicity will not have any gain or loss to recognize, because she sold the land for the same amount ($300,000) as she paid for the condo that she transferred to Bobby in exchange for the land.
   b. Felicity will have to recognize $50,000 in gain – the difference between the $300,000 she received when she sold the land, and the $250,000 it was worth when she got it from Bobby in exchange for the condo.
   c. Felicity will have to recognize $250,000 in gain – the difference between the $300,000 she received when she sold the land, and the $50,000 Bobby paid for the land before he transferred it to Felicity in the exchange for the condo.
   d. Felicity will have to recognize $300,000 in gain – the amount that she received when she sold the land.
10. Same facts as Question 9, except that Felicity used the condo for personal (not business or investment) purposes. What are the tax consequences to *Felicity*, as a result of her sale of the land in Palm Springs?
   a. Felicity will not have any gain or loss to recognize, because she sold the land for the same amount ($300,000) as she paid for the condo that she transferred to Bobby in exchange for the land.
   b. Felicity will have to recognize $50,000 in gain – the difference between the $300,000 she received when she sold the land, and the $250,000 it was worth when she got it from Bobby in exchange for the condo.
   c. Felicity will have to recognize $250,000 in gain – the difference between the $300,000 she received when she sold the land, and the $50,000 Bobby paid for the land before he transferred it to Felicity in the exchange for the condo.
   d. Felicity will have to recognize $300,000 in gain – the amount that she received when she sold the land.

11. Polly bought Park Place as an investment for $500,000, several years ago. This year, she transferred Park Place to Morry in exchange for his giving her Marvin Gardens plus $50,000 in cash. Polly intends to hold Marvin Gardens for investment. Marvin Gardens is now worth $700,000, so Polly received from Morry property and cash worth a total of $750,000. What are the tax consequences to Polly?

    a. She realized a gain of $250,000 – the difference between what she paid for Park Place and the value of what she received in the exchange – but she won't have to recognize any of it, because of § 1031.

    b. She realized a gain of $250,000 – the difference between what she paid for Park Place and the value of what she received in the exchange – and she will have to recognize all of it, because of section § 1001(c).

    c. She realized a gain of $250,000 – the difference between what she paid for Park Place and the value of what she received in the exchange – but she will have to recognize only $200,000 of that gain which is the difference between what she paid for Park Place and the current value of Marvin Gardens.

    d. She realized a gain of $250,000 – the difference between what she paid for Park Place and the value of what she received in the exchange – but she will have to recognize only $50,000 of that gain which is the amount of cash that she received.

12. Although Polly intended to hold Marvin Gardens for investment, Ronald Triumph offered to buy it from her from $1 million, and she sold it to him for that amount. What are the tax consequences to Polly as a result of her sale of Marvin Gardens? Recall that Polly:

• bought Park Place for	$500,000
• transferred Park Place to Morry when its fmv =	$750,000
• in exchange for Marvin Gardens whose fmw =	$700,000
plus cash	$50,000
• and then sold Marvin Gardens to Triumph for	$1,000,000

    a. She must recognize a gain of $500,000.

    b. She must recognize a gain of $550,000.

    c. She must recognize a gain of $700,000.

    d. She must recognize a gain of $1,000,000.

Read (in Posin & Tobin) re Recognition of Gain or Loss

Pages 237 – 239 (top)

Internal Revenue Code provisions re Involuntary Conversions

§ 1001. Determination of amount of and recognition of gain or loss

. . .

(c) Recognition of gain or loss.—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

§ 1033. Involuntary conversions

(a) General rule. If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted -

(1) *Conversion into similar property*
Into property similar or related in service or use to the property so converted, no gain shall be recognized.

(2) *Conversion into money*
Into money or into property not similar or related in service or use to the converted property, the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain
If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so converted, . . . the gain shall be recognized only to the extent that the amount realized upon such conversion . . . exceeds the cost of such other property. . . .

(B) Period within which property must be replaced
The period referred to in subparagraph (A) shall be the period beginning with the date of the disposition of the converted property, or the earliest date of the threat or imminence of requisition or condemnation of the converted property, whichever is the earlier, and ending -

(i) 2 years after the close of the first taxable year in which any part of the gain upon the conversion is realized. . . .

(E) Definitions. For purposes of this paragraph - . . .

(ii) Disposition of the converted property.
The term "disposition of the converted property" means the destruction, theft, seizure, requisition, or condemnation of the converted property, or the sale or exchange of such property under threat or imminence of requisition or condemnation.

(b) Basis of property acquired through involuntary conversion

(1) *Conversions described in subsection (a)(1)*

If the property was acquired as the result of a compulsory or involuntary conversion described in subsection (a)(1), the basis shall be the same as in the case of the property so converted . . . .

(2) *Conversions described in subsection (a)(2)*

In the case of property purchased by the taxpayer in a transaction described in subsection (a)(2) which resulted in the nonrecognition of any part of the gain realized as the result of a compulsory or involuntary conversion, the basis shall be the cost of such property decreased in the amount of the gain not so recognized. . . .

Questions re Involuntary Conversions

Section 1033 is difficult to summarize in a plain-English sentence or two, because it has several quite specific provisions, each of which is important. Beginning with Question 3 below, you'll have a chance to wrestle with the specifics of § 1033 in order to apply it to hypothetical situations. First, though, assume that you have to explain the essence of the section to someone who isn't a tax lawyer.

1. Which of the following statements would you use to explain Internal Revenue Code §1033(a) to someone who isn't a tax lawyer?

   a. If a taxpayer's property is destroyed, condemned or otherwise taken involuntarily, and the taxpayer receives other property or cash in return for the property that was taken, the taxpayer will *not* have to *recognize* a gain (assuming of course the taxpayer *realized* a gain), if the *property* received by the taxpayer is similar to the property that was taken, or if the taxpayer used the *cash* to buy property that is similar to the property that was taken. (If the taxpayer receives cash but uses only some of it to buy similar property, the rest of the cash will be a recognized gain to the taxpayer.)

   b. If a taxpayer's property is destroyed, condemned or otherwise taken involuntarily, and the taxpayer receives other property or cash in return for the property that was taken, the taxpayer *will* have to *recognize* a gain, if the property received by the taxpayer is worth more than the *fair market value* of the property that was taken, or if the taxpayer receives cash in an amount that exceeds the *fair market value* of the property that was taken.

   c. If a taxpayer's property is destroyed, condemned or otherwise taken involuntarily, and the taxpayer receives other property or cash to compensate for the property that was taken, the taxpayer *will* have to recognize a gain, if the property received by the taxpayer is worth more than the taxpayer's *basis* in the property that was taken, or if the taxpayer receives cash in an amount that exceeds the taxpayer's *basis* in the property that was taken.

   d. I have a better synopsis than any of these. (Write it down, so you can share it with the class.)

2. Which of the following statements would you use to explain Internal Revenue Code §1033(b) to someone who isn't a tax lawyer?

    a. If a taxpayer's property is destroyed, condemned or otherwise taken involuntarily, and the taxpayer receives *other property* to compensate for the property that was taken, the taxpayer's *basis in the replacement property* is the same as the taxpayer's *basis in the property that was taken*.

    b. If a taxpayer's property is destroyed, condemned or otherwise taken involuntarily, and the taxpayer receives *cash* which the taxpayer uses to buy property that is similar to the property that was taken, the taxpayer's *basis in the replacement property* is the amount the taxpayer spent to buy the replacement property, less any gain the taxpayer was not required to recognize despite receiving cash for the property that was taken.

    c. Both "a" and "b".

    d. I have a better synopsis than any of these. (Write it down, so you can share it with the class.)

Now answer these questions to be certain you understand how to apply § 1033:

3. Tex Taxpayer owned a gas station, and the land on which it sat, that had a highway in front and a state forest in the back. The state decided to widen the highway, and therefore condemned (i.e., took by eminent domain) a 30-foot strip of land along the front of Tex's property. In return, the state gave Tex a 30-foot strip of the forest land at the back of his gas station. Tex had owned the gas station for a long time, and his basis for the 30-foot strip that the state took from him was just $10,000. The 30-foot strip of forest land that Tex received from the state was worth $100,000, at the time the state transferred it to him. What were the tax consequences to Tex of the state's condemnation of part of his property?

    a. Tex realized and had to recognize a $90,000 gain – $90,000 being the difference between the value of the land he received from the state and his basis in the land the state took from him.

    b. Tex realized and had to recognize a $100,000 gain – $100,000 being the value of the land he received from the state in return for the land the state took from him.

    c. Tex did not realize, and thus did not have to recognize, any gain, because the state was willing to give him forest land worth $100,000, so the land the state took from him had to have been worth $100,000 too. Thus, the transaction was a simple exchange of properties having the same value, without gain or loss to either party.

    d. Tex *realized* $90,000 in gain – because he received land worth $100,000 in return for land in which his basis was just $10,000 – but he did not have to *recognize* any of that gain, because of §1033(a)(1).

4. A few years after the transaction described in Question 3, Tex decided to retire. By then, his property was too valuable to be used as a gas station, so Tex sold the gas station for $1 million to a company that tore down the station and built a motel on the property. Of the $1 million that Tex received when he sold the station, $200,000 was agreed (by Tex and the buyer) to be the value of the strip of forest land that Tex had received from the state. What were the tax consequences to Tex of his sale of the strip of forest land to the motel company?

    a. Tex had to recognize $200,000 in gross income, because that was the amount he received for the strip of forest land, for which he hadn't paid anything when he first got the land from the state.

    b. Tex had to recognize $190,000 in gross income, because that was the difference between what he received for the strip of forest land and his basis in that land, under §1033(b)(1).

    c. Tex had to recognize $100,000 in gross income, because that was the difference between what he received for the strip of forest land and the value of that land when he received it from the state.

    d. Tex did not have to recognize any gross income when he sold the strip of forest land, because of §1033(a).

5. At the same time the state condemned the 30-foot strip of Tex's gas station, the state also condemned the entire property directly across the highway. That property was the site of a diner owned by Trixie Taxpayer. Trixie didn't want forest land in exchange for her diner property; she wanted cash. So, after protracted negotiations, the state paid Trixie $300,000 for her property. Trixie had owned the diner for a long time, and her basis in the property at the time she settled with the state was just $25,000. Trixie took the $300,000 she got from the state and bought another diner, farther out of town and off the highway, for $200,000; and she put the remaining $100,000 in a federally-insured savings account. What were the tax consequences to Trixie?

    a. Trixie realized and had to recognize a $275,000 gain – $275,000 being the difference between the $300,000 in cash she received from the state and her $25,000 basis in the property the state took from her.

    b. Trixie realized and had to recognize a $300,000 gain – $300,000 being the amount of cash she received from the state in return for the property the state took from her.

    c. Trixie did not realize, and thus did not have to recognize, any gain, because the state was willing to give her $300,000 in cash for her property, so the property the state took from her had to have been worth $300,000 too. Thus, the transaction was a simple exchange of $300,000 in cash for property worth $300,000, without gain or loss to either party.

    d. Under § 1033(a)(2)(A), Trixie recognized a $100,000 gain, because she realized (i.e., received) $300,000 in cash for her property, in which her basis was $25,000, which meant she *realized* a *gain* of $275,000, of which she was required to *recognize* only $100,000, because (to quote the language of § 1033(a)(2)(A)) that is "the extent that the amount [she] realized [$300,000] . . . exceeds the [$200,000] cost of such other property [i.e., the new diner]."

Read (in Posin & Tobin) re "Wash Sales" of Stock

Pages 242 (§(5)) - 246

§ 165. Losses

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . .

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to

. . .

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; . . .

§ 1091. Loss from wash sales of stock or securities

(a) Disallowance of loss deduction. In the case of any loss claimed to have been sustained from any sale or other disposition of shares of stock or securities where it appears that, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date, the taxpayer has acquired (by purchase or by an exchange on which the entire amount of gain or loss was recognized by law), or has entered into a contract or option so to acquire, substantially identical stock or securities, then no deduction shall be allowed under section 165 unless the taxpayer is a dealer in stock or securities and the loss is sustained in a transaction made in the ordinary course of such business. For purposes of this section, the term "stock or securities" shall, except as provided in regulations, include contracts or options to acquire or sell stock or securities.

Questions re "Wash Sales" of Stock

6. Which of the following statements would you use to explain Internal Revenue Code §1091 to someone who isn't a tax lawyer?

    a. As a general rule, losses on the sale of stock are not deductible; but if a taxpayer sells stock at a loss and then buys substantially identical stock within 30 days, the loss is deductible. Congress enacted § 1091 to encourage taxpayers to retain their investments in companies, even when shares in those companies drop in value, because otherwise, the ability of companies to finance their operations could be destroyed by what otherwise would have been a temporary drop in the value of their shares.

    b. As a general rule, losses on the sale of stock are deductible; but if a taxpayer sells stock at a loss and then buys substantially identical stock within 30 days, the loss is not deductible. Congress enacted § 1091 to prevent taxpayers from taking deductions on what appear to be investment losses when in fact their investments remain unchanged.

    c. As a general rule, losses on the sale of stock are not deductible; and § 1091 simply confirms that the general rule remains true even if taxpayers quickly buy back the stock that caused them the loss in the first place.

    d. As a general rule, losses on the sale of stock are deductible; and § 1091 simply confirms that the general rule remains true even if taxpayers quickly buy back the stock that caused them the loss in the first place.

7. Morgan Taxpayer owns 1000 shares of stock in Minisoft Corp. which he bought for $35 a share. After he bought the stock, it's value dropped to $25 a share, as a result of a new service announced by Minisoft's rival, Boogle Corp. Morgan, however, believes that Boogle's service will prove to be a big disappointment to customers, and that Minisoft's stock will rise in value again. As a result, he sold his 1000 shares of Minisoft stock on September 1st, taking a $10 per share loss on the sale; and then, on September 2nd, he bought 1000 shares of Minisoft stock at $25 per share. Will Morgan be able to deduct the $10,000 he lost when he sold his 1000 shares of Minisoft stock?

    a. Yes; that's exactly what § 165(c)(2) permits.

    b. Yes, but only because he bought 1000 shares of Minisoft within 30 days of selling 1000 shares at a loss, as he had to do in order to take advantage of § 1091(a).

    c. No, because although he suffered what otherwise would have been a deductible loss under § 165(c)(2), he bought back identical stock within 30 days and thus lost the ability to deduct his loss because of § 1091(a).

    d. No, because losses on the sale of stock are never deductible under any circumstances.

TAX RATES

Ordinary Income vs. Capital Gains

Read (in Posin & Tobin) re Preferential Treatment of Capital Gains

Pages 251 – 252 (top)

Tables Showing Preferential Treatment of Capital Gains

Ordinary rates for 2008*

Taxable Income**	Portion in Bracket	Marginal Tax Rate
$357,701 or more	$1 - infinite	35%
$164,551 - $357,700	$193,150	33%
$78,851 - $164,550	$85,700	28%
$32,551 - $78,850	$46,300	25%
$8,026 - $32,550	$24,525	15%
$1 - $8,025	$8,025	10%
**	$8,950 or more**	0%

*Single taxpayers

** Tax is imposed only on "*taxable* income." This means that no tax at all (0%) is imposed on *actual* income that is

- excluded from "gross income" (e.g., gifts, inheritances, scholarships, municipal bond interest, personal injury damages)
- included in "gross income" up to the amount that is
  - deductible (which is at least the amount of the standard deduction, e.g., $5,450 for an unmarried taxpayer for 2008), plus
  - exempt (i.e., the personal exemption, which is $3,500 per taxpayer for 2008), =
  - $8,950 or more, tax-free (for most taxpayers for 2008)

Long-term capital gains rates for 2008 – 2010*

Taxable Income**	Portion in Bracket	Marginal Tax Rate
$357,701 or more	$1 - infinite	15%
$164,551 - $357,700	$193,150	15%
$78,851 - $164,550	$85,700	15%
$32,551 - $78,850	$46,300	15%
$8,026 - $32,550	$24,525	0%
$1 - $8,025	$8,025	0%
**	$8,950 or more**	0%

*Single taxpayers
**See earlier page re untaxed income

Tax Difference: Ordinary vs. Capital Gains for 2008*

Taxable Income	Tax if All Ordinary Income	Tax if All Capital Gains	Ordinary vs. Capital Difference
$750,000	$241,096.75	$107,617.50	$133,479.25
$357,700	$103,791.75	$48,772.50	$55,019.25
$164,550	$40,052.25	$19,800.00	$20,252.25
$78,850	$16,056.25	$6,945.00	$9,111.25
$32,550	$4,481.25	$0	$4,481.25
$8,025	$802.50	$0	$802.50

*Single taxpayers

Capital Assets

Read (in Posin & Tobin) re "Capital Assets"

Pages 282 (§(3)) – 289 (top)
Pages 301 (§(v)) – 306 (top)

Internal Revenue Code provisions re "Capital Assets"

§ 1221. Capital asset defined

(a) In general.—For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property . . .

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1) . . .

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

(b) Definitions and special rules. . . .

(3) Sale or exchange of self-created musical works. – At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3).

Questions re "Capital Assets"

1. Which of the following is the best explanation of § 1221's definition of "capital assets"?

   a. "Capital assets" are most types of property – business and personal-use property alike – except for a handful of specific types of business property (like inventory, accounts receivable and supplies), and most copyrights, which are not capital assets.

   b. "Capital assets" are most types of business – but not personal-use – property, except for a handful of specific types of business property (like inventory, supplies and accounts receivable), and most copyrights.

   c. "Capital assets" are most types of personal-use property, but not business property.

   d. I have a better explanation than any of these. (Write it down, so you can share it with the class.)

2. Lucy Taxpayer is a politically active lawyer who has her own private practice in Los Angeles. She has been offered and has accepted a job in Washington, D.C., working for President Obama. Never one to leave things to the last minute, Lucy has been thinking about the tax consequences of her selling the following items of property, because she doesn't want to take them to Washington.

   I. A (personal-use) car.

   II. A boat.

   III. Household furniture and furnishings.

   IV. Accounts receivable – i.e., amounts owed to her by her clients for services she has rendered.

   V. Photocopy paper, yellow legal pads, ball-point pens, purchased for her law office but not yet used.

   VI. The copyright to a legal treatise that she wrote.

   VII. The copyright to a song that she wrote.

   VIII. The patent to a device that makes it easy for lawyers to record the amount of time they spend working on client matters.

   Which of these items are capital assets?

   a. All of them.
   b. None of them.
   c. I, II, III, VII and VIII.
   d. IV, V and VI.

3. Why does it matter to Lucy which of the items described above are capital assets?

   a. If she sells the items, her gains (if she has gains) on the sale of the capital assets will be taxed at a lower rate than the gains on the sale of the items that are not capital assets.
   b. If she sells the items, her gains (if she has gains) on the sale of the items that are not capital assets will be taxed at a lower rate than the gains on the sale of the items that are capital assets.
   c. If she sells the items, her gains (if she has gains) on the sale of the capital assets will not be taxed at all, while the gains on the sale of the items that are not capital assets will be taxed.
   d. It doesn't really matter at all. Lucy is simply the kind of person who likes to sort and categorize things.

Capital Losses

Read (in Posin & Tobin) re Capital Losses

Pages 266 (§(ii) at very bottom of page) – 268 (top)

Internal Revenue Code provisions re Capital Losses

> **§ 1211. Limitation on capital losses**
> (a) Corporations. . .
> (b) Other taxpayers. In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of -
> (1) $3,000 ($1,500 in the case of a married individual filing a separate return), or
> (2) the excess of such losses over such gains.

Section 1211(b) clearly states that: (i) losses from sales or exchanges of capital assets are *fully* deductable only against *capital* gains; and (ii) if a taxpayer's capital losses exceed his or her capital gains, the taxpayer may deduct up to $3,000 (but not more) of those excess losses against his or her *ordinary income*.

The Posin/Tobin book also clearly states (pages 267-268) that if a taxpayer's capital losses exceed his or her capital gains by *more* than the $3,000 that may be deducted against his or her ordinary income, those excess losses may be carried over to the following year, and deducted then, against the next year's *capital gains*, and, if need be, against as much as (but not more than) $3,000 of the next year's *ordinary income*. And if necessary, this carryover process may be continued into as many future years as may be necessary to fully deduct the taxpayer's capital losses. The Code section that permits these carryovers is §1212 (the complexity of which does not reward the time spent reading it, so it is not reproduced here).

Questions re Capital Losses

4. Sammy Stocktrader had income last year from wages and interest totaling $100,000. He also sold stock that he bought a few years ago for $10,000 more than he paid for it. And he suffered a $5,000 loss on the sale of other stock that he also bought a few years ago. What were the tax consequences to Sammy of all this?

    a. He had $100,000 in ordinary income from wages and interest, plus $5,000 in long-term capital gains consisting of $10,000 from the sale of stock at a profit from which he was able to subtract the $5,000 he lost from the sale of other stock at a loss.

    b. He had $10,000 in long-term capital gains from the sale of stock at a profit, plus $95,000 in ordinary income consisting of $100,000 in wages and interest from which he was able to subtract the $5,000 he lost from the sale of other stock at a loss.

    c. He had $100,000 in ordinary income from wages and interest, plus $7,000 in long-term capital gains consisting of $10,000 from the sale of stock at a profit from which he was able to subtract $3,000 of the $5,000 he lost from the sale of other stock at a loss, and he was able to carry forward the remaining $2,000 in stock loss to this year.

    d. He had $97,000 in ordinary income, consisting of $100,000 in wages and interest from which he was able to subtract $3,000 of the $5,000 he lost from the sale of stock at a loss, plus $8,000 in long-term capital gains consisting of $10,000 from the sale of stock at a profit from which he was able to subtract the other $2,000 of the $5,000 he lost from the sale of stock at a loss.

5. Susanna Stocktrader had income last year from wages and interest totaling $100,000. She also sold stock that she bought a few years ago for $10,000 less than she paid for it. She didn’t sell any other stock (or any other capital assets) last year. What were the tax consequences to Susanna of all this?

    a. She had $100,000 in ordinary income from wages and interest, from which she was able to subtract $3,000 of the $10,000 she lost from the sale of stock, giving her $97,000 in gross income, and she was able to carry forward the remaining $7,000 in stock loss to this year.

    b. She had $100,000 in ordinary income from wages and interest, from which she was able to subtract $10,000 she lost from the sale of stock, giving her $90,000 in gross income.

    c. She had $100,000 in ordinary income from wages and interest, on which she will pay tax at ordinary rates; and she had $10,000 in capital losses, on which she will get a credit at capital gains rates against the tax she would otherwise have paid on her wages and interest income.

    d. None of the above.

<u>**Section 1231 Property**</u>

Note re Depreciable Property and Real Property, Used in Business, as "Capital Assets" and as "Section 1231 Property"

Earlier, we looked at what kinds of business expenses were deductible in the year they were incurred, and what kind were "capital expenditures" that had to be depreciated. Depreciable business property, you'll recall, includes such things as equipment, office furniture, and business-use vehicles. Real property used in business includes factories, offices, and the land on which they sit.

Even though money spent on these sorts of properties are "capital expenditures," §1221(a)(2) (above) tells us that *these* kinds of business-use properties are *not* "capital assets." This seems strange, I know; but §1221(a)(2)'s apparently arbitrary definition of "capital assets" was enacted by Congress in order to give a valuable tax benefit to businesses. Here's how the benefit works:

If § 1221(a)(2) was everything the Internal Revenue Code had to say about what "capital assets" are, we would know that if a taxpayer sold these kinds of business-use properties

- at a gain, the gain would be ordinary income, not capital gain, and thus would be taxed at higher ordinary rates
- at a loss, the loss would be an ordinary loss, not a capital loss, and thus the loss could be deducted against the taxpayer's ordinary income, not simply against whatever capital gains the taxpayer had that year.

From the taxpayer's point of view, the tax consequences of selling these kinds of business-use properties at a loss would be good, but the tax consequences of selling them at a gain would be bad.

You now know that *if* § 1221(a)(2) were deleted from the Code entirely (it *hasn't* been deleted, but *if* it were), these kinds of business-use properties *would be* capital assets, so that if a taxpayer sold them

- at a gain, the gain would be a capital gain, and thus would be taxed at lower capital gains rates
- at a loss, the loss would be a capital loss, and thus could be deducted only against whatever capital gains the taxpayer had that year.

From the taxpayer's point of view, the tax consequences of selling these kinds of business-use properties at a gain would be good, but the tax consequences of selling them at a loss would be bad.

For historically interesting reasons (which are described in Posin/Tobin at pages 292-295), Congress decided that taxpayers should enjoy the best of both worlds. Congress accomplished this by adding § 1231 to the Code – a section that deals specifically with the sale and exchange of business-use depreciable property and real property. In fact, business-use depreciable property and real property are now referred to as "section 1231 property."

Section 1231 gives taxpayers the best of both worlds, because if taxpayers sell "section 1231 property"

- at a gain, the gain is a capital gain, and thus is taxed at lower capital gains rates
- at a loss, the loss is an ordinary loss (not a capital loss), and thus the loss may be deducted against the taxpayer's ordinary income, not simply against whatever capital gains the taxpayer had that year.

From the taxpayer's point of view, the tax consequence of selling "section 1231 property" at a gain is good, and the tax consequence of selling it at a loss is good too!

Alas, this description of § 1231 is a good deal simpler than § 1231 itself. I thought about providing you with the text of § 1231, but decided not too. If you're curious, you'll find the text at http://www.taxalmanac.org/index.php/Internal_Revenue_Code_-_Subtitle_A_-_Index (and scroll down, when you get there). If you'd like to read a description of how §1231 works, take a look at Posin/Tobin's excellent description, chart and examples at pages 295-301. The multi-step calculations required by § 1231 would have made Rube Goldberg proud, if he had invented the section. (If Rube Goldberg is as unfamiliar to you as the Pussycat Dolls are to me, see http://en.wikipedia.org/wiki/Rube_Goldberg.)

For our purposes this semester, it's sufficient to know that if a taxpayer sells business-use depreciable property or real property at a gain, it's a capital gain taxed at lower capital gains rates, while if the taxpayer sells such property at a loss, it's an ordinary loss that is deductible from the taxpayer's ordinary income.

Questions re Section 1231 Property

1. Tildy Taxpayer owns a building that she uses in connection with the operation of her business. She has been taking depreciation deductions on the building, as permitted by law. Tildy is planning to move her business, so she will be selling the building. She doesn't know, yet, what price she'll be able to get for the building. But she has asked you for advice about what the tax consequences will be to her, if she sells it at a gain, and if she sells it at a loss. What do you advise her?
    a. If she sells the building at a gain, she will pay tax at ordinary income rates; but if she sells it at a loss, she will be able to deduct her loss against her income from other sources.
    b. If she sells the building at a gain, she will pay tax at capital gains rates; but if she sells it at a loss, she will be able to deduct only $3,000 of her loss against her income from other sources (assuming she has no capital gains that year).
    c. If she sells the building at a gain, she will pay tax at capital gains rates; but if she sells it at a loss, she will be able to deduct her entire loss against her income from other sources (not just against capital gains she may have that year, even if her loss exceeds $3,000).
    d. The tax treatment of her sale of the building is more complicated than any of the three choices of above indicate.

2. Tildy Taxpayer also owns another building that she does not use in connection with her business. It is simply investment property. She has been taking depreciation deductions on the building, as permitted by law. Because Tildy is planning to move, she will be selling the investment building (as well as her business building). She doesn't know, yet, what price she'll be able to get for the investment building. But she has asked you for advice about what the tax consequences will be to her, if she sells it at a gain, and if she sells it at a loss. What do you advise her?

    a. If she sells the investment building at a gain, she will pay tax at ordinary income rates; but if she sells it at a loss, she will be able to deduct her loss against her income from other sources.

    b. If she sells the investment building at a gain, she will pay tax at capital gains rates; but if she sells it at a loss, she will be able to deduct only $3,000 of her loss against her income from other sources (assuming she has no capital gains that year).

    c. If she sells the investment building at a gain, she will pay tax at capital gains rates; but if she sells it at a loss, she will be able to deduct her entire loss against her income from other sources (not just against capital gains she may have that year, even if her loss exceeds $3,000).

    d. The tax treatment of her sale of the investment building is more complicated than any of the three choices of above indicate.

Calculation of Capital Gains Tax

Note re Calculation of Capital Gains Taxes, When Taxpayer Has Both Ordinary Income and Capital Gains

Capital gains rates, and the way capital gains taxes are calculated, are set forth in § 1(h) of the Code. I was going to reproduce § 1(h) in this Study Guide, just for laughs. Then I considered how much paper would be used to print the section (and how much text reformatting I'd have to do, and how long that would take) and I decided not to include it. If you're curious, have a look at http://www.taxalmanac.org/ index.php/ Internal_Revenue_Code:Sec._1._Tax_imposed.

Part of the reason § 1(h) is so funny is that:

- the rates change every few years (as we discussed earlier), and
- in addition to the rates applied to most capital assets (like stocks), there are special and different rates for
    - "collectibles"
    - shares of stock in small business corporations, and
    - unrecaptured depreciation on certain kinds of real property (known as "section 1250 property").

A popular tax casebook by Professor Samuel A. Donaldson (*Federal Income Taxation of Individuals*) says that "Section 1(h) is, far and away, the most difficult provision of the Code discussed in this book – maybe the most difficult provision of the Code period. Even after several readings, the operation of the statute remains elusive." Indeed, even Posin and Tobin's explanation of the workings of § 1(h) is a tough slog (Posin/Tobin 254-282). The biggest reason § 1(h) is so difficult is that it is the epitome of a complex math formula transposed into words.

Nevertheless, when viewed at a level of abstraction appropriate for a course like this one, it's quite easy to see what Congress intended, and what the complex calculation actually is doing. Take a look at the following tables (which we'll also go over in class).

Tax rates for 2008 - Ordinary and Capital Gains*

Taxable Income	Ordinary	Capital Gains
$357,701 or more	35%	15%
$164,551 - $357,700	33%	15%
$78,851 - $164,550	28%	15%
$32,551 - $78,850	25%	15%
$8,026 - $32,550	15%	0%
$1 - $8,025	10%	0%

Example 1:

$52,550
total income
(i.e., total *taxable* income)

$20,000
capital gains

$32,550
ordinary
income

*Single taxpayers

Tax rates for 2008 - Ordinary and Capital Gains*

Taxable Income	Ordinary	Capital Gains
$357,701 or more	35%	15%
$164,551 - $357,700	33%	15%
$78,851 - $164,550	28%	15%
$32,551 - $78,850	25%	15%
$8,026 - $32,550	15%	0%
$1 - $8,025	10%	0%

Example 2:

$78,850
total income
(i.e., total *taxable* income)

$46,300
capital gains

$32,550
ordinary
income

*Single taxpayers

Tax rates for 2008 - Ordinary and Capital Gains*

Taxable Income	Ordinary	Capital Gains
$357,701 or more	35%	15%
$164,551 - $357,700	33%	15%
$78,851 - $164,550	28%	15%
$32,551 - $78,850	25%	15%
$8,026 - $32,550	15%	0%
$1 - $8,025	10%	0%

Example 3:

$78,850
total income
(i.e., total *taxable* income)

*Single taxpayers

Tax rates for 2008 - Ordinary and Capital Gains*

Taxable Income	Ordinary	Capital Gains
$357,701 or more	35%	15%
$164,551 - $357,700	33%	15%
$78,851 - $164,550	28%	15%
$32,551 - $78,850	25%	15%
$8,026 - $32,550	15%	0%
$1 - $8,025	10%	0%

Example 4:

$350,000
total income
(i.e., total *taxable* income)

*Single taxpayers

<u>Capital Gains Policy</u>

Read (in Posin & Tobin) re Reasons for Unique Treatment of Capital Gains and Losses

Pages 319 (§(4)) – 322 (top)

Questions re Reasons for Unique Treatment of Capital Gains and Losses

Posin and Tobin describe four arguments that are made for taxing capital gains at lower rates than ordinary income; and they offer counterarguments as well.

3. With respect to the "bunching of income" argument, are you
    a. persuaded that it's a good reason to tax capital gains at lower rates
    b. not persuaded that it's a good reason to tax capital gains at lower rates
    c. uncertain whether it's a good reason
    d. have some other reaction, and if so, what is it?
4. With respect to the "lock-in effect" argument, are you
    a. persuaded that it's a good reason to tax capital gains at lower rates
    b. not persuaded that it's a good reason to tax capital gains at lower rates
    c. uncertain whether it's a good reason
    d. have some other reaction, and if so, what is it?
5. With respect to the "encouraging investment" argument, are you
    a. persuaded that it's a good reason to tax capital gains at lower rates
    b. not persuaded that it's a good reason to tax capital gains at lower rates
    c. uncertain whether it's a good reason
    d. have some other reaction, and if so, what is it?
6. With respect to the "inflation effect" argument, are you
    a. persuaded that it's a good reason to tax capital gains at lower rates
    b. not persuaded that it's a good reason to tax capital gains at lower rates
    c. uncertain whether it's a good reason
    d. have some other reaction, and if so, what is it?
7. With respect to all four arguments taken together, are you
    a. persuaded that capital gains should be taxed at lower rates
    b. not persuaded that capital gains should be taxed at lower rates
    c. uncertain whether capital gains should be taxed at lower rates
    d. have some other reaction, and if so, what is it?

Tobin and Posin also report that there do not appear to be any (persuasive) reasons for treating capital losses in the restrictive way they are treated (i.e., deductible only against capital gains, not against more than $3,000 of ordinary income). They don't, however, suggest any specific alternative for the treatment of capital losses.

8. Which of the following do you think is the most attractive alternative treatment of capital losses?
    a. Capital losses should be deductible in full against ordinary income, even though doing so would mean that capital gains would be taxed at lower rates while capital losses would reduce the amount of income taxed at ordinary rates.
    b. Capital losses should be partially deductible against ordinary income, but instead of capping the deduction at $3,000 per year (as is now done), the limit should be a percentage of the total capital loss – say, 50% of the total capital loss – without any carryover to future years.
    c. Capital losses should be partially deductible against ordinary income, but instead of capping the deduction at $3,000 per year (as is now done), the per-year cap should be a percentage of the taxpayer's ordinary income for that year, with the balance carried over to future years.
    d. I have another idea. (Write it down, so you can share it with the class.)

9. If you were thinking about making an investment in a business, which of the following would offer you greater encouragement to make that investment?
    a. Paying taxes on any eventual gain at rates that are lower than the rates you pay on your salary?
    b. Being able to deduct your entire loss (even it exceeds $3,000) against your income from other sources (such as your salary)?

10. If your answer to Question 9 was "b" – or even if you simply thought that "b" was as important as "a" – does section 1244 of the Code (reproduced on the next page) adequately provide that encouragement?
    a. Yes.
    b. No. (Why not?)

§ 1244. Losses on small business stock

(a) General rule. – In the case of an individual, a loss on section 1244 stock issued to such individual . . . which would (but for this section) be treated as a loss from the sale or exchange of a capital asset shall, to the extent provided in this section, be treated as an ordinary loss.

(b) Maximum amount for any taxable year. – For any taxable year the aggregate amount treated by the taxpayer by reason of this section as an ordinary loss shall not exceed–

(1) $50,000, or

(2) $100,000, in the case of a husband and wife filing a joint return for such year. . . .

(c) Section 1244 stock defined. –

(1) In general. – For purposes of this section, the term “section 1244 stock” means stock in a domestic corporation if–

(A) at the time such stock is issued, such corporation was a small business corporation,

(B) such stock was issued by such corporation for money or other property (other than stock and securities), and

(C) such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.

. . .

(3) Small business corporation defined. –

(A) In general. – For purposes of this section, a corporation shall be treated as a small business corporation if the aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed $1,000,000. . . .

TAX

Alternative Minimum Tax

Read (in Posin & Tobin) re the Alternative Minimum Tax

Pages 532 – 539

Internal Revenue Code provisions re the Alternative Minimum Tax

§ 55. Alternative minimum tax imposed

(a) General rule. – There is hereby imposed (in addition to any other tax imposed by this subtitle) a tax equal to the excess (if any) of–

(1) the tentative minimum tax for the taxable year, over

(2) the regular tax for the taxable year.

(b) Tentative minimum tax. – For purposes of this part–

(1) Amount of tentative tax. –

(A) Noncorporate taxpayers. –

(i) In general. – In the case of a taxpayer other than a corporation, the tentative minimum tax for the taxable year is the sum of–

(I) 26 percent of so much of the taxable excess as does not exceed $175,000, plus

(II) 28 percent of so much of the taxable excess as exceeds $175,000.

. . .

(ii) Taxable excess. – For purposes of this subsection, the term "taxable excess" means so much of the alternative minimum taxable income for the taxable year as exceeds the exemption amount. . . .

(2) Alternative minimum taxable income. – The term "alternative minimum taxable income" means the taxable income of the taxpayer for the taxable year–

(A) determined with the adjustments provided in section 56 . . .

. . .

(d) Exemption amount. – For purposes of this section–

(1) Exemption amount for taxpayers other than corporations. – In the case of a taxpayer other than a corporation, the term "exemption amount" means -

(A) $45,000 ($66,250 in the case of taxable years beginning in 2007) [$69,950 beginning in 2008] in the case of–

(i) a joint return, or

(ii) a surviving spouse,

(B) $33,750 ($44,350 in the case of taxable years beginning in 2007) [$46,200 beginning in 2008] in the case of an individual who -

(i) is not a married individual, and

(ii) is not a surviving spouse,

(C) 50 percent of the dollar amount applicable under paragraph (1)(A) in the case of a married individual who files a separate return. . . .

(3) Phase-out of exemption amount. – The exemption amount of any taxpayer shall be reduced (but not below zero) by an amount equal to 25 percent of the amount by which the alternative minimum taxable income of the taxpayer exceeds [certain amounts for each category of taxpayer].

§ 56. Adjustments in computing alternative minimum taxable income

. . .

(b) Adjustments applicable to individuals. – In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax):

(1) Limitation on deductions. –

(A) In general. – No deduction shall be allowed–

(i) for any miscellaneous itemized deduction (as defined in section 67(b)), or

(ii) for any taxes described in paragraph (1), (2), or (3) of section 164(a).

Clause (ii) shall not apply to any amount allowable in computing adjusted gross income.

(B) Medical expenses. – In determining the amount allowable as a deduction under section 213, subsection (a) of section 213 shall be applied by substituting "10 percent" for "7.5 percent".

. . .

(E) Standard deduction and deduction for personal exemptions not allowed. – The standard deduction under section 63(c), [and] the deduction for personal exemptions under section 151 . . . shall not be allowed.

The purpose of the Alternative Minimum Tax is to require most taxpayers to pay at least a minimum amount of tax, even if – as a result of taking advantage of deductions given to them by the law – they wouldn't otherwise have to pay that amount of tax (and maybe not even any tax at all). In a nutshell, the Alternative Minimum Tax achieves its objective by:

- eliminating several types of deductions (though not all), which
- are replaced with a flat deduction (called an "exemption amount"), and
- imposing tax on the resulting alternative minimum taxable income, at rates that are different than the rates the taxpayer would have paid on his or her regular taxable income, and finally
- requiring the taxpayer to pay whichever tax is greater: the regular tax on his or her regular taxable income, or the alternative minimum tax on his or her alternative minimum taxable income.

The Alternative Minimum Tax is confusing for a couple of reasons. First, the Code doesn't use the simple steps described above; instead, it uses a round-Robin-Hood's-barn approach that is difficult to follow (without, at least, doodling it out on a napkin). Second, the Code uses several alternative-minimum-tax-specific terms that are confusingly similar to one another, and to terms the Code uses to determine "regular" taxes. These new terms are:

- tentative minimum tax
- alternative minimum taxable income
- taxable excess, and
- exemption amount.

Here is another statement of what the Alternative Minimum Tax does – one that includes the new terms:

The Alternative Minimum Tax

- adds the amount of several types of deductions back to taxable income, thereby creating the *alternative minimum taxable income*,
- taxes the increased taxable income (i.e., the *alternative minimum taxable income*), *if* (and only by the amount) it exceeds a certain amount of money, called the *exemption amount*, though this tax is imposed at lower rates than were applied to the taxpayer's regular taxable income, thereby creating the *tentative minimum tax*, and
- requires taxpayers to pay whichever tax is higher: the regular tax on their (regular) taxable income, or the tax (i.e., the *tentative minimum tax*) on their increased taxable income (i.e., the *alternative minimum taxable income*).

Note that *if* the Alternative Minimum Tax did *not* exempt a certain amount of alternative minimum taxable income (i.e., the *exemption amount*), every taxpayer would have to pay the Alternative Minimum Tax. This would be so, because the Alternative Minimum Tax eliminates two deductions that every taxpayer is entitled to take: the Standard Deduction and the Personal and Dependents Exemption deduction.

The reason that *every* taxpayer does *not* have to pay the Alternative Minimum Tax is that the *alternative minimum tax* is imposed only *if* a taxpayer's *alternative minimum taxable income* exceeds a certain amount. In 2007, that amount was $66,250 (or married couples filing jointly) or $44,350 (for unmarried taxpayers). For 2008 and thereafter, Congress raised these amounts (these are the *exemption amounts*) to $69,950 and $46,200.

For those of you who would like to track how the Code itself actually does this, here are the Code sections.

- If the *tentative minimum tax* is greater than a taxpayer's *regular tax*, the *excess* (i.e., the amount by which it is "greater") is *added to the regular tax*, and that's the amount the taxpayer must pay. In other words, if the Alternative Minimum Tax is greater than the regular tax, the taxpayer pays the Alternative Minimum Tax.

  Authority: Code § 55(a) which reads (with emphasis added): "There is hereby imposed (*in addition to* any other tax imposed by this subtitle [i.e., the "regular tax"]) a tax equal to the *excess* (if any) of – (1) the *tentative minimum tax* for the taxable year, *over* (2) *the regular tax* for the taxable year."

- The amount of the *tentative minimum tax* is a percentage of the amount by which the taxpayer's *alternative minimum taxable income* exceeds the *exemption amount*.

  Authority: Code § 55(b). For some reason, § 55(b) includes (in § 55(b)(1)(A)(i)) something called the "taxable excess"; and then, § 55(b) immediately (in subparagraph (ii)) defines "taxable excess" as the amount by which "the alternative minimum taxable income . . . exceeds the exemption amount." So, if you cut out the middle step of using "taxable excess," you get the statement immediately above.

- For 2007, the *exemption amount* was $66,250 for married couples filing jointly, or $44,350 for unmarried taxpayers.

  Authority: Code § 55(d). Congress just amended the Code to increase the exemption amount to $69,950 and $46,200 for 2008 and later years.

- The amount of a taxpayer's *alternative minimum taxable income* is the amount of the taxpayer's regular *taxable income*, increased (by adding back to the regular taxable income) the amounts of several kinds of deductions the taxpayer took in calculating his or her regular taxable income.

  Authority: Code § 56(b).

- The tax *rate* applied to the first $175,000 of the amount by which the taxpayer's *alternative minimum taxable income* exceeds the *exemption amount* is 26%; and the rate applied to greater amounts (of that excess) is 28%.

  Authority: Code § 55(b)(1)(A).

Here now is an example, showing how all of this is applied:

Example:

Joe Taxpayer is a plumber. He owns his own plumbing business, which he operates as a sole proprietor. The business is his only source of income, but it gives him a good income. (Not so good that his taxes will go up under President Obama. In fact, it's likely they'll go down. But good none-the-less.)

Joe's business generated gross income of $270,000 in 2007. Like all businesses, Joe's plumbing business had lots of expenses too, which he (quite properly) deducted, when computing his federal income taxes. Joe also had some personal expenses (like property taxes, state income taxes, and charitable contributions), which he also (quite properly) deducted. Joe and his wife (with whom he files a joint return) also had deductions for several personal and dependents exemptions, because they have a big family.

Joe's deductions came to $145,000 in all, business expenses and personal deductions and exemptions, included. So his regular taxable income was $125,000 ($270,000 - $145,000 = $125,000), on which his tax would have been $24,815 (Code § 1(a)), *if* the Code did *not* contain an Alternative Minimum Tax. However, the Code does contain an Alternative Minimum Tax. Here's what the Alternative Minimum Tax did:

- The Alternative Minimum Tax eliminated several of Joe's deductions – $75,000 worth, in fact, leaving him with just $70,000 in allowed deductions ($145,000 - $75,000 = $70,000).
- The Alternative Minimum Tax replaced those eliminated deductions with a flat deduction (something the Code calls an "exemption amount") of $66,250. That gave Joe an alternative minimum taxable income of $133,750 ($270,000 gross - $70,000 in allowed deductions - $66,250 exempt amount = $133,750).
- The Alternative Minimum Tax rate on Joe's $133,750 was 26% (Code §55(b)(1)(A)(i)), so his alternative minimum tax came to $34,775.
- Since Joe's alternative minimum tax (of $34,775) was greater than his regular tax (of $24,815), Joe had to pay $34,775 in taxes for 2007, not just $24,815. In other words, he paid $9,960 more in taxes because of the Alternative Minimum Tax than he would have had to pay if there were no Alternative Minimum Tax. (The exact wording of the Code required Joe to pay "the excess" of his "tentative minimum tax" of $34,775 "over" his "regular tax" of $24,815 – which excess comes to $9,960 – "in addition to" his regular tax of $24,815, which comes to $34,775.

Notice that Joe's alternative minimum taxable income was $133,750, which is why the Alternative Minimum Tax *rate* on that income was 26%. For taxpayers whose alternative minimum taxable incomes are, say, $180,000, the Alternative Minimum Tax *rate* would be 26% on $175,000 (of that $180,000) and 28% on the remaining $5,000. (Code § 55(b)(1)(A)(i))

Question re Alternative Minimum Tax

1. Tyrone Taxpayer is a graduate of Golden State Law School and has been hugely successful in the practice of law – so successful, in fact, that his taxable income now exceeds a million dollars a year. Tyrone's alma mater has asked him to endow a Chair by contributing $1 million to the school. Tyrone took a tax law course while in school, so he remembers that there is an Alternative Minimum Tax; but he doesn't practice tax law, so he doesn't remember exactly how it works. What he does remember, though, is that although charitable contributions are deductible, the AMT disallows certain deductions for the purpose of determining an alternative minimum taxable income. Tyrone knows that the disallowed deductions are replaced with a so-called "exemption amount," but he also knows that the exemption amount is much less than $1 million. As a result, he wonders whether he will have to pay more in tax if he makes the $1 million contribution than if he doesn't. Will he? (I.e., are charitable contributions among the deductions that are disallowed by the AMT?) To answer this question, review §56(b)(1)(A)(i) above, and the following two sections of the Code.

   § 67(b) Miscellaneous itemized deductions. –
   For purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than...
   (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts). . . .

   § 170 (a) Allowance of deduction. –
   (1) General rule. – There shall be allowed as a deduction any charitable contribution . . . payment of which is made within the taxable year.

   a. Yes, he will.
   b. No, he won't.

Social Security and Medicare taxes

Taxpayers who are employed by others

The Social Security tax is 12.4% of a taxpayer's wages up to $102,000 per year (for 2008). Half of that – 6.2% – is paid by the taxpayer's employer and the other half is paid by the employee him or herself. This means that a taxpayer who earns $102,000 in 2008 will pay $6,324 in Social Security tax (6.2% x $102,000).

The Medicare tax is 2.9% of a taxpayer's entire wages (for 2008). Half of that – 1.45% – is paid by the taxpayer's employer and the other half is paid by the employee him or herself.

Self-employed taxpayers

Self-employed taxpayers (i.e., those who do business as sole proprietors or independent contractors) pay the full 12.4% and 2.9% themselves, though half of what they pay may be taken as an above-the-line deduction. See 2008 Form 1040 at Lines 27 and 57, and 2008 Schedule SE.

Taxpayers who employ household help

Taxpayers who pay a household worker $1,600 or more in cash wages in 2008 (including any cash paid to cover the cost of the employee's transportation, meals or housing) are required to (a) deduct Social Security and Medicare taxes, and (b) pay those withheld taxes to the Treasury once a year. Household workers include cleaning people, cooks, gardeners and baby sitters (unless they are younger than age 18 and household employment is not the worker's primary occupation). See 2008 Form 1040 Line 60.

Question re Social Security and Medicare tax

2. Joe Taxpayer (the plumber) is self-employed, so he had to pay both the employee's share and the employer's share of Social Security and Medicare tax. Then, though, he was permitted to deduct, above the line, "One-half" of what he paid, which is an amount exactly equal to the employer's share. Assume that Taxpayer's taxable self-employment income is the same as the taxable salary he would have been paid if he been employed by a plumbing company. Which of the following is true?

    a. Because he was able to take an above the line deduction for the amount of the employer's share of Social Security and Medicare, he paid the same amount in income taxes as he would have paid, even if he had been employed by someone else.

    b. Even though he was able to take an above the line deduction for the amount of the employer's share of Social Security and Medicare, he paid more in income taxes than he would have paid, if he had been employed by someone else.

<u>Credits</u>

Introduction to Credits

The Code contains several sections that grant taxpayers credits; they run from § 21 through § 54. At least one of those credits is available to every *employed* taxpayer who files a tax return, regardless of income, marital status or age: the credit for taxes withheld from the pay of employees (§31). Other credits – such as the "enhanced oil recovery credit" (§ 43) and the "railroad maintenance tax credit" (§ 45G) – benefit taxpayers in particular industries (and perhaps even specific companies within those industries, given how detailed their eligibility requirements are).

Insofar as individual (rather than business) taxpayers are concerned, the most commonly-claimed credits are: the Child and Dependent Care Expenses Credit (§ 21); the Child Tax Credit (§ 24); the Earned Income Credit (§ 32); the Adoption Expense Credit (§ 23); the two education credits, i.e., the Hope Scholarship and Lifetime Learning Credits (§ 25A); and of course the Withheld Taxes Credit (§ 31).

I thought, at first, that I'd give you the text of some of the credit Code sections; but ultimately, I decided not to. The general concepts they embody are easily understood; but their eligibility rules and limitations are painfully specific and detailed. So I decided to cover the topic of credits simply by relying on the text in the Posin & Tobin book.

Read (in Posin & Tobin) re Earned Income and Certain Other Credits

Pages 633 - 634
Pages 637 - 638
Pages 639 - 640

Questions re Earned Income and Certain Other Credits

1. Which of the following is the most valuable to taxpayers (and thus the most costly to the Treasury)?
    a. exclusions from income
    b. above the line deductions
    c. credits
    d. "a" and "c" have the same effect on the bottom line, so both are equally valuable to taxpayers (and equally costly to the Treasury).

2. With respect to credits in particular, which is the most valuable to taxpayers (and thus the most costly to the Treasury)?
    a. "use-them-or-lose-them" credits
    b. credits that may be carried forward if they are not used in a single year
    c. refundable credits
    d. "a", "b" and "c" are simply different names for credits that have the same effect on taxpayers and the Treasury.

3. Thomas and Thelma Taxpayer are lawyers and the proud parents of 5-year-old twins. Thomas earns $100,000 a year, and Thelma does too, so together they earn $200,000 a year. Thomas and Thelma are friendly with another couple who also have young children. The other couple told Thomas and Thelma that they – the other couple –claim an "Earned Income Credit," and that Thomas and Thelma probably could too. Can they?

    a. Yes, because Thomas and Thelma both earn income, thus making them eligible for the Credit.

    b. No, because the Earned Income Credit is phased out as a taxpayer's income increases; and Thomas and Thelma earn so much, the Earned Income Credit would be phased out to $0.

4. Tessa Taxpayer works at the center that cares for Thomas and Thelma's twins. Tessa earns $1,000 a month, working from 7:30 am to 2:30 pm, five days a week (i.e., she makes the minimum wage now required by federal law). Tessa has two young children of her own, and has supported them entirely on her own since her husband, an Army Reservist, was killed in the war in Iraq three years ago. Although Tessa's gross income is $12,000 a year, she doesn't have any taxable income because she takes a standard deduction of $7,850 [the Head of Household amount for 2007], and a $10,200 deduction for the personal and dependents exemptions for herself and her two children (3 x $3,400). Is Tessa entitled to an Earned Income Credit?

    a. Yes, she is, but it won't do her any good, because she doesn't have any tax against which to offset her credit.

    b. Yes, she is, but it won't do her any good, because she doesn't have any tax against which to offset her credit. But she can carry the credit forward in time, so that if in future years, she does have to pay tax, she can use the carried-forward Earned Income Tax to offset her tax at that time.

    c. Yes, she is, and it will result in a cash refund to her this year. The amount of the credit that will be refunded to her is the amount by which her standard deduction and deductions for exemptions exceed her gross income, i.e., $6,050 ($7,850 + $10,200 - $12,000 = $6,050).

    d. Yes, she is, and it will result in a cash refund to her this year. However, answer "c" is not correct concerning the amount of the credit that will be refunded to her, or even about the formula that's used to determine how much of a refund she will get. The amount of her refund is determined by a formula that's so complex, it isn't even spelled out in the book. But it looks as though (using the formula that was in effect back in 2002), Tessa will get about $4,140.

PART 2: SELECTED APPLICATIONS

FAMILY

<u>The "Marriage Tax"</u>

Read (in Posin & Tobin) re the "Marriage Tax"

Pages 448 - 451

Internal Revenue Code Provisions re the "Marriage Tax"

§ 1. Tax imposed

(a) Married individuals filing joint returns and surviving spouses. –
There is hereby imposed on the taxable income of–
(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and
(2) every surviving spouse (as defined in section 2(a)),
a tax determined in accordance with the following table:

If taxable income is:	*The tax is:*
Not over $36,900	15% of taxable income.
Over $36,900 but not over $89,150	$5,535, plus 28% of the excess over $36,900.
Over $89,150 but not over $140,000	$20,165, plus 31% of the excess over $89,150.
Over $140,000 but not over $250,000	$35,928.50, plus 36% of the excess over $140,000.
Over $250,000	$75,528.50, plus 39.6% of the excess over $250,000.

. . .

(c) Unmarried individuals
(other than surviving spouses and heads of households). –
There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703) a tax determined in accordance with the following table:

If taxable income is:	*The tax is:*
Not over $22,100	15% of taxable income.
Over $22,100 but not over $53,500	$3,315, plus 28% of the excess over $22,100.
Over $53,500 but not over $115,000	$12,107, plus 31% of the excess over $53,500.
Over $115,000 but not over $250,000	$31,172, plus 36% of the excess over $115,000.
Over $250,000	$79,772, plus 39.6% of the excess over $250,000.

Questions re the "Marriage Tax"

The chart on pages 448 and 449 of the Posin & Tobin book still accurately illustrates the *point* made in the text; but the specific amounts are now out of date. Here's a chart of the current tax figures, calculated using § 1(a) and (c) of the Internal Revenue Code as it now reads (above).

Taxable Income	Tax Paid by Married Taxpayers	Tax Paid by Unmarried Taxpayer
$25,000	$3,750	$4,127
$50,000	$9,203	$11,127
$100,000	$23,529	$26,522
$250,000	$75,529	$79,772

1. Odessa and Octavius are legal assistants. Each earns $50,000 a year in taxable income. They aren't married but they do live together. Odessa's parents are very traditional folks, and they wish (more than anything) that Odessa and Octavius would get married. Octavius' parents aren't traditional at all; in fact, they lived together for years before they got married, so they're not embarrassed by their son's unmarried cohabitation. However, Octavius' parents are financially astute, so they would like Odessa and Octavius to do whatever would save them the most taxes (!). What effect, if any, would getting married have on the total amount of tax that Odessa and Octavius pay?
    a. They would pay exactly the same after getting married as they pay now as unmarried cohabiters.
    b. They would pay more after getting married.
    c. They would pay less after getting married.
    d. I can't answer this question, because I have a question of my own that needs to be answered before I can take a stab at this one.

2. Quentin and Quiana are married. Quiana is a lawyer who makes $100,000 a year in taxable income. Quentin is an aspiring songwriter who devotes his entire day to writing, but who so far hasn't made a single dime from his songs or from anything else. Quiana thinks Quentin's songs are terrible, and that's why he hasn't sold any; and she wants him to get a "real job" – something he absolutely refuses to do. This has caused a great deal of strain in their marriage, and Quiana is thinking about getting a divorce. Doing that, of course, involves a lot of factors; money is just one of them. What effect, if any, would getting a divorce have on the total amount of tax that Quentin and Quiana pay? (Assume that after the divorce, Quentin still doesn't sell any songs or get a real job. And put aside, for the moment, the possibility that Quiana may have to pay alimony to Quentin, which itself would have tax implications we'll look at below.)

    a. They would pay exactly the same after getting divorced as they pay now as a married couple.

    b. They would pay more after getting divorced.

    c. They would pay less after getting divorced.

    d. I can't answer this question, because I have a question of my own that needs to be answered before I can take a stab at this one.

Personal and Dependents Exemptions

Read (in Posin & Tobin) re Personal and Dependents Exemptions

Pages 530 – 532

Internal Revenue Code provisions re Personal and Dependents Exemptions

§ 151. Allowance of deductions for personal exemptions

(a) Allowance of deductions. – In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

(b) Taxpayer and spouse. – An exemption of the exemption amount for the taxpayer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.*

(c) Additional exemption for dependents. – An exemption of the exemption amount for each individual who is a dependent (as defined in section 152) of the taxpayer for the taxable year.

(d) Exemption amount. . . . [For 2008, the exemption is $3,500 per person. See Form 1040, Line 42, for taxpayers with adjusted gross incomes of $119,975 or less. The amount of the exemption is phased out (i.e., reduced) for taxpayers whose income is more than $119,975.]

. . .

* If a husband and wife file a *joint* return, both of them are "taxpayers" and thus exemptions are allowed for both of them as "taxpayers" rather than as "the spouse of a taxpayer."

§ 152. Dependent defined

(a) In general. – For purposes of this subtitle, the term "dependent" means–

(1) a qualifying child, or

(2) a qualifying relative.

(b) Exceptions. . . .

(c) Qualifying child. – For purposes of this section–

(1) In general. – The term "qualifying child" means, with respect to any taxpayer for any taxable year, an individual–

(A) who bears a relationship to the taxpayer described in paragraph (2),

(B) who has the same principal place of abode as the taxpayer for more than one-half of such taxable year,

(C) who meets the age requirements of paragraph (3), and

(D) who has not provided over one-half of such individual's own support for the calendar year in which the taxable year of the taxpayer begins.

(2) Relationship. – For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if such individual is–

(A) a child of the taxpayer or a descendant of such a child, or

(B) a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.

(3) Age requirements. –

(A) In general. – For purposes of paragraph (1)(C), an individual meets the requirements of this paragraph if such individual–

(i) has not attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, or

(ii) is a student who has not attained the age of 24 as of the close of such calendar year.

. . .

(d) Qualifying relative. – For purposes of this section–

(1) In general. – The term "qualifying relative" means, with respect to any taxpayer for any taxable year, an individual–

(A) who bears a relationship to the taxpayer described in paragraph (2),

. . .

(C) with respect to whom the taxpayer provides over one-half of the individual's support for the calendar year in which such taxable year begins, and

(D) who is not a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which such taxable year begins.

(2) Relationship. – For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if the individual is any of the following with respect to the taxpayer:

(A) A child or a descendant of a child.

(B) A brother, sister, stepbrother, or stepsister.

(C) The father or mother, or an ancestor of either.

(D) A stepfather or stepmother.

(E) A son or daughter of a brother or sister of the taxpayer.

(F) A brother or sister of the father or mother of the taxpayer.

(G) A son-in-law, daughter-in-law, father-in-law, mother-in- law, brother-in-law, or sister-in-law.

(H) An individual . . . who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.

Questions re Personal and Dependents Exemptions

3. Harry and Wanda Taxpayer are married and have two children. Their children are 16 and 18 years of age; they lived with Harry and Wanda for all of 2007; and Harry and Wanda provided all of their children's support. When Harry and Wanda filed their 2007 income tax return, were they able to take a deduction for exemptions, and if so, how much of a deduction?

    a. The answer depends on whether Harry and Wanda itemized their deductions or took the standard deduction. If they took the standard deduction, they could not take a deduction for exemptions. It they itemized their deductions, the amount they were able to take as an exemption deduction is the amount set forth in one of the following answers.

    b. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $13,400 in exemption deductions ($3,400 x 4 = $13,400).

    c. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $6,800 in exemption deductions ($3,400 x 2 = $6,800).

    d. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $3,400 in exemption deductions.

4. Herman and Wilhelmina Taxpayer are married and have two children. Their children were 18 and 23 years of age at the end of 2007; they lived with Herman and Wilhelmina for all of 2007; and Herman and Wilhelmina provided all of their children's support. The 18-year-old was a senior in high school in 2007; the 23-year-old was law student. When Harry and Wanda filed their 2007 income tax return, were they able to take a deduction for exemptions, and if so, how much of a deduction?

    a. The answer depends on whether Herman and Wilhelmina itemized their deductions or took the standard deduction. If they took the standard deduction, they could not take a deduction for exemptions. It they itemized their deductions, the amount they were able to take as an exemption deduction is the amount set forth in one of the following answers.

    b. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $13,400 in exemption deductions ($3,400 x 4 = $13,400).

    c. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $6,800 in exemption deductions ($3,400 x 2 = $6,800).

    d. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $3,400 in exemption deductions.

5. Herbert and Wilma Taxpayer are married and have two children. Their children are twins and both were 25 years of age at the end of 2007; they lived with Herbert and Wilma for all of 2007; and Herman and Wilma provided all of the twin's support that year, while they – the twins – attended medical school. Wilma's 65-year-old mother also lived with Herbert and Wilma during 2007, and they provided all of her support that year. When Herbert and Wilma filed their 2007 income tax return, were they able to take a deduction for exemptions, and if so, how much of a deduction?

    a. The answer depends on whether Herbert and Wilma itemized their deductions or took the standard deduction. If they took the standard deduction, they could not take a deduction for exemptions. It they itemized their deductions, the amount they were able to take as an exemption deduction is the amount set forth in one of the following answers.

    b. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $17,000 in exemption deductions ($3,400 x 5 = $17,000).

    c. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $10,200 in exemption deductions ($3,400 x 3 = $10,200).

    d. They were able to take a deduction for exemptions, regardless of whether they took the standard deduction or instead itemized their deductions. They were able to deduct $6,800 in exemption deductions ($3,400 x 2 = $6,800).

<u>Dependents Exemptions after Divorce</u>

Posin & Tobin on Dependents Exemptions after Divorce

Posin & Tobin have very little to say about who gets the dependency exemption for children when their parents divorce. They devote just one paragraph to that issue; it's the second paragraph on page 532. In my experience, however, the question of which parent gets to claim the children as dependents, after divorce, is an important one. As a matter of tax law, both parents are not permitted to do so. Yet, because divorced couples file separate returns, both sometimes try to. When that happens, it invites audits; and once the IRS gets auditing, it looks at everything, not just the dependency-exemption issue. So let's take a look at what the Code has to say about this.

Internal Revenue Code provisions re Dependents Exemptions after Divorce

§ 152. Dependent defined

. . .

(c) Qualifying child. – For purposes of this section–

. . .

(4) Special rule relating to 2 or more claiming qualifying child. –

. . .

(B) More than 1 parent claiming qualifying child. – If the parents claiming any qualifying child do not file a joint return together, such child shall be treated as the qualifying child of–

(i) the parent with whom the child resided for the longest period of time during the taxable year, or

(ii) if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income.

. . .

(e) Special rule for divorced parents. –

(1) In general. – Notwithstanding subsection . . . (c)(4) . . . , if–

(A) a child receives over one-half of the child's support during the calendar year from the child's parents–

(i) who are divorced or legally separated under a decree of divorce or separate maintenance,

(ii) who are separated under a written separation agreement, or

(iii) who live apart at all times during the last 6 months of the calendar year, and

(B) such child is in the custody of 1 or both of the child's parents for more than one-half of the calendar year, such child shall be treated as being the qualifying child or qualifying relative of the noncustodial parent for a calendar year if the requirements described in paragraph (2) are met.

(2) Requirements. – For purposes of paragraph (1), the requirements described in this paragraph are met if–

(A) a decree of divorce or separate maintenance or written separation agreement between the parents applicable to the taxable year beginning in such calendar year provides that–

(i) the noncustodial parent shall be entitled to any deduction allowable under section 151 for such child, or

(ii) the custodial parent will sign a written declaration (in such manner and form as the Secretary may prescribe) that such parent will not claim such child as a dependent for such taxable year,

. . .

(3) Custodial parent and noncustodial parent. – For purposes of this subsection–

(A) Custodial parent. – The term "custodial parent" means the parent with whom a child shared the same principal place of abode for the greater portion of the calendar year.

(B) Noncustodial parent. – The term "noncustodial parent" means the parent who is not the custodial parent.

Questions re Dependents Exemptions after Divorce

6. Mona and David Taxpayer were married and are the parents of two children. They now are divorced. Their divorce decree gave custody of the children to Mona, and requires David to pay Mona a total of $3,000 per month: $2,000 a month in child support (i.e., $1,000 per month per child, which is more than half of what it costs to support them, at their age), and an additional $1,000 per month to Mona as alimony. The children live with Mona Monday through Friday and every other Saturday and Sunday, 50 weeks a year. The children live with David every other Saturday and Sunday, 50 weeks a year, and for the entire week preceding Easter and the week beginning the day after Christmas through the day after New Years. The divorce decree says nothing about which parent may claim the children as dependents. Which of the following is true?
    a. Mona may claim both children as her dependents, because they live with her most of the time.
    b. David may claim both children as his dependents, because he pays more than half of what it costs to support them.
    c. Mona may claim one child as her dependent, and David may claim the other child as his.
    d. Neither may claim either child as a dependent. (That's why the divorce decree or a divorce agreement should have specified who got to claim them as dependents.)
7. Assume the same facts as Question 6, with one exception: the divorce decree provides that David may claim both children as his dependents. Which of the following is true now?
    a. Mona may claim both children as her dependents, because they live with her most of the time.
    b. David may claim both children as his dependents, because the divorce decree so provides.
    c. Mona may claim one child as her dependent, and David may claim the other child as his.
    d. Mona may claim both children as her dependents, because she has not signed a declaration that she wouldn't claim them as her dependents.

<u>Alimony and Child Support</u>

Read (in Posin & Tobin) re Alimony and Child Support

Pages 443 – 447 (top)

Internal Revenue Code provisions re Alimony and Child Support

§ 71. Alimony and separate maintenance payments

(a) General rule.—Gross income includes amounts received as alimony or separate maintenance payments.

(b) Alimony or separate maintenance payments defined.—For purposes of this section—

(1) In general.—The term "alimony or separate maintenance payment" means any payment in cash if—

(A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,

(B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,

(C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and

(D) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

(2) Divorce or separation instrument.—The term "divorce or separation instrument" means—

(A) a decree of divorce or separate maintenance or a written instrument incident to such a decree,

(B) a written separation agreement, or

(C) a decree (not described in subparagraph (A)) requiring a spouse to make payments for the support or maintenance of the other spouse.

(c) Payments to support children.—

(1) In general.—Subsection (a) shall not apply to that part of any payment which the terms of the divorce or separation instrument fix (in terms of an amount of money or a part of the payment) as a sum which is payable for the support of children of the payor spouse.

(2) Treatment of certain reductions related to contingencies involving child.—For purposes of paragraph (1), if any amount specified in the instrument will be reduced—

(A) on the happening of a contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or

(B) at a time which can clearly be associated with a contingency of a kind specified in subparagraph (A),

an amount equal to the amount of such reduction will be treated as an amount fixed as payable for the support of children of the payor spouse.

(3) Special rule where payment is less than amount specified in instrument.—For purposes of this subsection, if any payment is less than the amount specified in the instrument, then so much of such payment as does not exceed the sum payable for support shall be considered a payment for such support.

§ 62. Adjusted gross income defined

(a) General rule. For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions: . . .

(10) Alimony. The deduction allowed by section 215.

§ 215. Alimony, etc., payments

(a) General rule.—In the case of an individual, there shall be allowed as a deduction an amount equal to the alimony or separate maintenance payments paid during such individual's taxable year.

(b) Alimony or separate maintenance payments defined.—For purposes of this section, the term "alimony or separate maintenance payment" means any alimony or separate maintenance payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71.

Questions re Alimony and Child Support

1. Mona and David Taxpayer were married and are the parents of two children. They now are divorced. Their divorce decree gave custody of the children to Mona, and requires David to pay Mona a total of $3,000 per month: $2,000 a month in child support (i.e., $1,000 per month per child), and an additional $1,000 per month to Mona as alimony. The decree is silent, however, about the tax aspects of these payments. David makes the required payment, in full, each month. Which of the following is true?

    a. David may deduct all $3,000 in monthly payments from his income, and Mona must include all $3,000 in her gross income.

    b. David may deduct all $3,000 in monthly payments from his income, but Mona is not required to include any of the $3,000 a month she receives in her gross income.

    c. David may not deduct any of the $3,000 in monthly payments from his income, and Mona is not required to include any of the $3,000 in her gross income.

    d. David may deduct the $1,000 a month he pays in alimony, but not the $2,000 a month he pays in child support; and Mona must include the $1,000 a month she receives in alimony in her gross income, but not the $2,000 a month she receives as child support.

2. [This is another version of the facts in Question 1.] Mona and David Taxpayer were married and are the parents of two children. They now are divorced. Their divorce decree gave custody of the children to Mona, and requires David to pay Mona a total of $3,000 per month: $2,000 a month in child support (i.e., $1,000 per month per child), and an additional $1,000 per month to Mona as alimony. Following the divorce, David was unexpectedly laid off at work, and for several months he has been paying only $1,500 a month rather than the $3,000 he is supposed to pay. Which of the following is true about the tax treatment of the payments he made during the months he was paying only $1,500?

   a. David may deduct the $1,500 in monthly payments from his income, and Mona must include $1,500 in her gross income.

   b. David may deduct the $1,500 in monthly payments from his income, but Mona is not required to include any of the $1,500 a month she receives in her gross income.

   c. David may not deduct any of the $1,500 in monthly payments from his income, and Mona is not required to include any of the $1,500 in her gross income.

   d. David may deduct $1,000 of the $1,500 a month he pays as alimony, but not the remaining $500 a month he pays, because that's child support; and Mona must include the $1,000 a month she receives as alimony in her gross income, but not the $500 a month she receives as child support.

3. [This is yet another version of the facts in Question 1.] Mona and David Taxpayer were married and are the parents of two children. They now are divorced. Their written divorce agreement gave custody of the children to Mona, and requires David to pay Mona a total of $3,000 per month in spousal support and nothing at all for child support. However, the agreement also provides that when each child reaches the age of 18, the amount of alimony David must pay will be decreased by $1,000 per month. David makes the entire payment, in full, each month. Which of the following is true?

   a. David may deduct all $3,000 in monthly payments from his income, and Mona must include all $3,000 in her gross income.

   b. David may deduct all $3,000 in monthly payments from his income, but Mona is not required to include any of the $3,000 a month she receives in her gross income.

   c. David may not deduct any of the $3,000 in monthly payments from his income, and Mona is not required to include any of the $3,000 in her gross income.

   d. David may deduct the $1,000 a month of the $3,000 he pays in alimony, but not the remaining $2,000 a month; and Mona must include $1,000 a month in her gross income, but not the remaining $2,000 a month.

<u>Property Division in Connection with Divorce</u>

Read (in Posin & Tobin) re Property Division in Connection with Divorce

Pages 166 – 171

The Posin & Tobin book's discussion of *United States v. Davis* (pages 167-168) illustrates why we haven't used a conventional casebook in this course. The *Davis* case is a landmark Supreme Court decision. But the result in that case turned on the difference between "common law" marital property rules and "community property" rules – for example, the difference between the marital property laws of California (community property) and New York (common law). Congress thought the difference between common law marital property and community property was an unfair basis for making distinctions *for federal income tax purposes*. As a result, Congress "overruled" the *Davis* case by adding section 1041 to the Internal Revenue Code. It was my judgment that our time is better devoted to understanding section 1041 than to reading and discussing *Davis*.

Internal Revenue Code provisions re Property Division in Connection with Divorce

> **§ 1041. Transfers of property between spouses or incident to divorce**
> (a) General rule.—No gain or loss shall be recognized on a transfer of property from an individual to . . . —
> (1) a spouse, or
> (2) a former spouse, but only if the transfer is incident to the divorce.
> (b) Transfer treated as gift; transferee has transferor's basis. – In the case of any transfer of property described in subsection (a)–
> (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
> (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.
> (c) Incident to divorce.— For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—
> (1) occurs within 1 year after the date on which the marriage ceases, or
> (2) is related to the cessation of the marriage.

Reg. § 1.1041-1T Treatment of transfer of property between spouses or incident to divorce (temporary)

Q–1: How is the transfer of property between spouses treated under section 1041?

A–1: Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if the transfer is incident to a divorce, a former spouse. The following questions and answers describe more fully the scope, tax consequences and other rules which apply to transfers of property under section 1041.

(a) Scope of section 1041 in general.

Q–2: Does section 1041 apply only to transfers of property incident to divorce?

A–2: No. Section 1041 is not limited to transfers of property incident to divorce. Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift or is a sale or exchange between spouses. . . . A divorce or legal separation need not be contemplated between the spouses at the time of the transfer nor must a divorce or legal separation ever occur.

. . .

(b) Transfer incident to the divorce.

Q–6: When is a transfer of property incident to the divorce?

A–6: A transfer of property is incident to the divorce in either of the following 2 circumstances—

(1) The transfer occurs not more than one year after the date on which the marriage ceases, or

(2) The transfer is related to the cessation of the marriage.

Thus, a transfer of property occurring not more than one year after the date on which the marriage ceases need not be related to the cessation of the marriage to qualify for section 1041 treatment. (See A–7 for transfers occurring more than one year after the cessation of the marriage.)

Q–7: When is a transfer of property related to the cessation of the marriage?

A–7: A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument . . . and the transfer occurs not more than 6 years after the date on which the marriage ceases. . . . Any transfer not pursuant to a divorce or separation instrument and any transfer occurring more than 6 years after the cessation of the marriage is presumed to be not related to the cessation of the marriage. This presumption may be rebutted only by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage. For example, the presumption may be rebutted by showing that (a) the transfer was not made within the one- and six-year periods described above because of factors which hampered an earlier transfer of the property, such as legal or business impediments to transfer or disputes concerning the value of the property owned at the time of the cessation of the marriage, and (b) the transfer is effected promptly after the impediment to transfer is removed.

Questions re Property Division in Connection with Divorce

1. Bobby Taxpayer borrowed $400,000 in cash from his wealthy brother Larry so that Bobby could buy a yellow Robinson R44 helicopter (www.robinsonheli.com) which Bobby now uses in his aerial photography business. Bobby was (and is) wealthy too; but Bobby's wealth was tied up in the stock market. In order to put his hands on the $400,000 in cash he needed to buy the helicopter, Bobby would have had to sell stock for which he had paid only $100,000. His lawyer told Bobby that if he sold that stock, he'd have to pay tax on his gain – even if he immediately spent the proceeds on the helicopter – and thus Bobby would have to sell additional stock to cover the tax, which in turn would have given him additional income on which he'd have to pay tax. That's why Bobby borrowed the money he needed for the helicopter from his brother Larry. Did Bobby get good tax advice about the consequences of his selling stock to raise money for the helicopter?

    a. Yes. Selling the stock would be a "realizing" event for Bobby, even if he immediately spent the proceeds on the helicopter.

    b. No. Selling the stock would not have been a "realizing" event, because if it were, he wouldn't have enough cash to buy the helicopter unless he sold more stock which in turn would be a further (or greater) realizing event.

    c. No. Selling the stock would not have been a "realizing" event no matter what he did with the cash. Selling stock simply converts one form of investment – stock – into another form of investment – cash.

    d. None of the above.

2. A few months after Bobby bought his Robinson R44 heli, Larry got a divorce and had to transfer half of his marital property to his wife. The $400,000 Larry loaned to Bobby (in question 1) was marital property, so Larry asked Bobby to repay the loan. At that time, the stock for which Bobby had paid $100,000 was still worth $400,000; and Bobby's lawyer was still advising Bobby that he would realize a gain on the stock if he sold it – even to repay the loan he had gotten from Larry. Bobby then asked his lawyer what the tax consequences would be if Bobby transferred the stock to Larry, so that Larry could transfer half of the stock to his wife who then could sell it or keep it, as she pleased. How should Bobby's lawyer have answered that question?

    a. If Bobby transferred the stock to his brother Larry, Bobby would *not* realize a gain, because Bobby wouldn't have converted the stock into cash.

    b. If Bobby transferred the stock to his brother Larry, Bobby would *not* realize a gain, because Bobby would simply be repaying a loan.

    c. If Bobby transferred the stock to his brother Larry, Bobby would realize a gain, because when Larry transferred the stock to Larry's wife, no gain or loss would be realized by Larry (under section 1041); and there has to be a realized gain somewhere along the line in order to fund the operations of the federal government.

    d. If Bobby transferred the stock to his brother Larry, Bobby would realize a gain, regardless of what Larry did with the stock – even if Larry reconciled with his wife, cancelled the divorce, and kept the stock.

3. Bobby transferred the stock to Larry (to repay the loan described in Question 1). Immediately thereafter, Larry and his wife attempted a reconciliation and put the divorce proceedings on hold. After working at their marriage for six months, the reconciliation attempt failed; and Larry and his wife got divorced after all. By then, however, the stock that Bobby had given Larry had increased in value from $400,000 to $500,000. In order to evenly split their marital property, Larry had to give his wife $500,000 worth of assets. Larry offered his wife their vacation condo in Mammoth, but she doesn’t ski, hike or fish, so she didn’t want it. Instead, she demanded $500,000 in cash or stock. Larry asked his lawyer what to do, tax wise. What should his lawyer have said?

   a. If Larry sells the stock, it will be a realizing event, and he’ll have a gain.

   b. If Larry gives the stock to his wife, it will not be a realizing event and he won’t have a gain.

   c. Both of the above.

   d. Neither of the above, because advice about matters like this always requires more than one or two sentences.

4. One of the reasons that Larry and his wife were unable to reconcile was that they separated for the first time because she had a boyfriend and he had a girlfriend. Ultimately, Larry decided that he loved his girlfriend more than his wife, and his wife decided that she loved her boyfriend more than Larry. Since they had no children, the divorce was simply a financial matter. By the time the attempted reconciliation failed, both Larry and his wife were anxious to remarry their new loved ones. So Larry and his wife finalized the divorce, and actually got divorced, before they sorted out how they were going to handle the question of the $500,000 in assets that Larry had to transfer to his, by then, ex-wife. Ultimately – nine months after their divorce, Larry and his wife decided that Larry would transfer to his wife the stock he had received from his brother Bobby. What were the tax ramifications of the transfer?

   a. The stock transfer was not a realizing event to Larry, and wouldn’t have been, even if it had taken Larry and his wife nine *years* to decide what to do.

   b. The stock transfer was not a realizing event to Larry, because the transfer took place within one year of their divorce.

   c. The stock transfer was a realizing event to Larry, because by transferring the stock, Larry discharged a financial obligation he had to his ex-wife.

   d. The stock transfer was a realizing event to Larry, because in *United States v. Davis*, the Supreme Court held that a virtually identical transaction was a realizing event to the ex-husband.

5. Same facts as #4, with these two changes: (a) When Larry and his wife got divorced, they entered into a written agreement by which they acknowledged that they still hadn't decided how to divide their marital property and that eventually Larry would be transferring $500,000 in property of some sort to his wife. (b) It took Larry and his wife *two years* after their divorce to finally agree that he would transfer the stock to her (which stock was still worth $500,000). Under these circumstances, what were the tax ramifications of the transfer?

    a. The stock transfer was not a realizing event to Larry, even though it didn't take place within one year of their divorce.

    b. The stock transfer was a realizing event to Larry, because the transfer took place more than one year after their divorce.

    c. The stock transfer was a realizing event to Larry, because by transferring the stock, Larry discharged a financial obligation he had to his ex-wife.

    d. The stock transfer was a realizing event to Larry, because in *United States v. Davis*, the Supreme Court held that a virtually identical transaction was a realizing event to the ex-husband.

6. Immediately after Larry remarried, he gave his new wife a diamond ring that he inherited from his mother (following his divorce from wife #1). The ring was a wedding present – a gift of love; wife #2 did not give up marital rights or anything else in return for the ring. Larry's "basis" in the ring was $500; but by the time he gave it to wife #2, it was worth $5,000. Did Larry realize income by giving wife #2 the ring?

    a. No, because it is customary for husbands to give their wives diamond rings when they get married.

    b. No, because he gave the ring to wife #2 *after* they were married. If he had given her the ring as an engagement gift, *before* they got married, section 1041 would *not* have applied; so the answer would depend on whether giving appreciated property as a gift is a realizing event to the donor (it isn't).

    c. Yes, because the value of the gift was $5,000 and Larry's basis was just $500.

    d. None of the above.

<u>Child and Dependent Care Credit</u>

Read (in Posin & Tobin) re Child Care Credit and Child Tax Credit

Pages 634 – 637

Question re Child and Dependent Care Credit

7. Thomas and Thelma Taxpayer are lawyers and the proud parents of 5-year-old twins. Because Thomas and Thelma work outside their home, they've enrolled their children in a day-care facility that cares for the twins five days a week, from 7:30 am to 5:30 pm. Day-care for the twins costs the Taxpayers $40,000 a year; but it's a necessary expense, given that Thomas and Thelma both work. Thomas earns $100,000 a year, and Thelma does too, so together they earn $200,000 a year. What are the tax implications, if any, of the $40,000 a year that Thomas and Thelma pay for their twins' child care?

    a. There aren't any "tax implications." Day care expenses for children are the epitome of personal expenses, and thus are not deductible, at all.

    b. Answer "a" is not entirely correct. It's true that day care expenses are not deductible. But the twins satisfy all requirements to be "qualifying child[ren]," and thus Thomas and Thelma may claim them as dependents and take a $3,400 deduction for each child which means they can deduct $6,800, because of the twins.

    c. Answer "b" is correct as far as it goes; but it doesn't go far enough. Thomas and Thelma also may claim a Child and Dependent Care Expenses Credit on account of the twins (in addition to the dependency exemption deduction). Given the amount they pay for day care expenses and their incomes, they may claim an $8,000 credit against the taxes they otherwise would owe – $8,000 being 20% of their $40,000 in day care expenses.

    d. Answer "b" is correct as far as it goes; but it doesn't go far enough. Thomas and Thelma also may claim a Child and Dependent Care Expenses Credit on account of the twins (in addition to the dependency exemption deduction). Given the amount they pay for day care expenses and their incomes, they may claim an $1,200 credit against the taxes they otherwise would owe – $1,200 being 20% of the $6,000 cap on the amount of employment-related expenses that count for the purpose of calculating the credit.

<u>Child Tax Credit</u>

Read (in Posin & Tobin) re Child Tax Credit

Pages 640 – 642

Question re Child and Dependent Care Credit and Child Tax Credit

8. Answers "c" and "d" to Question 7 referred only to the Child and Dependent Care Expenses Credit. Thomas and Thelma are friendly with another couple who also have young children. At a children's birthday party earlier this year, Thomas and Thelma were commiserating with the other couple about the high cost of day care. The other couple said that in addition to the Child and Dependent Care Expenses Credit, they – the other couple – also claim a "Child Tax Credit," and that Thomas and Thelma probably could too. Can they?

    a. Not really. The "Child Tax Credit" is just another, shorter, name for the "Child and Dependent Care Expenses Credit," so Thomas and Thelma already are claiming the only credit they are eligible to claim (assuming they are eligible to claim the Child and Dependent Care Expenses Credit).

    b. No. Although the Child Tax Credit is entirely separate from the Child and Dependent Care Expenses Credit, the Child Care Credit is phased out for those whose adjusted gross incomes exceed $125,000. If we assume that Thomas and Thelma do not have any above-the-line deductions, so their adjusted gross income is $200,000, they aren't eligible for the Child Tax Credit.

    c. Answer "b" is correct, but it doesn't fully explain why Thomas and Thelma aren't eligible for the Child Tax Credit. Answer "b" implies that the Child Tax Credit disappears if a taxpayer's AGI exceeds $125,000; and that's not right. Instead, if a taxpayer's AGI exceeds $125,000, the Child Tax Credit is reduced by $50 for each $1,000 of the excess. In Thomas and Thelma's case, their $200,000 AGI exceeds $125,000 by $75,000; so the Child Tax Credit they otherwise could have claimed is reduced by $3,750 ($75,000/$1,000 x $50 = $3,750). Since the Child Tax Credit is $1,000 per child, or $2,000 for two children, the $3,750 reduction completely wipes out Thomas and Thelma's claim for the Child Tax Credit.

    d. Yes, Thomas and Thelma are entitled to a $1,000 per child Child Tax Credit – $2,000 in all – so the birthday party was a valuable party for them to have attended.

HEALTH CARE

Medical Expenses

Read (in Posin & Tobin) re Medical Expenses, including Health Insurance

Pages 514 – 519

Internal Revenue Code provisions re Medical Expenses, including Health Insurance

The following sections deal with the tax treatment *to employees* of

- benefits paid to, or for the benefit of, employees by medical insurance companies, and
- amounts paid by employers to obtain medical insurance for their employees.

§ 104. Compensation for injuries or sickness

(a) In general. . . . gross income does not include - . . .

(3) amounts received through accident or health insurance . . . for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer). . .

§ 105. Amounts received under accident and health plans

(a) Amounts attributable to employer contributions. Except as otherwise provided in this section, amounts received by an employee through accident or health insurance for personal injuries or sickness shall be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

(b) . . . gross income does not include amounts referred to in subsection (a) if such amounts are paid, directly or indirectly, to the taxpayer to reimburse the taxpayer for expenses incurred by him for the medical care (as defined in section 213(d)) of the taxpayer, his spouse, and his dependents (as defined in section 152, determined without regard. . . .

§ 106. Contributions by employer to accident and health plans

(a) General rule.—Except as otherwise provided in this section, gross income of an employee does not include employer-provided coverage under an accident or health plan.

Employers are premitted to take an above-the-line deduction for the amount they pay for medical insurance for their employees, under § 162(a), because medical insurance for employees is an ordinary and necessary business expenses.

The following Code section deals with medical insurance costs paid by those who are *self*-employed.

§ 162. Trade or business expenses

(l) Special rules for health insurance costs of self-employed individuals. —

(1) Allowance of deduction. —

(A) In general. — In the case of an individual who is an employee within the meaning of section 401(c)(1) [i.e., self-employed individuals], there shall be allowed as a deduction under this section an amount equal to the applicable percentage of the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

(B) Applicable percentage. — For purposes of subparagraph (A), the applicable percentage shall be determined under the following table:

For taxable years beginning in calendar year -	The applicable percentage is -
. . .	
2003 and thereafter	100.

(2) Limitations. —

(A) Dollar amount. — No deduction shall be allowed under paragraph (1) to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of section 401(c) [i.e., net earnings from self-employment]) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

. . .

(3) Coordination with medical deduction. — Any amount paid by a taxpayer for insurance to which paragraph (1) applies shall not be taken into account in computing the amount allowable to the taxpayer as a deduction under section 213(a).

The next sections deal with the tax treatment of amounts paid by taxpayers for medical expenses that are *not* covered by medical insurance.

§ 213. Medical, dental, etc., expenses

(a) Allowance of deduction.—There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent . . . , to the extent that such expenses exceed 7.5 percent of adjusted gross income.

(b) Limitation with respect to medicine and drugs.—An amount paid during the taxable year for medicine or a drug shall be taken into account under subsection (a) only if such medicine or drug is a prescribed drug or is insulin.

. . .

(d) Definitions.—For purposes of this section—

(1) The term "medical care" means amounts paid—

(A) for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,

(B) for transportation primarily for and essential to medical care referred to in subparagraph (A),

(C) for qualified long-term care services . . . , or

(D) for insurance (including amounts paid as premiums under part B of title XVIII of the Social Security Act, relating to supplementary medical insurance for the aged) covering medical care referred to in subparagraphs (A) and (B) or for any qualified long-term care insurance contract. . . .

(2) Amounts paid for certain lodging away from home treated as paid for medical care.—Amounts paid for lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care referred to in paragraph (1)(A) shall be treated as amounts paid for medical care if—

(A) the medical care referred to in paragraph (1)(A) is provided by a physician in a licensed hospital (or in a medical care facility which is related to, or the equivalent of, a licensed hospital), and

(B) there is no significant element of personal pleasure, recreation, or vacation in the travel away from home.

The amount taken into account under the preceding sentence shall not exceed $50 for each night for each individual.

. . .

(9) Cosmetic surgery.—

(A) In general.—The term "medical care" does not include cosmetic surgery or other similar procedures, unless the surgery or procedure is necessary to ameliorate a deformity arising from, or directly related to, a congenital abnormality, a personal injury resulting from an accident or trauma, or disfiguring disease.

(B) Cosmetic surgery defined.—For purposes of this paragraph, the term "cosmetic surgery" means any procedure which is directed at improving the patient's appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.

§ 223. Health Savings Accounts.

(a) Deduction Allowed.— In the case of an individual who is an eligible individual for any month during the taxable year, there shall be allowed as a deduction for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by or on behalf of such individual to a health savings account of such individual.

(b) Limitations.— [The amount that can be paid into a Health Savings Account is limited to amounts set forth in this subparagraph.]

(c) Definitions and Special Rules.— For purposes of this section—

(1) Eligible individual.—

(A) In general.—The term "eligible individual" means, with respect to any month, any individual if—

(i) such individual is covered under a high deductible health plan as of the 1st day of such month,

(ii) such individual is not, while covered under a high deductible health plan, covered under any health plan—

(I) which is not a high deductible health plan, and

(II) which provides coverage for any benefit which is covered under the high deductible health plan. . . .

Questions re Medical Expenses, including Health Insurance

Ali, Benny and Chad were law school classmates. All three graduated, took the bar exam, got married, and passed the bar exam (in that order). Career-wise, though, the three went in slightly different directions.

- Ali went to work for a large downtown law firm that provides health insurance to its employees, and also allows them to contribute to a Health Savings Account, which Ali did. The group health insurance policy that Ali's firm purchased costs the firm $5,000 per employee per year. Along with other benefits, the policy pays 80% of the doctor and hospital costs of child birth. Ali contributes enough to his Health Savings Account to cover the remaining 20% of any doctor and hospital costs of child birth he and his wife might incur. Ali makes $100,000 a year working for the firm.
- Benny went to work for a very small firm that specializes in exactly the kind of work that Benny wants to do. But Benny's firm doesn't provide health insurance for anyone, nor has it set up a Health Savings Account plan. So Benny bought his own health insurance. It costs him $5,000 per year. Along with other benefits, the policy pays 80% of the doctor and hospital costs of child birth. Benny makes $105,000 a year working for the firm.
- When Chad graduated from law school, he had paying clients just waiting for him to open his own law office, so he did. He too bought his own health insurance at a cost of $5,000 per year, though he did not set up a Health Savings Account plan for himself. Along with other benefits, Chad's health insurance pays 80% of the doctor and hospital costs of child birth. Chad nets $105,000 a year, after paying all his law office expenses except health insurance (i.e., the health insurance comes out of his $105,000).

Though the three former classmates took slightly different career paths, their personal lives continued to run along parallel tracks, because all three of their wives gave birth, during the same year. Of course, all three incurred doctor and hospital costs in connection with the birth of their children. Consider, now, the following questions concerning the tax treatment of the three former classmates' medical expenses:

1. Which of the following is the best description of the tax treatment of Ali's medical expenses?

    a. Ali had $5,000 in additional income, on account of the medical insurance his law firm provided to him. He will not be able to deduct the money he contributed to his Health Savings Account. On the other hand, when the insurance company paid the doctor and hospital costs for the birth his child, those amounts were not income to him, even though 80% of those costs exceeded $5,000. Nor did he have income when he withdrew money from his Health Savings Account to pay the remaining 20% of those costs.

    b. Ali did *not* have additional income on account of the medical insurance his law firm provided to him. He was able to deduct the money he contributed to his Health Savings Account. On the other hand, when the insurance company paid the doctor and hospital costs for the birth his child, the amount by which 80% of those costs exceeded $5,000 was income to him. And when he withdrew money from his Health Savings Account to pay the remaining 20% of those costs, the amount that he withdrew was income to him then as well.

    c. Ali did *not* have additional income on account of the medical insurance his law firm provided to him. He was able to deduct the money he contributed to his Health Savings Account. When the insurance company paid the doctor and hospital costs for the birth his child, the amount by which 80% of those costs exceeded $5,000 was income to him. And when he withdrew money from his Health Savings Account to pay the remaining 20% of those costs, the amount that he withdrew was income to him then as well. On the other hand, he was able to deduct the portion of the doctor and hospital costs that was not covered by insurance, though only if and to the extent that portion exceeded 7.5% of his adjusted gross income.

    d. Ali did *not* have additional income on account of the medical insurance his law firm provided to him. He was able to deduct the money he contributed to his Health Savings Account. What's more, when the insurance company paid the doctor and hospital costs for the birth his child, the amount that it paid was not income to him either. Nor did he have income when he withdrew money from his Health Savings Account to pay the remaining 20% of those costs.

2. Which of the following is the best description of the tax treatment of Benny's medical expenses?

    a. Benny had $5,000 more in gross income than Ali. But Benny was able to deduct all of the $5,000 he paid for health insurance, so Benny and Ali's "after-insurance" income was the same. What's more, although Benny didn't have a Health Savings Account, he was able to deduct all of the 20% of the doctor and hospital costs that were not covered by his health insurance. And the portion of those costs that was covered was *not* income to him.

    b. Benny had $5,000 more in gross income than Ali. But Benny was able to deduct all of the $5,000 he paid for health insurance, so Benny and Ali's "after-insurance" incomes were really the same. What's more, although Benny didn't have a Health Savings Account, he was able to deduct all of the 20% of the doctor and hospital costs for the birth of his child that were not covered by his health insurance. However, the portion of the doctor and hospital costs that was covered by insurance *was* income to him, so after paying taxes on that income, Benny didn't actually get the full economic benefit of the 80% of the medical costs the insurance covered.

    c. Benny had $5,000 more in gross income than Ali. But Benny was able to deduct all of the $5,000 he paid for health insurance, so Benny and Ali's "after-insurance" incomes were really the same. What's more, although Benny didn't have a Health Savings Account, he might have been able to deduct some of the 20% of the doctor and hospital costs for the birth of his child that were not covered by his health insurance; he could deduct the amount by which those expenses exceeded 7.5% of Benny's adjusted gross income. But the portion of the doctor and hospital costs that was covered by insurance was not income to him.

    d. Benny had $5,000 more in gross income than Ali. But Benny was able to deduct only some of the $5,000 he paid for health insurance – the amount by which that insurance (and any other medical expenses) exceeded 7.5% of Benny's adjusted gross income – so Benny and Ali's "after-insurance" incomes weren't really the same. What's more, although Benny didn't have a Health Savings Account, he was able to deduct some of the 20% of the doctor and hospital costs for the birth of his child that were not covered by his health insurance – again, the amount by which those expenses (plus his health insurance costs) exceeded 7.5% of Benny's adjusted gross income. But the portion of the doctor and hospital costs that was covered by insurance was not income to him.

3. Which of the following is the best description of the tax treatment of Chad's medical expenses?

   a. Chad had $5,000 more in gross income than Ali. But Chad was able to deduct all of the $5,000 he paid for health insurance, so Chad and Ali's "after-insurance" income was the same. What's more, although Chad didn't have a Health Savings Account, he was able to deduct all of the 20% of the doctor and hospital costs that were not covered by his health insurance. And the portion of those costs that was covered was *not* income to him.

   b. Chad had $5,000 more in gross income than Ali. But Chad was able to deduct all of the $5,000 he paid for health insurance, so Chad and Ali's "after-insurance" incomes were really the same. What's more, although Chad didn't have a Health Savings Account, he was able to deduct all of the 20% of the doctor and hospital costs for the birth of his child that were not covered by his health insurance. However, the portion of the doctor and hospital costs that was covered by insurance *was* income to him, so after paying taxes on that income, Chad didn't actually get the full economic benefit of the 80% of the medical costs the insurance covered.

   c. Chad had $5,000 more in gross income than Ali. But Ali was able to deduct *either* the $5,000 he paid for health insurance, *or* the amount he paid for the 20% of medical expenses that weren't covered by the insurance – whichever amount was greater. Since we don't know how much Chad's total medical expenses were, and thus don't know what he paid for the 20% that weren't covered by insurance, we can't say whether Chad's "after-insurance" income was the same as, or greater or less than, Ali's.

   d. Chad had $5,000 more in gross income than Ali. But Chad was able to deduct all of the $5,000 he paid for health insurance, so Chad and Ali's "after-insurance" incomes were really the same. What's more, although Chad didn't have a Health Savings Account, he might have been able to deduct some of the 20% of the doctor and hospital costs for the birth of his child that were not covered by his health insurance; he could deduct the amount by which those expenses exceeded 7.5% of Chad's adjusted gross income. But the portion of the doctor and hospital costs that was covered by insurance was not income to him.

4. Who does the Internal Revenue Code treat the kindest, with respect to medical expenses? Make a note to yourself concerning why you selected the answer you did.

   a. Ali.

   b. Benny.

   c. Chad.

   d. It treats all three exactly the same.

HOME OWNERSHIP

Internal Revenue Code provision re living expenses

> **§ 262. Personal, living, and family expenses**
>
> (a) General rule. Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

__**Home Mortgage Interest**__

Read (in Posin & Tobin) re Home Mortgage Interest

Pages 490 – 498

Internal Revenue Code provisions re Home Mortgage Interest

> **§ 163. Interest**
>
> (a) General rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> . . .
>
> (h) Disallowance of deduction for personal interest
>
> (1) In general. In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.
>
> (2) Personal interest. For purposes of this subsection, the term "personal interest" means any interest allowable as a deduction under this chapter other than -
>
> . . .
>
> (D) any qualified residence interest (within the meaning of paragraph (3)),
>
> . . .
>
> (3) Qualified residence interest. For purposes of this subsection -
>
> (A) In general. The term "qualified residence interest" means any interest which is paid or accrued during the taxable year on -
>
> (i) acquisition indebtedness with respect to any qualified residence of the taxpayer, or
>
> (ii) home equity indebtedness with respect to any qualified residence of the taxpayer.
>
> . . .
>
> (B) Acquisition indebtedness
>
> (i) In general. The term "acquisition indebtedness" means any indebtedness which -
>
> (I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and
>
> (II) is secured by such residence.
>
> . . .
>
> (ii) $1,000,000 limitation. The aggregate amount treated as acquisition indebtedness for any period shall not exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return).

(C) Home equity indebtedness

(i) In general. The term "home equity indebtedness" means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed -

(I) the fair market value of such qualified residence, reduced by

(II) the amount of acquisition indebtedness with respect to such residence.

(ii) Limitation. The aggregate amount treated as home equity indebtedness for any period shall not exceed $100,000 ($50,000 in the case of a separate return by a married individual).

. . .

(4) Other definitions and special rules. For purposes of this subsection -

(A) Qualified residence

(i) In general. The term "qualified residence" means -

(I) the principal residence (within the meaning of section 121) of the taxpayer, and

(II) 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

Questions re Home Mortgage Interest

1. Ida Taxpayer just decided that the best investment she could make right now is in a new home for herself. She's been living in a rented apartment, but with real estate prices at their lowest point in years, she's going to buy the condo of her dreams in a new high rise building in Century City. The condo will be Ida's principal residence, and it will cost her $2.5 million, of which she will put $1 million down, using cash she earned and pulled out of the stock market before its recent crash. Her bank will lend her the remaining $1.5 million, secured by a deed of trust on the condo, at a fixed rate of 5% per year. Will she be able to deduct her interest payments?

    a. No. Interest on loans to buy homes is non-deductible personal interest under §163(h)(1).

    b. No. But if she makes a $1.5 million down payment (rather than just $1 million), so she borrows just $1 million, then she can deduct her interest payments under §163(h)(3).

    c. Yes, but she'll only be able to deduct interest on $1 million of her loan. The interest she pays on the remaining $500,000 of the loan will not be deductible.

    d. Yes, but she'll only be able to deduct interest on $100,000 of her loan. The interest she pays on the remaining $1.4 million of the loan will not be deductible.

2. If Ida needs another $100,000 to furnish her new condo, or even to buy more stocks and bonds, and she borrows that $100,000 using a second deed of trust on her condo as security, will she be able to deduct the interest she pays on that loan?

   a. No, because she's already "used up" her deductible interest with the loan she took to buy the condo.

   b. No, because she won't be using the $100,000 to buy a principal residence.

   c. Yes, but only if she uses the $100,000 to buy furniture for her principal residence, not if she uses it to buy stock or anything else unrelated to her condo.

   d. Yes, regardless of what she uses the $100,000 for.

Property Taxes

Internal Revenue Code provisions re Taxes

> **§ 164. Taxes**
>
> (a) General rule. Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:
>
> (1) State and local, and foreign, real property taxes.

Questions re Property Taxes

3. Ida's new condo is going to cost her a big bundle in L.A. County property taxes. As a general rule, Ida doesn't like to pay taxes. But the real estate agent who sold her the condo told Ida not to worry too much about the property taxes, because Ida would be able to deduct the property taxes when calculating her taxable income for federal income tax purposes. Was the real estate agent right?

   a. No. Real estate agents will say anything to close a sale. But property taxes on a personal residence are not deductible, because they're personal expenses (unlike property taxes on business property which are deductible because they're business expenses).

   b. The property taxes won't be fully deductible, because Ida's condo cost more than $1 million, and her property taxes will be based on the condo's full cost. She will, however, be able to deduct the property taxes attributable to $1 million in condo value.

   c. Yes, they will be deductible in full, and *above* the line to boot!

   d. Yes, they will be deductible in full, though they will be a *below* the line deduction.

First-Time Homebuyers Credit

The Housing and Economic Recovery Act of 2008 became law on July 30, 2008. It was enacted in an attempt to deal with the subprime housing mortgage crisis. One provision of the Act provided first-time homebuyers with a tax credit of as much as $7,500. A later amendment extended the Act's expiration date and gave a credit to some homebuyers who had previously purchased a home (i.e., to those who were not first-time buyers). The following is an IRS News Release that describes the original credit and explains how it worked. The credit has now expired completely, but it raised some important policy issues that are still worth discussing.

IR-2008-106, Sept. 16, 2008

WASHINGTON — First-time homebuyers should begin planning now to take advantage of a new tax credit included in the recently enacted Housing and Economic Recovery Act of 2008. Available for a limited time only, the credit:

- Applies to home purchases after April 8, 2008, and before July 1, 2009.
- Reduces a taxpayer's tax bill or increases his or her refund, dollar for dollar.
- Is fully refundable, meaning that the credit will be paid out to eligible taxpayers, even if they owe no tax or the credit is more than the tax that they owe.

However, the credit operates much like an interest-free loan, because it must be repaid over a 15-year period. So, for example, an eligible taxpayer who buys a home today and properly claims the maximum available credit of $7,500 on his or her 2008 federal income tax return must begin repaying the credit by including one-fifteenth of this amount, or $500, as an additional tax on his or her 2010 return.

Eligible taxpayers will claim the credit on new IRS Form 5405. This form, along with further instructions on claiming the first-time homebuyer credit, will be included in 2008 tax forms and instructions and be available later this year on IRS.gov, the IRS Web site.

If you bought a home recently, or are considering buying one, the following questions and answers may help you determine whether you qualify for the credit.

Q. Which home purchases qualify for the first-time homebuyer credit?
A. Only the purchase of a main home located in the United States qualifies and only for a limited time. Vacation homes and rental property are not eligible. You must buy the home after April 8, 2008, and before July 1, 2009. For a home that you construct, the purchase date is the first date you occupy the home.

. . .

Q. How much is the credit?
A. The credit is 10 percent of the purchase price of the home, with a maximum available credit of $7,500 for either a single taxpayer or a married couple filing jointly. The limit is $3,750 for a married person filing a separate return. In most cases, the full credit will be available for homes costing $75,000 or more. Whatever the size of the credit a taxpayer receives, the credit must be repaid over a 15-year period.

Q. Are there income limits?
A. Yes. The credit is reduced or eliminated for higher-income taxpayers.
The credit is phased out based on your modified adjusted gross income (MAGI). MAGI is your adjusted gross income plus various amounts excluded from income—for

example, certain foreign income. For a married couple filing a joint return, the phase-out range is $150,000 to $170,000. For other taxpayers, the phase-out range is $75,000 to $95,000.

This means the full credit is available for married couples filing a joint return whose MAGI is $150,000 or less and for other taxpayers whose MAGI is $75,000 or less.

Q. Who cannot take the credit?
A. If any of the following describe you, you cannot take the credit, even if you buy a main home:

- Your income exceeds the phase-out range. This means joint filers with MAGI of $170,000 and above and other taxpayers with MAGI of $95,000 and above.
- You buy your home from a close relative. This includes your spouse, parent, grandparent, child or grandchild.
- You stop using your home as your main home.
- You sell your home before the end of the year.
- You are a nonresident alien.
- You are, or were, eligible to claim the District of Columbia first-time homebuyer credit for any taxable year.
- Your home financing comes from tax-exempt mortgage revenue bonds.
- You owned another main home at any time during the three years prior to the date of purchase. For example, if you bought a home on July 1, 2008, you cannot take the credit for that home if you owned, or had an ownership interest in, another main home at any time from July 2, 2005, through July 1, 2008.

Q. How and when is the credit repaid?
A. The first-time homebuyer credit is similar to a 15-year interest-free loan. Normally, it is repaid in 15 equal annual installments beginning with the second tax year after the year the credit is claimed. The repayment amount is included as an additional tax on the taxpayer's income tax return for that year. For example, if you properly claim a $7,500 first-time homebuyer credit on your 2008 return, you will begin paying it back on your 2010 tax return. Normally, $500 will be due each year from 2010 to 2024.
. . .

Questions re First-Time Homebuyers Credit

4. How did this credit help to improve the housing market, temporarily?
5. Was the credit good for people of your generation?
6. Was it good policy, generally?
7. If it was good policy, why isn't the credit available any longer?
8. Even if you don't like this credit in particular, what do you think about the *procedure* it uses to distribute money? Is a good procedure for the federal government to use to make loans to taxpayers for other reasons as well?

<u>Home Office Expenses</u>

Read (in Posin & Tobin) re Home Office Expenses

Pages 412 –417

Internal Revenue Code provisions re Home Office Expenses

§ 280A. Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.

(a) *General rule.* Except as otherwise provided in this section, in the case of a taxpayer who is an individual . . . , no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(b) *Exception for interest, taxes, casualty losses, etc.* Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

(c) *Exceptions for certain business or rental use; limitation on deductions for such use*

(1) *Certain business use*. Subsection (a) shall not apply to any item to the extent such item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis -

(A) as the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of his trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.

In the case of an employee, the preceding sentence shall apply only if the exclusive use referred to in the preceding sentence is for the convenience of his employer. For purposes of subparagraph (A), the term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business. . . .

(5) *Limitation on deductions*. In the case of a use described in paragraph (1) . . . , the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed the excess of -

(A) the gross income derived from such use for the taxable year, over

(B) the sum of -

(i) the deductions allocable to such use which are allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was so used, and

(ii) the deductions allocable to the trade or business (or rental activity) in which such use occurs (but which are not allocable to such use) for such taxable year.

Any amount not allowable as a deduction under this chapter by reason of the preceding sentence shall be taken into account as a deduction (allocable to such use) under this chapter for the succeeding taxable year. . . .

Questions re Home Office Expenses

1. Kimberly Taxpayer breeds her dogs and sells their pups. To do this, she needed an office and a place to meet customers. Previously, she and her family used the den of their home for reading, television watching and the like, and they rarely used the living room at all. In order to create an office for herself, Kimberly moved the contents of the den into the living room, and she converted the den into an office that has nothing in it but a desk, a computer, file cabinets and items she uses for her dog breeding business. The family no longer uses the den. Kimberly has the following home office expenses:

   I. Cleaning expenses attributable to the portion of his home that is her office.

   II. Utilities (like electricity and gas) attributable to the portion of her home that is her office.

   III. Home maintenance expenses attributable to the portion of her home that is her office.

   IV. Depreciation attributable to the portion of her home that is her office.

   Which of those expenses, if any, may Kimberly deduct?

   a. None of them.

   b. All of them.

   c. I only.

   d. I and II.

2. Lucy Taxpayer is an associate with a law firm in Century City. The firm provides her with an office. But she lives in Pasadena, so it takes her an hour or more to get to work and even longer to get home again. As a result, Lucy converted one of the bedrooms in her 4-bedroom home into a home office, so she can work at home one day of the week. Lucy's law firm is perfectly willing to have her do this; but it didn't ask her to do it. And although the firm doesn't find it inconvenient for her to work at home, she doesn't do it for the firm's convenience; she does it for her own convenience. Lucy doesn't use her home office for anything but work; neither her husband nor her daughter ever enter her home office. Lucy has the following home office expenses:

   I. Cleaning expenses attributable to the portion of his home that is her office.

   II. Utilities (like electricity and gas) attributable to the portion of her home that is her office.

   III. Home maintenance expenses attributable to the portion of her home that is her office.

   IV. Depreciation attributable to the portion of her home that is her office.

   Which if any of them may Lucy deduct?

   a. None of them.

   b. All of them.

   c. I only.

   d. I and II.

3. Lucy's husband Larry is a dentist. He also is an active stock market investor, and he spends a great deal of time studying investment data, making calculations, and placing buy and sell orders. In order to be able to do this without distraction, Larry has converted one of their home's four bedrooms into his own office. He doesn't use it for anything except investing, and neither Lucy nor their daughter ever enter Larry's home office. Larry has the same home office expenses as Lucy (listed in Question 14). Which if any of them may Larry deduct?
    a. None of them.
    b. All of them.
    c. I only.
    d. I and II.

<u>Vacation Homes</u>

Read (in Posin & Tobin) re Rental of Vacation or Second Homes

Pages 417 – 422

Internal Revenue Code provisions re Rental of Vacation or Second Homes

The Code section dealing with vacation and second home expenses is a long one. As the book points out, however, the tax treatment of such homes is one that frequently generates questions from family, friends and even mere acquaintances (pg 418 fn. 175). So having an understanding of this area of the law is likely to be useful to you.

§ 280A. Disallowance of certain expenses in connection with business use of home, rental of vacation homes, etc.

(a) *General rule*. Except as otherwise provided in this section, in the case of a taxpayer who is an individual . . . , no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

(b) *Exception for interest, taxes, casualty losses, etc.* Subsection (a) shall not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity).

(c) *Exceptions for certain business or rental use; limitation on deductions for such use*

. . .

(3) *Rental use*. Subsection (a) shall not apply to any item which is attributable to the rental of the dwelling unit or portion thereof (determined after the application of subsection (e)).

. . .

(5) *Limitation on deductions*. In the case of a use described in . . . paragraph (3) where the dwelling unit is used by the taxpayer during the taxable year as a residence, the deductions allowed under this chapter for the taxable year by reason of being attributed to such use shall not exceed . . . -

(A) the gross income derived from such use for the taxable year. . . .

(d) *Use as residence*

(1) *In general*. For purposes of this section, a taxpayer uses a dwelling unit during the taxable year as a residence if he uses such unit (or portion thereof) for personal purposes for a number of days which exceeds the greater of -

(A) 14 days, or

(B) 10 percent of the number of days during such year for which such unit is rented at a fair rental. For purposes of subparagraph (B), a unit shall not be treated as rented at a fair rental for any day for which it is used for personal purposes.

(2) *Personal use of unit*. For purposes of this section, the taxpayer shall be deemed to have used a dwelling unit for personal purposes for a day if, for any part of such day, the unit is used -

(A) for personal purposes by the taxpayer or any other person who has an interest in such unit, or by any member of the family (as defined in section 267(c)(4)) of the taxpayer or such other person;

(B) by any individual who uses the unit under an arrangement which enables the taxpayer to use some other dwelling unit (whether or not a rental is charged for the use of such other unit); or

(C) by any individual . . . unless for such day the dwelling unit is rented for a rental which, under the facts and circumstances, is fair rental. . . .

(3) *Rental to family member, etc., for use as principal residence*

(A) *In general*. A taxpayer shall not be treated as using a dwelling unit for personal purposes by reason of a rental arrangement for any period if for such period such dwelling unit is rented, at a fair rental, to any person for use as such person's principal residence.

. . .

(e) *Expenses attributable to rental*

(1) *In general*. In any case where a taxpayer who is an individual . . . uses a dwelling unit for personal purposes on any day during the taxable year (whether or not he is treated under this section as using such unit as a residence), the amount deductible under this chapter with respect to expenses attributable to the rental of the unit (or portion thereof) for the taxable year shall not exceed an amount which bears the same relationship to such expenses as the number of days during each year that the unit (or portion thereof) is rented at a fair rental bears to the total number of days during such year that the unit (or portion thereof) is used.

(2) *Exception for deductions otherwise allowable*. This subsection shall not apply with respect to deductions which would be allowable under this chapter for the taxable year whether or not such unit (or portion thereof) was rented.

(f) *Definitions and special rules*

(1) *Dwelling unit defined*. For purposes of this section -

(A) *In general*. The term "dwelling unit" includes a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to such dwelling unit.

(B) *Exception*. The term "dwelling unit" does not include that portion of a unit which is used exclusively as a hotel, motel, inn, or similar establishment.

. . .

(g) *Special rule for certain rental use*. Notwithstanding any other provision of this section . . . , if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, then -

(1) no deduction otherwise allowable under this chapter because of the rental use of such dwelling unit shall be allowed, and

(2) the income derived from such use for the taxable year shall not be included in the gross income of such taxpayer under section 61.

Questions re Rental of Vacation or Second Homes

4. Section 280A of the Code is a little tough to state in plain English, because it deals with several different sets of circumstances under which taxpayers own and use vacation homes. Nevertheless, with that qualification in mind, which of the following do you think best states the essence of that Code section?

    a. Taxpayers may deduct the expenses of owning and maintaining a vacation home to the same extent as they may deduct the expenses of owning and maintaining a principal residence.

    b. Taxpayers may deduct the expenses of owning and maintaining a vacation home to the same extent as they may deduct the expenses of owning and managing any other kind of investment.

    c. Taxpayers may not deduct any of the expenses of owning and maintaining a vacation home, because vacation home expenses are purely personal.

    d. Taxpayers may not deduct the expenses of owning and maintaining a vacation home (except expenses like property taxes that may be deducted by anyone), unless the vacation home is rented to others, in which case vacation home expenses may be deductible, at least in part.

5. Virginia Taxpayer owns and occupies her own home in Los Angeles. Virginia's parents used to live in Chicago (in a rented apartment), but when her father passed away last year, Virginia bought a condo near her own home, and rents to her mother. The condo is her mother's principal residence, and Virginia's mother pays Virginia a fair rental, though Virginia gives her mother a cash gift each month that covers the rent (and because the annual total of those gifts will exceed the gift tax exemption, Virginia will file a Gift Tax Return and pay a gift tax on the excess). May Virginia deduct the expenses of owning and maintaining the condo she rents to her mother?

    a. Yes, all of them, even if they exceed the amount of rent paid by her mother.

    b. Yes, all of them, but only up to the amount of rent paid by her mother.

    c. Only the property taxes.

    d. No, none of them.

6. Schuyler Taxpayer loves to ski, so he bought a condominium on slopes in Mammoth. He uses the condo himself 15 days a year, and rents it to others 175 days a year. (The rest of the year, the condo sits empty.) May Schuyler deduct the expenses of owning and maintaining the condo?

    a. Yes, all of them, even if they exceed the amount of rent he collects from those to whom he rents the condo.

    b. Yes, all of them, but only up to the amount of rent he collects from those to whom he rents the condo.

    c. Yes, but only 92.1% (i.e., 175/190's) of them, though the 92.1% is deductible even if it exceeds the amount of rent he collects from those to whom he rents the condo.

    d. Yes, but only 92.1% (i.e., 175/190's) of them, and only up to the amount of rent he collects from those to whom he rents the condo.

7. Teresa Taxpayer is a veteran school teacher. She lives in a home in Los Angeles, near the school where she teaches. But she spends the entire 12 weeks of summer, as well as the 2 weeks of Christmas, at a condo she owns in Pismo Beach, California (just south of San Lois Obispo). She doesn't want to let strangers occupy her condo, but a fellow teacher told Teresa that if she rented her condo – even just to other teachers – for a couple of weeks at the beginning and a couple of weeks at the end of the summer, the condo would become a "business" or "investment" so she would be able to deduct the cost of owning and maintaining the condo. Did Teresa get good advice?

    a. No. If Teresa occupies the condo herself 10 weeks a year (8 during the summer and 2 at Christmas), and rents it to others just 4 weeks a year, Teresa will not be able to deduct any of her condo expenses.

    b. Yes, sort of. If Teresa occupies the condo herself 10 weeks a year, and rents it to others 4 weeks a year, Teresa will be able to deduct some, though not all, of her condo expenses. She will be able to deduct 28.6% (4/14ths) of her expenses, though the 28.6% will be deductible even if it exceeds the amount of rent she collects from those to whom he rents the condo.

    c. Yes, sort of. If Teresa occupies the condo herself 10 weeks a year, and rents it to others 4 weeks a year, Teresa will be able to deduct some, though not all, of her condo expenses. She will be able to deduct 28.6% (4/14ths) of her expenses, so long as that amount doesn't exceed the amount of rent she collects from those to whom he rents the condo.

    d. Yes. If Teresa rents the condo to others 4 weeks a year, she will be able to deduct all of her condo expenses, even if they exceed the amount she collects in rent.

8. Teresa decided that she would rent her condo to others, but just for 2 weeks a year – 7 days at the beginning of the summer, and 7 days at the end, for a total of 14 days – while continuing to use it herself 12 weeks a year. May Teresa deduct any part of her condo expenses?

    a. No; and she'll have to include the rent that she collects in her gross income.

    b. Yes, she'll be able to deduct 14.3% (2/14ths) of her expenses; but she will have to include the rent that she collects in her gross income.

    c. No; but she will not have to include the rent that she collects in her gross income.

    d. Yes, she'll be able to deduct 14.3% (2/14ths) of her expenses; and she will not have to include the rent that she collects in her gross income.

<u>Gains (and Losses) on Sales of Homes</u>

Earlier, we covered the tax treatment of gains and losses of the sale of property, and the tax treatment of property divisions in connection with divorces. Now, we are going to combine aspects of those topics to consider the tax treatment of the gains and losses on the sale of a particular kind of property – homes – and the tax consequences of the sale of homes that were previously transferred by one spouse to the other in connection with their divorce.

Read (in Posin & Tobin) re Exclusions of Some Gains

Pages 210 - 217

Internal Revenue Code provision re Gains from Sales of Homes

§ 61. Gross income defined

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: . . .

(3) Gains derived from dealings in property. . . .

§ 121. Exclusion of gain from sale of principal residence

(a) Exclusion.—Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

(b) Limitations.—

(1) In general.—The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed $250,000.

(2) Special rules for joint returns.—In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

(A) $500,000 limitation for certain joint returns.—Paragraph (1) shall be applied by substituting "$500,000" for "$250,000" if —

(i) either spouse meets the ownership requirements of subsection (a) with respect to such property; [and]

(ii) both spouses meet the use requirements of subsection (a) with respect to such property; and

(iii) neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

(B) Other joint returns.—If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.

(3) Application to only 1 sale or exchange every 2 years.—

(A) In general.—Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

. . .

(c) Exclusion for taxpayers failing to meet certain requirements.—

(1) In general.—In the case of a sale or exchange to which this subsection applies, the ownership and use requirements of subsection (a), and subsection (b)(3), shall not apply; but the dollar limitation under paragraph (1) or (2) of subsection (b), whichever is applicable, shall be equal to—

(A) the amount which bears the same ratio to such limitation (determined without regard to this paragraph) as

(B)

(i) the shorter of—

(I) the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence; or

(II) the period after the date of the most recent prior sale or exchange by the taxpayer to which subsection (a) applied and before the date of such sale or exchange, bears to

(ii) 2 years.

(2) Sales and exchanges to which subsection applies.—This subsection shall apply to any sale or exchange if—

(A) subsection (a) would not (but for this subsection) apply to such sale or exchange by reason of—

(i) a failure to meet the ownership and use requirements of subsection (a), or

(ii) subsection (b)(3), and

(B) such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

. . .

(d) Special rules

(3) *Property owned by spouse or former spouse*. For purposes of this section -

(A) *Property transferred to individual from spouse or former spouse*. In the case of an individual holding property transferred to such individual in a transaction described in section 1041(a), the period such individual owns such property shall include the period the transferor owned the property.

(B) *Property used by former spouse pursuant to divorce decree, etc*. Solely for purposes of this section, an individual shall be treated as using property as such individual’s principal residence during any period of ownership while such individual’s spouse or former spouse is granted use of the property under a divorce or separation instrument. . . .

Questions re Gains from Sales of Homes

1. Wilma and her husband Hubert own a house in Los Angeles which they bought 15 years ago and have lived in continuously ever since. The house is now worth $400,000 more than they paid for it, and they may have to sell it. If they do, what will the tax consequences be?

    a. They will have a $400,000 gain, all of which will be taxable income to them.

    b. They will have a $400,000 gain, but only $150,000 will be taxable income to them, because the law permits them to exclude $250,000 of the gain from their taxable income.

    c. The will have a $400,000 gain, but none of it will be taxable income to them, because the law permits them to exclude all $400,000 from their taxable income, so long as they file a joint return the year the sell the house.

2. Wilma and Hubert also own a cabin in Lake Arrowhead which they bought 10 years ago and use on vacations. The cabin is now worth $100,000 more than they paid for it, and they may have to sell it too. If they do, what will the tax consequences be?

    a. They will have a $100,000 gain, all of which will be taxable income to them.

    b. They will have a $100,000 gain, but none of it will be taxable income to them, because the law permits them to exclude as much as $500,000 from their taxable income, so long as they file a joint return the year the sell the house, so even if they exclude $400,000 of the gain from the sale of the house in Los Angeles, they still have $100,000 "left over" that they may exclude from the sale of the cabin in Lake Arrowhead.

    c. They will have a $100,000 gain, but none of it will be taxable income to them, because the law permits them to exclude as much as $500,000 from their taxable income, so long as they file a joint return the year the sell the house and do not sell (or exclude gain from the sale of) their house in Los Angeles, because the law permits the exclusion of gains from the sale of only one house at a time.

3. The reason that Wilma and Hubert may have to sell their house and cabin is that they are getting divorced. They have a 14-year-old daughter, and Wilma would like to continue to live in the house in Los Angeles, at least until her daughter leaves for college in four years. Hubert, on the other hand, wants to sell the house immediately, before their divorce is final. (All of the rest of their assets are insignificant, so, sooner or later, the house has to be sold, and the gain divided between them.) As a matter of state family law, it is possible that a divorce court judge would permit Wilma and her daughter to stay in the house until the daughter leaves for college, at which time the house will be sold and proceeds split evenly between Wilma and Hubert. What would the tax consequences be, if the judge issued such an order and the house were sold – hopefully at a gain – four years from now, and four years after the divorce is final?

    a. All the gain would be taxable, in equal shares, to Wilma and Hubert, because by the time the house is sold, they no longer will be married and thus no longer will be eligible to file a joint return.

    b. Wilma will be able to exclude up to $250,000 of her gain, because she will have lived in the house continuously for the last 19 years; but Hubert will have to pay tax on his entire gain, because he will not have lived in the house for the last four years.

    c. Wilma and Hubert each will be able to exclude up to $250,000 of their gains.

4. Lucy and Larry Taxpayer are young, politically active lawyers who used to live in Los Angeles. Although they are married to one another, during the 2008 Presidencial campaign, Lucy supported Senator John McCain and Larry supported Senator Barak Obama. (When asked how they did this and kept their marriage together, they pointed to Mary Matalin and James Carvel, and said "The same way they do.") When Barak Obama won, Lucy and Larry moved to Washington, D.C., where she went to work for the new administration and he joined a big D.C. law firm. They bought their house in L.A. – the first either has ever owned – shortly before moving to D.C. In anticipation of their move, they sold the house, for $500,000 more than they paid for it. (Unlikely, I know, in this real estate market. But, hey, there you have it!) By coincidence, escrow closed exactly one year after they first moved into the house. What were the tax consequences to Carly from the sale of their?

    a. They had income of $500,000, because that was the amount of their gain.

    b. They had income of $500,000, because they didn't live in their house long enough to exclude their gain under section 121(a).

    c. They were able to exclude their entire $500,000 gain on the sale of their L.A. house, under section 121(b)(2)(A).

    d. They were able to exclude $250,000 of their gain, under section 121(c)(1) and (2).

5. Ollie and Ophilia Taxpayer are married and in their early 60s. Their children are grown; indeed, they're grandparents. Their house is now too big for them, so they're selling it, for $1 million. They bought the house for $500,000 in 1995 – before the Taxpayer Relief Act of 1997 added section 121 to the Internal Revenue Code and repealed what had been section 1034 – and they've lived in the house ever since. This isn't the first house that Ollie and Ophilia have owned. They bought their first house in 1975, for $100,000 and sold it for $500,000 in 1995. The sale of that first house, in fact, is where they got the money to buy the house they're selling now. Under what used to be section 1034 of the Internal Revenue Code, they didn't have to report the $400,000 gain from the sale of their first house as income, because they "rolled" that gain "over" into the house they're now selling. However, under section 1034, their $100,000 basis in their first house carried over – along with the cash – into the house they're now selling. So, the house they're selling now has a basis of $100,000, even though they paid $500,000 for it. What are the tax consequences of the sale of their house for $1 million?

    a. They will have no income from the $1 million sale of their house, because they paid $500,000 for it, and they will be able to exclude their $500,000 gain under sections 121(a) and 121(b)(2)(A) of the Internal Revenue Code.

    b. They will have $400,000 in income, because they will have a $900,000 gain on the sale of their house and will be able to exclude $500,000 of it under sections 121(a) and 121(b)(2)(A) of the Internal Revenue Code.

    c. They will have $900,000 in income on the sale of their house, because section 121 only applies to houses purchased after 1997 when that section was added to the Internal Revenue Code by the Taxpayer Relief Act. Their transaction is covered by section 1034 which was in effect when they bought the house they're now selling. And that section requires them to carry over the $100,000 basis of their first house.

    d. They will have $1 million in income, because that's the amount they are getting for their house.

Internal Revenue Code provisions and Regulations re Disallowance of Some Losses from the Disposition of Property

§ 165. Losses

(a) General rule.—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

. . .

(c) Limitation on losses of individuals.—In the case of an individual, the deduction under subsection (a) shall be limited to
  (1) losses incurred in a trade or business;
  (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
  (3) except as provided in subsection (h) [which limits the amount that may be deducted for casualty losses], losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

Reg. § 1.165-9 Sale of residential property

(a) Losses not allowed. A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a).

(b) Property converted from personal use.
  (1) If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under section 165(a).
  (2) The loss allowed under this paragraph upon the sale of the property shall be the excess of the adjusted basis prescribed in §1.1011–1 for determining loss over the amount realized from the sale. For this purpose, the adjusted basis for determining loss shall be the lesser of either of the following amounts, adjusted as prescribed in §1.1011–1 for the period subsequent to the conversion of the property to income-producing purposes:
    (i) The fair market value of the property at the time of conversion, or
    (ii) The adjusted basis for loss, at the time of conversion, determined under §1.1011–1 but without reference to the fair market value.

Questions re Disallowance of Some Losses

6. Carly Taxpayer is a successful recording artist. Two years ago, she bought a Cadillac Escalade SUV for her personal use. She liked the Escalade quite a lot, but when fans began criticizing her for driving a gas guzzler, she sold it. The Escalade was in perfect condition; but because of the increase in the price of gas, Carly had to sell it for $30,000 less than she paid for it. What are the tax consequences of her loss on the sale of the Escalade?

    a. Despite section 165(c) of the Internal Revenue Code, she will be able to deduct the $30,000 loss under section 165(a), *if* she can persuade the IRS that even though the car was for her personal use, she really used it for business, or she expected to resell it for a profit, or that the run-up in the price of gas was a "casualty"; and her chances of doing that are good.

    b. Despite section 165(c) of the Internal Revenue Code, she would be able to deduct the $30,000 loss, *if* she could persuade the IRS that even though the car was for her personal use, she really used it for business, or she expected to resell it for a profit, or that the run-up in the price of gas was a "casualty"; but her chances of doing that are somewhere between poor and none.

    c. Section 165(c) appears to prevent her from deducting the loss. But that's an unconstitutional denial of equal protection, because if – instead of being a recording artist – she was in the limo business, or even the pizza delivery business, and she used the Escalade for business, she'd be able to deduct the loss under section 165(a). Moreover, recording artists are a suspect class, which means they can't be discriminated against except for compelling reasons – of which there are none, insofar as Carly's loss on the sale of her Escalade are concerned.

    d. None of the above.

7. After Carly Taxpayer sold her Cadillac Escalade, she bought a previously-owned Toyota Prius Hybrid for her personal use. She didn't like it, however (too small), so she sold it. Because of the increase in the price of gas, she was able to sell the Prius for $1,000 *more* than she paid for it! What are the tax consequences of her gain on the sale of the Prius?

    a. She has $1,000 in income.

    b. She has income in the full amount for which she sold the Prius.

    c. She has no income, because the Prius was for her personal use, and the sale of personal use property is not a taxable event, regardless of whether the sale was at a gain or a loss.

    d. She has no income, because section 121(a) of the Internal Revenue Code permits her to exclude her $1,000 gain.

8. Until earlier this year, Carly Taxpayer's personal residence was a fancy condominium in Beverly Hills. She bought it a few years ago for $2 million, and she used it often to entertain her music business friends and associates. Unfortunately, Carly's parties were noisy, drunken affairs; and the Condo Owners Association threatened to take action against her for violating the CC&R's. As a result, Carly decided to sell the condo. However, as a result of the mortgage meltdown and a new and very fancy condo under construction in nearby Century City, the best offer she has been able to get for her condo is $1.5 million. Carly's realtor told her that $1.5 million is likely to be the best price she'll be able to get, for years to come; so naturally, the realtor would like Carly to sell, now. What are the tax consequences to Carly, if she sells her condo for $1.5 million?

    a. She will be able to deduct her $500,000 loss under section 165(a) of the Internal Revenue Code.

    b. She will be able to deduct her $500,000 loss under section 165(a) of the Internal Revenue Code, but only because the condo is her principal residence.

    c. She will not be able to deduct her $500,000 loss, because of section 165(c) of the Internal Revenue Code and section 1.165-9 of the Regulations.

    d. None of the above.

9. Although Carly's realtor told Carly that $1.5 million is the best price she'll get for years to come, another realtor – one who specializes in condo rentals – told Carly that the value of her condo is likely to go back to $2 million or more in a couple of years. That realtor suggested that Carly rent the condo for a year or two, and then put it back on the market. If Carly does rent the condo for a year or two, and then sells it for $1.5 million (because it turns out that her original realtor was right), what will the tax consequences be to Carly?

    a. She will be able to deduct her $500,000 loss under section 165(a) of the Internal Revenue Code and section 1.165-9 of the Regulations.

    b. She will not be able to deduct her $500,000 loss under section 165(a) of the Internal Revenue Code, because the condo will no longer be her principal residence by the time she actually sells it.

    c. She will not be able to deduct her $500,000 loss, because of section 165(c) of the Internal Revenue Code and section 1.165-9 of the Regulations.

    d. None of the above.

10. Suppose that when Wilma and Hubert (the folks from Question 1 above) sell the Los Angeles house in four years, they sell it for $600,000 *more* than they originally paid for it 19 years before. Suppose also that the same year they sell the house at a gain, each of them also sells some stock at a *loss*. May they deduct their loss on the stock from their gain on the house?

    a. Yes.

    b. No.

11. Suppose that when Wilma and Hubert sell the Los Angeles house in four years, they sell it for *less* than they originally paid for it 19 years before. (It's a shocking thought, I know; but consider it nonetheless, for the sake of your tax education.) Suppose also that the same year they sell the house at a loss, each of them also sells some stock at a *gain*. May they deduct their loss on the house from their gain on the stock?

    a. Yes.

    b. No.

EDUCATION

Scholarships

Read (in Posin & Tobin) re Scholarships

Pages 118-121

Internal Revenue Code provisions re Scholarships

§ 117. Qualified scholarships

(a) General rule.—Gross income does not include any amount received as a qualified scholarship by an individual who is a candidate for a degree at an educational organization . . .

(b) Qualified scholarship.—For purposes of this section—

(1) In general.—The term "qualified scholarship" means any amount received by an individual as a scholarship or fellowship grant to the extent the individual establishes that, in accordance with the conditions of the grant, such amount was used for qualified tuition and related expenses.

(2) Qualified tuition and related expenses.—For purposes of paragraph (1), the term "qualified tuition and related expenses" means-

(A) tuition and fees required for the enrollment or attendance of a student at an educational organization . . . , and

(B) fees, books, supplies, and equipment required for courses of instruction at such an educational organization.

(c) Limitation.—

(1) In general.—. . . subsections (a) and (d) shall not apply to that portion of any amount received which represents payment for teaching, research, or other services by the student required as a condition for receiving the qualified scholarship or qualified tuition reduction.

. . .

(d) Qualified tuition reduction.-

(1) In general.—Gross income shall not include any qualified tuition reduction.

(2) Qualified tuition reduction.—For purposes of this subsection, the term "qualified tuition reduction" means the amount of any reduction in tuition provided to an employee of an [educational] organization . . . for the education (below the graduate level) at such organization. . . .

(3) Reduction must not discriminate in favor of highly compensated, etc.—Paragraph (1) shall apply with respect to any qualified tuition reduction provided with respect to any highly compensated employee only if such reduction is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees. . . .

(5) Special rules for teaching and research assistants.—In the case of the education of an individual who is a graduate student . . . who is engaged in teaching or research activities for such organization, paragraph (2) shall be applied as if it did not contain the phrase "(below the graduate level)".

Reg. § 1.117-4 Items not considered as scholarships or fellowship grants
The following payments or allowances shall not be considered to be amounts received as a scholarship or a fellowship grant for the purpose of section 117:
. . .
(c) Amounts paid as compensation for services or primarily for the benefit of the grantor.
 (1) . . . any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, if such amount represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor.
 (2) . . . However, amounts paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research are considered to be amounts received as a scholarship or fellowship grant for the purpose of section 117 if the primary purpose of the studies or research is to further the education and training of the recipient in his individual capacity and the amount provided by the grantor for such purpose does not represent compensation or payment for the services described in subparagraph (1) of this paragraph. . . .

§ 127. Educational assistance programs
(a) Exclusion from gross income.—
 (1) In general.—Gross income of an employee does not include amounts paid or expenses incurred by the employer for educational assistance to the employee if the assistance is furnished pursuant to a program which is described in subsection (b).
 (2) $5,250 maximum exclusion.—If, but for this paragraph, this section would exclude from gross income more than $5,250 of educational assistance furnished to an individual during a calendar year, this section shall apply only to the first $5,250 of such assistance so furnished.
(b) Educational assistance program. . . .
(c) Definitions; special rules.—For purposes of this section—
 (1) Educational assistance.—The term "educational assistance" means—
  (A) the payment, by an employer, of expenses incurred by or on behalf of an employee for education of the employee (including, but not limited to, tuition, fees, and similar payments, books, supplies, and equipment), and
  (B) the provision, by an employer, of courses of instruction for such employee (including books, supplies, and equipment),
 but does not include payment for, or the provision of, tools or supplies which may be retained by the employee after completion of a course of instruction, or meals, lodging, or transportation. The term "educational assistance" also does not include any payment for, or the provision of any benefits with respect to, any course or other education involving sports, games, or hobbies.
 (2) Employee.—The term "employee" includes, for any year, an individual who is . . . (. . . self-employed . . .).
 (3) Employer.—An individual who owns the entire interest in an unincorporated trade or business shall be treated as his own employer. A partnership shall be treated as the employer of each partner who is an employee within the meaning of paragraph (2).

Questions re Scholarships

1. Golden State University charges $30,000 a year in tuition, but it has a tuition reduction program for its employees, so they have to pay just $5,000 in tuition. Felicity works for the University as an assistant in the Registrar's office. She is enrolled in the University as a part-time undergraduate Political Science student. She is taking advantage of the University's tuition reduction program and is paying just $5,000 a year in tuition. Does Felicity have any income as a result of her *tuition reduction*?
    a. No.
    b. Yes, she has $25,000 a year in income.
    c. Yes, she has $19,750 ($25,000 - $5,250 = $19,750) a year in income.
    d. Yes, she has $5,000 a year in income.
2. When Felicity gets her Bachelor's degree from Golden State University, she hopes to enroll in the University's law school evening program, because Golden State's tuition reduction program applies to its graduate schools too. If she does that, will she have any income as a result of her *tuition reduction*?
    a. No.
    b. Yes, she has $25,000 a year in income.
    c. Yes, she has $19,750 ($25,000 - $5,250 = $19,750) a year in income.
    d. Yes, she has $5,000 a year in income.
3. Would your answer to Question 2 be the same or different, if, when she enrolls in law school, she changes jobs so that she no longer works as an assistant in the Registrar's office but instead works as a Teaching Assistant in the Political Science Department?
    a. The same.
    b. Different. Under these circumstances, she would have $25,000 a year in income.
    c. Different. Under these circumstances, she would have $19,750 a year in income.
    d. Different. Under these circumstances, she would have no income.

4. Sam Student is a 3L at Southwestern Law School. Sam has a full-tuition scholarship. In addition, he is a Research Assistant for a Southwestern professor and is paid by the hour for the research he does for that professor. Sam uses some of the money he earns as a research assistant to buy his books, and he uses the rest to pay his apartment rent. Here are some *possible* ways the law could treat Sam's scholarship and research assistant pay:

   (I) The scholarship is income.

   (II) The scholarship is not income.

   (III) All of the money he earns as a research assistant is income.

   (IV) None of the money he earns as a research assistant is income.

   Which of those possibilities actually is the law?

   a. I and III.
   b. I and IV.
   c. II and III.
   d. II and IV.

5. At page 121 of the Posin & Tobin book, a Westinghouse engineer named Phil goes back to Carnegie Mellon for a Ph.D., and Westinghouse pays $15,000 towards his tuition and books. Posin & Tobin wrote that the $15,000 will be income to Phil, if he is required to return to Westinghouse after getting his degree, and maybe even if he isn't required to return. Why isn't the $15,000 a scholarship or an educational assistance program payment, and thus *not* income to Phil?

   a. Because it doesn't satisfy the requirements of § 117(b).
   b. Because it is disqualified by § 117(c)(1).
   c. Because it is disqualified by Regulation § 1.117-4(c).
   d. Actually, Posin & Tobin may have exaggerated the extent to which it is income to Phil. Under § 127(a), only $9,750 of the $15,000 will be income to him, and the remaining $5,250 will not be income, if Westinghouse paid the $15,000 pursuant to a program that satisfies the requirements of § 127(b).

<u>Education Expenses</u>

Read (in Posin & Tobin) re Education Expenses

Pages 384 – 388

Internal Revenue Code and Regulation provisions re Education Expenses

§ 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

Reg. § 1.162-5 Expenses for education

(a) *General rule.* Expenditures made by an individual for education . . . which are not expenditures of a type described in paragraph (b)(2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education—

(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

(b) *Nondeductible educational expenditures*—

(1) *In general*. Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual's employer or of applicable law or regulations.

(2) *Minimum educational requirements*.

(i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. . . .

(iii) The application of this subparagraph may be illustrated by the following examples:

. . .

Example (3). E, who has completed 2 years of a normal 3-year law school course leading to a bachelor of laws degree (LL.B.), is hired by a law firm to do legal research and perform other functions on a full-time basis. As a condition to continued employment, E is required to obtain an LL.B. and pass the State bar examination. E completes his law school education by attending night law school, and he takes a bar review course in order to prepare for the State bar examination. The law courses and bar review course constitute education required to meet the minimum educational requirements for qualification in E's trade or business and, thus, the expenditures for such courses are not deductible.

(3) *Qualification for new trade or business*.

(i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. . . .

(ii) The application of this subparagraph to individuals other than teachers may be illustrated by the following examples:

Example (1). A, a self-employed individual practicing a profession other than law, for example, engineering, accounting, etc., attends law school at night and after completing his law school studies receives a bachelor of laws degree. The expenditures made by A in attending law school are nondeductible because this course of study qualifies him for a new trade or business.

Example (2). Assume the same facts as in example (1) except that A has the status of an employee rather than a self-employed individual, and that his employer requires him to obtain a bachelor of laws degree. A intends to continue practicing his nonlegal profession as an employee of such employer. Nevertheless, the expenditures made by A in attending law school are not deductible since this course of study qualifies him for a new trade or business.

. . .

(c) *Deductible educational expenditures—*

(1) *Maintaining or improving skills.* The deduction under the category of expenditures for education which maintains or improves skills required by the individual in his employment or other trade or business includes refresher courses or courses dealing with current developments as well as academic or vocational courses provided the expenditures for the courses are not within either category of nondeductible expenditures described in paragraph (b) (2) or (3) of this section.

. . .

(d) *Travel as a form of education.* Subject to the provisions of paragraph (b) and (e) of this section, expenditures for travel (including travel while on sabbatical leave) as a form of education are deductible only to the extent such expenditures are attributable to a period of travel that is directly related to the duties of the individual in his employment or other trade or business. For this purpose, a period of travel shall be considered directly related to the duties of an individual in his employment or other trade or business only if the major portion of the activities during such period is of a nature which directly maintains or improves skills required by the individual in such employment or other trade or business. The approval of a travel program by an employer or the fact that travel is accepted by an employer in the fulfillment of its requirements for retention of rate of compensation, status or employment, is not determinative that the required relationship exists between the travel involved and the duties of the individual in his particular position.

(e) *Travel away from home.*

(1) If an individual travels away from home primarily to obtain education the expenses of which are deductible under this section, his expenditures for travel, meals, and lodging while away from home are deductible. However, if as an incident of such trip the individual engages in some personal activity such as sightseeing, social visiting, or entertaining, or other recreation, the portion of the expenses attributable to such personal activity constitutes nondeductible personal or living expenses and is not allowable as a deduction. If the individual's travel away from home is primarily personal, the individual's expenditures for travel, meals and lodging (other than meals and lodging during the time spent in participating in deductible education pursuits) are not deductible. Whether a particular trip is primarily personal or primarily to obtain education the expenses of which are deductible under this section depends upon all the facts and circumstances of each case. An important factor to be taken into consideration in making the determination is the relative amount of time devoted to personal activity as compared with the time devoted to educational pursuits. . . .

(2) *Examples.* The application of this subsection may be illustrated by the following examples:

Example (1). A, a self-employed tax practitioner, decides to take a 1-week course in new developments in taxation, which is offered in City X, 500 miles away from his home. His primary purpose in going to X is to take the course, but he also takes a side trip to City Y (50 miles from X) for 1 day, takes a sightseeing trip while in X, and entertains some personal friends. A's transportation expenses to City X and return to his home are deductible but his transportation expenses to City Y are not deductible. A's expenses for meals and lodging while away from home will be allocated between his educational pursuits and his personal activities. Those expenses which are entirely personal, such as sightseeing and entertaining friends, are not deductible to any extent.

Example (2). The facts are the same as in example (1) except that A's primary purpose in going to City X is to take a vacation. This purpose is indicated by several factors, one of which is the fact that he spends only 1 week attending the tax course and devotes 5 weeks entirely to personal activities. None of A's transportation expenses are deductible and his expenses for meals and lodging while away from home are not deductible to the extent attributable to personal activities. His expenses for meals and lodging allocable to the week attending the tax course are, however, deductible.

§ 274. Disallowance of certain entertainment, etc., expenses

(m) Additional limitations on travel expenses

. . .

(2) Travel as form of education. No deduction shall be allowed under this chapter for expenses for travel as a form of education.

§ 222. Qualified tuition and related expenses

(a) Allowance of deduction. In the case of an individual, there shall be allowed as a deduction an amount equal to the qualified tuition and related expenses paid by the taxpayer during the taxable year.

(b) Dollar limitations

(1) In general. The amount allowed as a deduction under subsection (a) with respect to the taxpayer for any taxable year shall not exceed the applicable dollar limit.

(2) Applicable dollar limit

. . .

(B) After 2003. In the case of any taxable year beginning after 2003, the applicable dollar amount shall be equal to -

(i) in the case of a taxpayer whose adjusted gross income for the taxable year does not exceed $65,000 ($130,000 in the case of a joint return), $4,000,

(ii) in the case of a taxpayer not described in clause (i) whose adjusted gross income for the taxable year does not exceed $80,000 ($160,000 in the case of a joint return), $2,000, and

(iii) in the case of any other taxpayer, zero.

Questions re Education Expenses

6. Tyrone Taxpayer is Los Angeles real estate lawyer. This year he attended a two-day CLE program In New York City about bankruptcy law. He attended the program because more and more of his real estate developer clients are insolvent themselves or are dealing with debtors who are going bankrupt. The program also satisfied Continuing Legal Education requirements imposed on Tyrone by the California State Bar. While in New York, Tyrone had dinner one evening with his old college roommate who now lives there. Tyrone incurred expenses:

   I. to register for the program,

   II. to travel to New York City by air (he flew business class, rather than coach)

   III. for three nights' lodging in a hotel (the night before the program began, and the two nights of the program), and

   IV. meal expenses (for all meals except the dinner he had with his roommate, because his roommate picked up the check).

   Which, if any, of his expenses will Tyrone be able to deduct?

   a. All of them.

   b. I, some of II, some of III, and IV.

   c. I only.

   d. None of them.

7. Tyra Taxpayer is an accountant in Los Angeles where she works for a large accounting firm. She also attends law school at night, where she is taking (or will) all of the tax courses her law school offers. She is going to law school to improve her skills and to qualify for a promotion in her accounting firm. She intends to stay with her accounting firm even after she graduates from law school; she does not, in other words, intend to join a law firm or open her own law office. Naturally, Tyra is spending a good deal of money for tuition and books. Being a tax accountant, she knows, of course, whether she is permitted to deduct her tuition and book expenses. What is it that she knows?
   a. Her tuition and book expenses are fully deductible, because she is incurring them in order to improve her skills and qualify for a promotion – not to change her profession.
   b. None of her tuition and book expenses are deductible, because even though she does not intend to practice law, her law school education will make her eligible for a promotion within her accounting firm.
   c. None of her tuition and book expenses are deductible, because even though she does not intend to practice law, her law school education will make her eligible to practice law, which is a different profession from accounting.
   d. She will not be able to deduct all of her tuition and book expenses, because even though she does not intend to practice law, her law school education will make her eligible to practice law, which is a different profession from accounting; but she will be able to deduct: $4,000 a year of those expenses, if she currently earns less than $65,000 a year; or $2,000 a year of those expenses, if she currently earns less than $80,000 a year. If she earns $80,000 or more a year, answer "c" is correct.
8. Shana Student is a J.D. candidate who is now in her third year of law school. She has enjoyed her tax courses very much, and she has decided she would like to be a tax lawyer. She also has decided that an LLM in tax law would be very useful to her in achieving that goal. She hasn't decided yet whether to enroll in an LLM program: immediately after getting her J.D. degree, and thus before she begins practicing law at all; or after practicing law for a year or two. Are there any *tax*-related factors she should consider in deciding when to enroll in an LLM program?
   a. No, not any *tax*-related factors. This is strictly a career-planning decision.
   b. No, not any *tax*-related factors. She'll be able to deduct $4,000 of her tuition and book expenses for the LLM program – but no more – regardless of whether she enrolls in the LLM program immediately after getting her J.D. degree or later.
   c. Yes. She should consider whether enrolling in an LLM program immediately after getting her J.D. degree would result in her LLM studies being classified, for tax purposes, as education that qualifies her for what would be for her a new trade or business, while practicing for a year or two before enrolling in the LLM program would enable her to deduct her tuition and book expenses.
   d. Answer "c" may be an intelligent one. But whether it's relevant to Shana would depend on whether she will have any income while enrolled in an LLM program, from which to deduct her LLM tuition and book expenses. If she'll be studying for an LLM full-time and thus not working, and if she doesn't have any other income from which to deduct her LLM tuition and book expenses, then it won't matter whether or not they are deductible; and answer "a" (or if she has only a small income, answer "b") would be right *for her*.

9. Artemis Taxpayer is a history professor whose specialty is the Middle Ages, and especially the history of the Knights Templar. During his last sabbatical, Artemis traveled to Europe to do research about the locations in which the Knights Templar were active. His travels were strictly for research. His wife didn't travel with him. The only places he visited were those where the Knight Templars were active. He incurred substantial expenses, but only because the dollar-Euro exchange rate made Europe an expensive place for Americans; Artemis stayed in modest hotels and ate in modest restaurants. Are his expenses deductible educational expenses?

    a. Yes, under Reg. § 1.162-5(d).

    b. No, because of Code § 274(m)(2).

    c. I haven't a clue.

    d. I have another answer.

<u>Student Loan Interest</u>

Internal Revenue Code provisions re Student Loan Interest

§ 163. Interest

(h) Disallowance of deduction for personal interest

(1) In general. In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

§ 62. Adjusted gross income defined

(a) General rule.—For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

. . .

(17) Interest on education loans.—The deduction allowed by section 221.

§ 221. Interest on education loans

(a) Allowance of deduction. In the case of an individual, there shall be allowed as a deduction for the taxable year an amount equal to the interest paid by the taxpayer during the taxable year on any qualified education loan.

(b) Maximum deduction

(1) In general. Except as provided in paragraph (2), the deduction allowed by subsection (a) for the taxable year shall not exceed the amount determined in accordance with the following table:

In the case of taxable years beginning in:	The dollar amount is:
. . .	
2001 or thereafter	$2,500.

(2) Limitation based on modified adjusted gross income

(A) In general. The amount which would (but for this paragraph) be allowable as a deduction under this section shall be reduced (but not below zero) by the amount determined under subparagraph (B).

(B) Amount of reduction. [This subparagraph reduces the $2,500 cap on interest deduction, if the taxpayer's "modified adjusted gross income" is greater than $100,000 (for married taxpayers) or $50,000 (for single taxayers).]

Question re Student Loan Interest

10. If you (and by "you," I mean *you*, the person who is reading this right now) borrowed money this year to pay tuition to attend law school, may you deduct the interest you'll be paying on your loan?

    a. Alas, no, because interest on student loans is personal interest that is not deductible under §163(h)(1).

    b. Yes, but it'll be a below the line deduction.

    c. Yes, though I won't be able to deduct more than $2,500 in interest per year, (unless my modified adjusted gross income is too great – though how can my income ever be "too" great? – in which case my deduction will be less than $2,500). And it'll be an *above* the line deduction, to boot!

    d. It'll be deductible only if my student loan was secured by a deed of trust on my principal residence, and only if I don't have more than $100,000 in loans secured in that fashion.

<u>HOPE Scholarship and Lifetime Earning Credits</u>

Read (in Posin & Tobin) re HOPE Scholarship and Lifetime Earning Credits

Pages 644 – 646

Questions re HOPE Scholarship and Lifetime Earning Credits

11. Are you eligible for either of these credits? If so, which one?

    a. No, as to both.

    b. Yes, as to both.

    c. No as to the HOPE Scholarship Credit; yes as to the Lifetime Learning Credit.

    d. No as to the Lifetime Leanring Credict; yes as to the HOPE Scholarhips Credit.

TRAVEL EXPENSES

<u>Business Travel Expenses</u>

Read (in Posin & Tobin)

Pages 370 – 380

Internal Revenue Code provisions re Business Travel and Transportation Expenses

> **§ 162. Trade or business expenses**
>
> (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including –
>
> . . .
>
> (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business;
>
> . . . For purposes of paragraph (2), the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. The preceding sentence shall not apply to any Federal employee during any period for which such employee is . . . traveling on behalf of the United States in temporary duty status to investigate or prosecute, or provide support services for the investigation or prosecution of, a Federal crime.

Questions re Business Travel and Transportation Expenses

1. Thelma Taxpayer is employed by the federal government as a civilian accountant at a commissary located in the center of the nation's largest Army base. She is not permitted to live on the base, because she's a civilian. Thelma resides as close to her workplace as possible; but because the base is so large, she has to, and does, live 50 miles from the commissary. Thelma drives her own car to and from work, and her commuting expenses are substantial. Which of the following is true?

   a. Because Thelma's commuting expenses are both ordinary and necessary, she may deduct them as expenses incurred in her trade as an "accountant."

   b. Because Thelma's commuting expenses are both ordinary and necessary, she may deduct them as "traveling expenses," because the distance between her home and the commissary is so great that she is "away from home" whenever she is at work.

   c. Thelma may deduct her commuting expenses, because she drives her own car, and auto expenses are deductible.

   d. Thelma may not deduct her commuting expenses, because commuting expenses are not deductible, no matter how far an employee lives from work, or how far a self-employed person lives from his or her place of business.

2. Thelma Taxpayer's husband Tommy also is an accountant. Tommy is self-employed. Tommy's office is just a mile from their home, but he meets his clients at their business premises; he doesn't make them come to his office. Unfortunately, Tommy's clients are located far from his office, and he incurs substantial travel expenses driving (in his own car) to their places of business. Which of the following is true about the expenses he incurs driving from his office to his clients' places of business?

    a. Because Tommy's driving expenses are both ordinary and necessary, he may deduct them as expenses incurred in his trade as an accountant.

    b. Because Tommy's driving expenses are both ordinary and necessary, he may deduct them as "traveling expenses," because the distance between his home and his clients is so great that he is "away from home" whenever he visits his clients.

    c. Tommy may deduct his driving expenses, because he drives his own car, and auto expenses are deductible.

    d. Tommy may not deduct his driving expenses, because even though he has his own office, these expenses were incurred commuting to his clients' places of business; and commuting expenses are not deductible.

3. Regardless of your answer to Question 2, Tommy did take a deduction for his driving expenses, claiming those expenses are ordinary and necessary and were incurred in his trade as an accountant (i.e., answer "a" above). The IRS is auditing Tommy, and wants to know what his legal authority is for the deduction that he took. Which of the following arguments do you think is the best?

    a. Code § 162(a), dealing with trade or business expenses "In general," from the words "There shall be allowed" up to (but not including) the word "including."

    b. Code § 162(a)(2), dealing with "traveling expenses" in particular, reading it exactly as it written.

    c. Code § 162(a)(2), dealing with "traveling expenses" in particular, reading it *as though* the closing parentheses came after the word "home" rather than after the word "circumstances."

    d. I have a better argument than any of those above.

4. Tommy often eats dinner away from home, in restaurants, by himself, because his clients are located too far from his home for him to get home in time for dinner. He does, however, come home each evening; he doesn't stay away from home overnight. Which of the following is true?

   a. He may deduct the cost of his dinners as a "traveling expense," so long as the costs are not lavish or extravagant.

   b. He may deduct the cost of his dinners as a "traveling expense," even if the costs are lavish or extravagant, because the costs are actually incurred by him, and because the IRS does not inquire into the *reasonableness* of actually-incurred business expenses. It only looks at whether they are "ordinary and necessary"; and eating dinner is both.

   c. He is not permitted to deduct the cost of his dinners as a "traveling expense" or otherwise, because he comes home each evening. If his clients were located so far from his home that he had to stay overnight in a hotel, he would be able to deduct both his hotel expenses and his meal costs – breakfast, lunch and dinner!

   d. He is not permitted to deduct the cost of his dinners as a "traveling expense" or otherwise, because he chose where to live, and chose clients despite where their businesses were located. So his dinners are not a "necessary" expense; he could have lived closer or chosen clients who were closer.

5. Polly and Peter Taxpayer both are lawyers. Polly is a federal prosecutor. Peter is a law professor. Their permanent home is in Los Angeles. But the Department of Justice sent Polly to Tucson, to investigate and prosecute a Federal crime. Peter, who ordinarily teaches at a law school in Los Angeles, was offered and accepted a Visiting Professor position at the University of Arizona School of Law. Originally, Polly thought her assignment would last no more than nine months, so originally Peter's Visiting Professorship was for one school year (from August through May). As things turned out, however, the investigation and prosecution has taken well over a year; and Polly's assignment in Tucson isn't completed yet. Fortunately, the University of Arizona was happy to have Peter, and it has extended his Visitorship for a second year. Polly and Peter deducted all of their travel, meal and house rental expenses in Tucson for their first year there, and they plan to do likewise for their second year. Their home in Los Angeles is being occupied by a professor who is visiting at Peter's home school. Which of the following is true?

    a. They shouldn't have deducted their first year expenses, and should not deduct their second year expenses either, because these are not "travel expenses." They have relocated from Los Angeles to Tucson, even if temporarily; and these expenses are simply the same expenses they would have had, if they had stayed in L.A.

    b. They shouldn't have deducted their first year expenses, and should not deduct their second year expenses either, because these are not expenses they incurred in a "trade or business." Both are employees; they are not engaged in a trade or business.

    c. They shouldn't have deducted their first year expenses, and should not deduct their second year expenses either, because as things turned out, they will be away from home for a period that exceeds a year, and § 162(a)(2) provides that taxpayers "shall not be treated as being temporarily away from home *during any period of employment* if such period exceeds 1 year."

    d. They properly deducted all of Polly's first year expenses, and may deduct Polly's second year expenses, but they may not deduct Peter's second year expenses and they may not be able to deduct his first year expenses either.

Business vs. Pleasure Travel Expenses

Read (in Posin & Tobin)

Pages 394 – 396

The law recognizes that some travel is done for two purposes: business *and* pleasure. In dual-purpose travel cases, we saw that the "Expenses for education" Regulations provide that such expenses may be *partially* deductible. (Reg. § 1.162-5(e), in Study Guide 27 at page 27.7)

I'm sure it won't surprise you to learn that travel expenses may be partially deductible even when they are incurred for reasons other than education. Indeed, as you'll read below, where expenses are incurred for *foreign* travel, the Code specifically provides for an allocation between deductible business-related travel expenses and non-deductible personal travel expenses.

The overarching question to be considered now is whether the *allocation* between

- deductible business or education expenses, and
- non-deductible personal travel expenses

is done the same, or differently, in connection with

- travel for education
- other domestic travel, and
- foreign travel.

Internal Revenue Code provisions re Business vs. Travel Expenses

Reg. § 1.162-2 Traveling expenses

(b)(1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

(2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

§ 274. Disallowance of certain entertainment, etc., expenses

. . .

(c) Certain foreign travel

(1) In general. In the case of any individual who travels outside the United States away from home in pursuit of a trade or business or in pursuit of an activity described in section 212, no deduction shall be allowed under section 162, or section 212 for that portion of the expenses of such travel otherwise allowable under such section which, under regulations prescribed by the Secretary, is not allocable to such trade or business or to such activity.

(2) Exception. Paragraph (1) shall not apply to the expenses of any travel outside the United States away from home if -

(A) such travel does not exceed one week, or

(B) the portion of the time of travel outside the United States away from home which is not attributable to the pursuit of the taxpayer's trade or business or an activity described in section 212 is less than 25 percent of the total time on such travel.

(3) Domestic travel excluded. For purposes of this subsection, travel outside the United States does not include any travel from one point in the United States to another point in the United States.

Reg. § 1.274-4 Disallowance of certain foreign travel expenses

(a) *Introductory.* Section 274(c) and this section impose certain restrictions on the deductibility of travel expenses incurred in the case of an individual who, while traveling outside the United States away from home in the pursuit of trade or business (hereinafter termed "business activity"), engages in substantial personal activity not attributable to such trade or business (hereinafter termed "nonbusiness activity"). . .

(b) *Limitations on application of section.* The restrictions on deductibility of travel expenses contained in paragraph (f) of this section are applicable only if:

(1) The travel expense is otherwise deductible under section 162 or 212 and the regulations thereunder,

(2) The travel expense is for travel outside the United States away from home which exceeds 1 week . . . , and

(3) The time outside the United States away from home attributable to nonbusiness activity . . . constitutes 25 percent or more of the total time on such travel.

. . .

(f) *Application of disallowance rules—*

(1) *In general.* In the case of expense for travel outside the United States away from home by an individual to which this section applies. . . , no deduction shall be allowed for that amount of travel expense . . . which is obtained by multiplying the total of such travel expense by a fraction:

(i) The numerator of which is the number of nonbusiness days during such travel, and

(ii) The denominator of which is the total number of business days and nonbusiness days during such travel.

. . .

(5) *Travel expense deemed entirely allocable to business activity.* Expenses of travel shall be considered allocable in full to business activity, and no portion of such expense shall be subject to disallowance under this section, if incurred under circumstances provided for in subdivision . . . (ii) of this subparagraph.

(ii) *Lack of major consideration to obtain a vacation.* Any expense of travel, which qualifies for deduction under section 162 or 212, shall be considered fully allocable to business activity if the individual incurring such expenses can establish that, considering all the facts and circumstances, he did not have a major consideration, in determining to make the trip, of obtaining a personal vacation or holiday. If such a major consideration were present, the provisions of subparagraph[] (1) . . . of this paragraph shall apply. However, if the trip were primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. . . .

. . .

(g) *Examples.* The application of this section may be illustrated by the following examples:

Example 1. Individual A flew from New York to Paris where he conducted business for 1 day. He spent the next 2 days sightseeing in Paris and then flew back to New York. The entire trip, including 2 days for travel en route, took 5 days. Since the time outside the United States away from home during the trip did not exceed 1 week, the disallowance rules of this section do not apply.

. . .

Example 3. Individual C flew from Los Angeles to New York where he spent 5 days. He then flew to Brussels where he spent 14 days on business and 5 days on personal matters. He then flew back to Los Angeles by way of New York. The entire trip, including 4 days for travel en route, took 28 days. However, the 2 days spent traveling from Los Angeles to New York and return, and the 5 days spent in New York are not considered travel outside the United States away from home and, thus, are disregarded for purposes of this section. Although the time spent outside the United States away from home exceeded 1 week, the time outside the United States away from home attributable to nonbusiness activities (5 days out of 21) was less than 25 percent of the total time outside the United States away from home during the trip. Therefore, the disallowance rules of this section do not apply.

. . .

Example 6. F, a self-employed professional man, flew from New York to Copenhagen, Denmark, to attend a convention sponsored by a professional society. The trip lasted 3 weeks, of which 2 weeks were spent on vacation in Europe. . . . Unless F can establish that obtaining a vacation was not a major consideration in determining to make the trip, the disallowance rules of this section apply.

Example 7. Taxpayer G flew from Chicago to New York where he spent 6 days on business. He then flew to London where he conducted business for 2 days. G then flew to Paris for a 5 day vacation after which he flew back to Chicago, with a scheduled landing in New York for the purpose of adding and discharging passengers. G would not have made the trip except for the business he had to conduct in London. The travel outside the United States away from home, including 2 days for travel en route, exceeded a week and the time devoted to nonbusiness activities was not less than 25 percent of the total time on such travel. The 2 days spent traveling from Chicago to New York and return, and the 6 days spent in New York are disregarded for purposes of determining whether the travel outside the United States away from home exceeded a week and whether the time devoted to nonbusiness activities was less than 25 percent of the total time outside the United States away from home. If G is unable to establish . . . that an opportunity for taking a personal vacation was not a major consideration in his determining to make the trip, 5/9ths (5 days devoted to nonbusiness activities out of a total 9 days outside the United States away from home on the trip) of the expenses attributable to transportation and food from New York to London and from London to New York will be disallowed. . .

. . .

If Code sections 162 and 274, and their companion Regulations, seemed a bit confusing, the reason is likely to be that they use of phrases like "traveling expenses" and "travel expense" to refer to three different types of expenses, without clearly indicating which of the three types is being referred to when they state that those expenses are allowed or disallowed.

These are three types of "traveling expenses" and "travel expense" referred to in the Code and Regulations:

1. Getting there and back expenses
2. Meal expenses
3. Lodging expenses

The following table shows which types of expenses (#1 through #3 above) are deductible, when the purpose of a taxpayer's trip is:

- all business
- primarily business with some personal activities
- primarily personal with some business activities, and
- all personal travel.

Deductible Portion of Travel Expenses					
Travel Is:	**All Business**	**Primarily Business with Some Personal**		**Primarily Personal with Some Business**	**All Personal**
Anywhere **§ 162**	All of 1, 2 & 3	All of 1; business-related 2 and 3		None of 1; business-related 2 and 3	None of 1, 2 or 3
Abroad **§ 274** *if* trip is more than a week *and* 25% or more pleasure; if not both of these, then § 162 applies.	§ 274 doesn't apply to an all-business trip, no matter how long it lasts because an all-business trip is not 25% pleasure. So § 162 applies.	Taxpayer *Can* Establish Business Motive All of 1; business-related 2 and 3	Taxpayer *Cannot* Establish Business Motive Only a % of 1; business-related 2 and 3	None of 1; business-related 2 and 3	None of 1, 2 or 3

Notice that the chart shows that even though getting to its conclusions required a painstaking job of interpretation of the Code, the Regulations and an IRS Publication (excerpts from which are reproduced below), the ultimate conclusion shows that the treatment of travel expenses – whether domestic or foreign – is not very complicated. Travel expenses are treated the *same* for domestic and foreign travel with just *one exception*:

> If a trip is primarily business (with some personal activities), *all* of the taxpayer's *getting-there-and-back* expenses are *fully* deductible, *unless* the taxpayer cannot establish that business was the motive for scheduling the trip in the first place. In that case, the taxpayer may deduct only a *portion* of his or her *getting-there-and-back* expenses (i.e., a percentage of those expenses that is the same as the percentage of the trip that was devoted to business).

The tax treatment of *meal* and *lodging* expenses is identical, regardless of whether the travel is domestic or foreign (and if foreign, regardless of how long the trip lasted or how much of it was for pleasure): meal and lodging expenses are deductible for business days and not deductible for personal days.

For those of you who have a personal interest in the topic of travel expenses and their deductibility, and therefore want to see exactly how I reached the conclusions described above, take a look at the following items. The first is my own translation into plain English of the Code and Regulations. The second is an IRS Publication about travel (and other) expenses. (The Publication is not "law," but it does show how the IRS interprets the Code and Regs, and it does so in language that was written to be read by taxpayers themselves.)

Code and Regs *in Plain-English (<u>not</u> as they actually are worded)*:

Reg. § 1.162-2 Traveling expenses

(b)(1) If a taxpayer engages in both business and personal activities while traveling away from home, his or her

- expenses for getting there and back
  - *are* deductible only if the trip is related primarily to the taxpayer's *business* but
  - are *not* deductible, if the trip is *primarily personal*, even though the taxpayer engages in business activities while at such destination, and
- expenses for meals and lodging which are related to the taxpayer's business *are* deductible, even if the taxpayer's expenses for getting there and back are not.

§ 274. Disallowance of certain entertainment, etc., expenses

(c) Certain foreign travel

(1) If a taxpayer travels outside the U.S. for business, *no deduction is allowed* for the portion of the taxpayer's **travel expenses** "which, under regulations prescribed by the Secretary," is "not allocable" to the taxpayer's business activities.

(2) *Paragraph (1)* does not apply to the **expenses of travel** outside the U.S. if:

(A) the trip is a week or less, or

(B) personal activities take less than 25% of the total travel time

(though in this situation, Reg § 1.162-2 does apply).

Reg. § 1.274-4 Disallowance of certain foreign travel expenses

(f) *Application of disallowance rules—*

(1) *In general.* If a taxpayer travels outside the U.S. for business

- for more than a week *and*
- spends more than 25% of his or her travel time engaged in personal activities,

the allowable deduction for **travel expenses** is *reduced* by the percentage of his or her total travel time devoted to *personal activities*.

(5) "**Expenses of travel**" shall be allocable *in full* to business activity, and *no portion* shall be *dis*allowed under this section, if those expenses are incurred under the following circumstances:

(ii) **Travel expenses** *that qualify as business deductions* are *fully* allocable to business activity

- if the taxpayer can establish that a vacation was not a major reason for deciding to take the trip,

but paragraph (f)(1) above applies

- if the taxpayer can*not* establish that a vacation was not a major reason for deciding to take the trip, then,

and

- if the trip is primarily personal, the "**traveling expenses to and from the destination**" are not deductible even though the taxpayer engages in business activities while abroad.

. . .

(g) *Example 7.* A taxpayer flew from New York to London where he conducted business for 2 days. The taxpayer then flew from London to Paris for a 5-day vacation after which he flew back to New York. The taxpayer spent 2 days traveling from New York to London and back, so his trip took a total of 9 days. The taxpayer would not have made the trip except for the business he had to conduct in London. The trip lasted longer than a week and the taxpayer spent more than 25% of his trip on vacation. If the taxpayer is *un*able to establish that taking a vacation was *not* a major consideration in his decision to take the trip, 5/9ths (5 days devoted to *non*-business activities out of a total 9 days) of the expenses attributable to "**transportation and food**" from New York to London and from London to New York will be disallowed.

Excerpts [some formatting, italics and underlying added] from

IRS Publication 463: "Travel, Entertainment, Gift, and Car Expenses"

http://www.irs.gov/publications/p463/ch01.html#d0e1192

Travel Outside the United States

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

Travel Entirely for Business or Considered Entirely for Business

You can deduct all your travel expenses of getting to and from your business destination if your trip is entirely for business or considered entirely for business.

Travel entirely for business.

If you travel outside the United States and you spend the entire time on business activities, you can deduct all of your travel expenses.

Travel considered entirely for business.

Even if you did not spend your entire time on business activities, your trip is considered entirely for business if you meet at least one of the following four exceptions.

Exception - Outside United States no more than a week.

Your trip is considered entirely for business if you were outside the United States for a week or less, combining business and nonbusiness activities. One week means seven consecutive days. In counting the days, do not count the day you leave the United States, but do count the day you return to the United States.

Example.

You traveled to Brussels primarily for business. You left Denver on Tuesday and flew to New York. On Wednesday, you flew from New York to Brussels, arriving the next morning. On Thursday and Friday, you had business discussions, and from Saturday until Tuesday, you were sightseeing. You flew back to New York, arriving Wednesday afternoon. On Thursday, you flew back to Denver.

Although you were away from your home in Denver for more than a week, you were not outside the United States for more than a week. This is because the day you depart does not count as a day outside the United States.

You can deduct your cost of the round-trip flight between Denver and Brussels. You can also deduct the cost of your stay in Brussels for Thursday and Friday while you conducted business. However, you cannot deduct the cost of your stay in Brussels from Saturday through Tuesday because those days were spent on nonbusiness activities.

Exception - Less than 25% of time on personal activities.

Your trip is considered entirely for business if:

- You were outside the United States for more than a week, and
- You spent less than 25% of the total time you were outside the United States on nonbusiness activities.

For this purpose, count both the day your trip began and the day it ended.

Example.

You flew from Seattle to Tokyo, where you spent 14 days on business and 5 days on personal matters. You then flew back to Seattle. You spent one day flying in each direction.

Because only 5/21 (less than 25%) of your total time abroad was for nonbusiness activities, you can deduct as travel expenses what it would have cost you to make the trip if you had not engaged in any nonbusiness activity. The amount you can deduct is the cost of the round-trip plane fare and 16 days of meals (subject to the 50% limit), lodging, and other related expenses.

Exception - Vacation not a major consideration.

Your trip is considered entirely for business if you can establish that a personal vacation was not a major consideration, even if you have substantial control over arranging the trip.

Travel Primarily for Business

If you travel outside the United States primarily for business but spend some of your time on other activities, you generally cannot deduct all of your travel expenses. You can only deduct the business portion of your cost of getting to and from your destination. You must allocate the costs between your business and other activities to determine your deductible amount. See Travel allocation rules, later.

You do not have to allocate your travel expenses if you meet one of the four exceptions listed earlier under Travel considered entirely for business. In those cases, you can deduct the total cost of getting to and from your destination.

Travel allocation rules.

If your trip outside the United States was primarily for business, you must allocate your travel time on a day-to-day basis between business days and nonbusiness days. The days you depart from and return to the United States are both counted as days outside the United States.

To figure the deductible amount of your round-trip travel expenses, use the following fraction. The numerator (top number) is the total number of business days outside the United States. The denominator (bottom number) is the total number of travel days outside the United States.

Nonbusiness activity at, near, or beyond business destination.

If you had a vacation or other nonbusiness activity at, near, or beyond your business destination, you must allocate part of your travel expenses to the nonbusiness activity.

The part you must allocate is the amount it would have cost you to travel between the point where travel outside the United States begins and your business destination and a return to the point where travel outside the United States ends.

You determine the nonbusiness portion of that expense by multiplying it by a fraction. The numerator of the fraction is the number of nonbusiness days during your travel outside the United States and the denominator is the total number of days you spend outside the United States.

None of your travel expenses for nonbusiness activities at, near, or beyond your business destination are deductible.

Example.

Assume that the dates are the same as in the previous example but that instead of going to Dublin for your vacation, you fly to Venice, Italy, for a vacation.

You cannot deduct any part of the cost of your trip from Paris to Venice and return to Paris. In addition, *you cannot deduct 7/18 of the airfare and other expenses from New York to Paris and back to New York.*

You can deduct 11/18 of the round-trip plane fare and other travel expenses from New York to Paris, plus your meals (subject to the 50% limit), lodging, and any other business expenses you had in Paris. (Assume these expenses total $900). If the round-trip plane fare and other travel-related expenses (such as food during the trip) are $800 from New York to Paris, you can deduct travel costs of $489 (11/18 × $800), plus the full $900 for the expenses you had in Paris.

Travel Primarily for Personal Reasons

If you travel outside the United States primarily for vacation or for investment purposes, the entire cost of the trip is a nondeductible personal expense. If you spend some time attending brief professional seminars or a continuing education program, you can deduct your registration fees and other expenses you have that are *directly related to your business*.

Questions re Business vs. Pleasure Travel Expenses

6. Please re-read Reg. § 1.162-5(d) and (e) on page 27.7 of Study Guide 27, and then decide which of the following is the best plain-English description of how allocations are to made between personal and business travel expenses, when travel is done for education.

    a. Taxpayers may deduct *travel* expenses (i.e., getting-there-and-back expenses, like gas or plane tickets) for away-from-home trips to obtain tax-deductible education, if *most* trip activities are tax-deductible educational activities. Taxpayers also may deduct meal and lodging expenses incurred during tax-deductible educational trips, though taxpayers may not deduct *meal* and *lodging* expenses for personal activities engaged in during an otherwise deductible trip. If a trip is primarily personal but includes tax-deductible educational activities, *travel* expenses (like gas or plane tickets) are not deductible, nor are any meal or lodging expenses incurred while engaged in personal activities, though taxpayers may deduct *meal* and *lodging* expenses incurred while engaged in deductible educational activities during an otherwise personal trip.

    b. Taxpayers may deduct some, though not all, of their travel (i.e., getting-there-and back expenses, like gas or plane tickets), meal and lodging expenses for away-from-home trips that combine tax-deductible education with personal activities. The deductible portion of these expenses is proportional to the number of days taxpayers devote to tax-deductible educational activities as compared to the number of days they devote to personal activities.

    c. Taxpayers may deduct all of their travel, meal and lodging expenses for away-from-home trips to obtain tax-deductible education, so long as the trip is "primarily" to obtain such education rather than for personal purposes.

    d. Taxpayers may not deduct any of the travel, meal and lodging expenses for away-from-home trips that include personal activities, even if a portion of the trip is to obtain tax-deductible education.

7. Which of the following is the best plain-English description of how Reg. § 1.162-2(b) above makes allocations between personal and business travel expenses, when taxpayers travel for business reasons unrelated to education?

   a. Taxpayers may deduct *travel* expenses (i.e., getting-there-and-back expenses, like like gas or plane tickets) for away-from-home business trips, if the trip is primarily related to business. Taxpayers also may deduct meal and lodging expenses incurred during business trips, though taxpayers may not deduct *meal* and *lodging* expenses for personal activities engaged in during an otherwise deductible business trip. If a trip is primarily personal but includes business activities, *travel* expenses (like gas or plane tickets) are not deductible, nor are any meal or lodging expenses incurred while engaged in personal activities, though taxpayers may deduct *meal* and *lodging* expenses incurred while engaged in business activities during an otherwise personal trip.

   b. Taxpayers may deduct some, though not all, of their travel (i.e., getting-there-and back expenses, like gas or plane tickets), meal and lodging expenses for away-from-home trips that combine business with personal activities. The deductible portion of these expenses is proportional to the number of days taxpayers devote to business activities as compared to the number of days they devote to personal activities.

   c. Taxpayers may deduct all of their travel, meal and lodging expenses for away-from-home business trips, so long as the trip is "primarily" for business rather than personal purposes.

   d. Taxpayers may not deduct any of the travel, meal and lodging expenses for away-from-home trips that include personal activities, even if a portion of the trip is related to business.

8. Which of the following is the best plain-English description of how § 274 and Reg. § 1.274-4 above make allocations between personal and business travel expenses, when taxpayers travel outside the United States?

   a. Taxpayers who travel for business outside the United States for *more* than a week, and who spend 25% (or more) of their time engaged in personal (rather than business) activities, may deduct their *travel* expenses (i.e., getting-there-and-back expenses, like plane tickets) for such foreign trips, so long as their non-personal activities are related to business. Taxpayers also may deduct meal and lodging expenses incurred during the business activity portion of such foreign trips, though they may not deduct *meal* and *lodging* expenses for personal activities engaged in during such trips. If a trip is primarily personal but includes business activities, *travel* expenses (like plane tickets) are not deductible, nor are any meal or lodging expenses incurred while engaged in personal activities, though taxpayers may deduct *meal* and *lodging* expenses incurred while engaged in business activities during the trip.

   b. Taxpayers who travel for business outside the United States for *less* than a week, or who spend *less* than 25% of their time engaged in personal (rather than business) activities, may deduct their getting-there-and-back expenses (like plane tickets) for such foreign trips, if the trip is primarily related to business. Taxpayers also may deduct meal and lodging expenses incurred during the business portion of such foreign trips, though taxpayers may not deduct *meal* and *lodging* expenses for personal activities engaged in during such trips. If a trip is primarily personal but includes business activities, getting there and back expenses (like plane tickets) are not deductible, nor are any meal or lodging expenses incurred while engaged in personal activities, though taxpayers may deduct *meal* and *lodging* expenses incurred while engaged in business activities during an otherwise personal trip.

   c. Taxpayers who travel for business outside the United States for *more* than a week and who spend 25% (or more) of their time engaged in personal (rather than business) activities, may deduct some, though not all, of their getting-there-and-back expenses (e.g., plane tickets). The deductible portion of their getting-there-and-back expenses is proportional to the number of days taxpayers devote to business activities as compared to the total number of days the trip lasts. Taxpayers also may deduct meal and lodging expenses for days engaged in business activities, but not for days engaged in personal activities.

   d. Both "b" and "c."

9. Taylor Taxpayer is Los Angeles bankruptcy lawyer. This year she attended a two-day CLE program In New York City about bankruptcy law, in order to keep up to date with recent developments in her specialty. The program also satisfied Continuing Legal Education requirements imposed on Taylor by the California State Bar. While in New York, Taylor had dinner one evening with an old college roommate who now lives there, and she attended a Broadway play the evening after the program concluded. Tyrone incurred expenses:

    (I) to register for the program,

    (II) to travel to New York City by air (she flew business class, rather than coach)

    (III) for *four* nights' lodging in a hotel: the night before the program began; the two nights of the program; and the night of the day following the program (the day she saw the Broadway play).

    (IV) meal expenses for all of her meals, including the dinner she had with her roommate, because Taylor picked up the check.

    (V) Tickets for the Broadway play.

    Which, if any, of her expenses will Tyrone be able to deduct?

    a. All of them.
    b. I, II, some of III, and some of IV.
    c. I, some of II, some of III, some of IV.
    d. None of them.

10. Taylor Taxpayer's twin brother Tyler owns a toy manufacturing business in Los Angeles. This year he went to New York to attend a two-day trade show at which manufacturers exhibit their new toys to retail store buyers, and to take orders from those stores for the Christmas season. Tyler attended in order to display his new toys and to take orders from his retail store customers. While in New York, Tyler had dinner one evening with an old college roommate who now lives there, and he attended a Broadway play the evening after the trade show concluded. Tyler incurred expenses:

    (I) to rent a booth at the convention center,

    (II) to travel to New York City by air (he flew business class, rather than coach)

    (III) for *four* nights' lodging in a hotel: the night before the trade show began; the two nights of the trade show; and the night of the day following the program (the day he saw the Broadway play)

    (IV) meal expenses for all of his meals, including the dinner he had with his roommate, because Tyler picked up the check

    (V) Tickets for the Broadway play

    Which, if any, of her expenses will Tyler be able to deduct?

    a. All of them.
    b. I, II, some of III, and some of IV.
    c. I, some of II, some of III, some of IV.
    d. None of them.

11. *Playing for Pizza* is a novel by author John Grisham. The book tells the story of a former NFL quarterback who is cut from his team, and who moves to Italy to play American-style football for the Parma (Italy) Panthers. The book is more about how the player adjusts to Italian culture than it is about football. And it contains many scenes that accurately describe Parma and the other Italian towns in which the Panthers play their games. It also contains many scenes that accurately describe the Italian restaurants in which the football player and his teammates eat, and detailed descriptions of the wonderful food they eat there. In order to write *Playing for Pizza*, Grisham traveled to Italy, carefully observed the towns about which he then wrote, and ate many meals at many Italian restaurants so he could describe the restaurants and the meals in his book. Grisham's trip to Italy took much longer than a week. And though I'm sure that every minute of the trip was a pleasure, I'm also sure he would say that the entire trip was research for his novel, and thus was "in pursuit of [his] trade" as a novelist. Naturally, Grisham incurred expenses for airfare to and from Italy, transportation while in Italy, and meals and lodging while there. To what extent, do you suppose, were his expenses deductible?

    a. Completely.
    b. Partially.
    c. Not at all.
    d. It depends on facts not given in the question (which are what?).

Tyler Taxpayer (the toy manufacturer from Question 10) had a customer in Rome who went bankrupt. The customer's Italian bank had issued a letter of credit to Tyler that was supposed to assure him of payment, in case the customer didn't pay. But at first, the bank refused to pay. In an eventually-successful effort to get the matter straightened out, Tyler traveled to Rome, along with his twin-sister Taylor Taxpayer (the lawyer from Question 10). Their business meetings with Tyler's customer, the customer's bank, and an Italian lawyer took 3 days. Travel to and from Rome took a full day in each direction (2 days in all). Taylor had pressing legal work back in Los Angeles, so she was only able to spend 1 day sightseeing in Rome. As a result, Taylor's trip took 6 days in all, including travel. Tyler, on the other hand, spent 10 more days in Italy, sightseeing in Rome, Florence and Venice; so his trip took 15 days in all. Tyler and Taylor both incurred expenses for airfare to and from Italy, transportation while in Italy, and meals and lodging while there.

12. Which of Taylor's expenses were deductible? (Taylor is the lawyer whose trip took 6 days in all: 3 for business; 2 for travel; and 1 for sightseeing.)
    a. All of them.
    b. All of them except her expenses for meals and lodging for the 1 day she spent sightseeing.
    c. 5/6's of all her expenses.
    d. 5/6's of her airfare, and all of her expenses for meals and lodging except for meals and lodging for the day she spent sightseeing.
13. If Tyler is able to establish that he would not have gone to Italy at all, if meetings with his customer, his customer's bank and an Italian lawyer had been unnecessary, which of Tyler's expenses were deductible? (Tyler is the toy manufacturer whose trip took 15 days in all: 3 for business; 2 for travel; and 10 for sightseeing.)
    a. All of them.
    b. All of them except his expenses for meals and lodging for the 10 days he spent sightseeing, and except the getting-there-and-back expenses he incurred in getting from Rome to Florence and Venice and back to Rome.
    c. 5/15'ths of all his expenses.
    d. 5/15'ths of his airfare, 5/15'ths of his meals and lodging for the 5 days he spent in meetings and travel; but none of his meals and lodging for the 10 days he spent sightseeing, and none of his travel within Italy, to and from Florence and Venice.

14. What would your answer to Question 13 have been, if Tyler acknowledged that meetings in Italy were not necessary to get the matter straightened out – that the whole thing could have been taken care of by the Italian lawyer and email – but Tyler went to Italy anyway, because he had always wanted to visit Rome, Florence and Italy?

    a. None of them.

    b. All of them except his expenses for meals and lodging for the 10 days he spent sightseeing.

    c. 5/15'ths of all his expenses.

    d. 5/15'ths of his airfare, and all of his meals and lodging for the 5 days he spent in meetings in Rome; but none of his meals and lodging for the 10 days he spent sightseeing, and none of his travel within Italy to and from Florence and Venice. This presumes that even though Tyler decided to go to Italy for personal reasons, the IRS would agree that the trip as a whole was "primarily business with some personal." Because Tyler spent so many more days sightseeing than in meetings, the IRS might take the position that his trip was "primarily personal with some business" – in which case he wouldn't be able to deduct any of his getting-to-Rome-and-home-again expenses, though he would still be able to deduct his meals and lodging for the 5 days he was engaged in business meetings.

ENTERTAINMENT, AMUSEMENT, AND RECREATION EXPENSES

Read (in Posin & Tobin)

Pages 396 – 403

Internal Revenue Code provisions re Entertainment, Amusement, and Recreation Expenses

§ 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

§ 274. Disallowance of certain entertainment, etc., expenses

(a) Entertainment, amusement, or recreation

(1) In general. No deduction otherwise allowable under this chapter shall be allowed for any item -

(A) Activity. With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated with, the active conduct of the taxpayer's trade or business, or

(B) Facility. With respect to a facility used in connection with an activity referred to in subparagraph (A).

In the case of an item described in subparagraph (A), the deduction shall in no event exceed the portion of such item which meets the requirements of subparagraph (A).

(2) Special rules. For purposes of applying paragraph (1) -

(A) Dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities.

(B) An activity described in section 212 shall be treated as a trade or business.

(C) In the case of a club, paragraph (1)(B) shall apply unless the taxpayer establishes that the facility was used primarily for the furtherance of the taxpayer's trade or business and that the item was directly related to the active conduct of such trade or business.

(3) Denial of deduction for club dues. Notwithstanding the preceding provisions of this subsection, no deduction shall be allowed under this chapter for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

Questions re Entertainment, Amusement, and Recreation Expenses

1. Tyler Taxpayer (the toy manufacturer you met in Study Guide 28) is a huge fan of the Chicago Cubs, and so is his twin sister Taylor, even though both of them live in Los Angeles. When the Cubs played the Dodgers in Los Angeles in a National League playoff game (in 2008), Tyler bought two very expensive tickets and took his sister to the game. Tayler, you'll recall, is Tyler's lawyer. But they didn't discuss business or law before, during or after the game. They simply went to the game, and suffered together through the Cubs' loss. May Tyler deduct (any part of the cost of) the tickets to the game?

    a. Yes. Tyler could legitimately take the position that since Taylor is his lawyer, taking her to the game was "directly related to . . . the active conduct of [his] . . . business," and thus (at least some part) the cost of the tickets is deductible under § 162(a) and not disallowed by § 274(a)(1)(A).

    b. Yes. Tyler could legitimately take the position that since Taylor is his lawyer, taking her to the game was "directly related to . . . the active conduct of [his] . . . business," and because the tickets do not constitute "dues," (at least some part of) their cost is not disallowed by § 274(a)(2)(A).

    c. Both "a" and "c."

    d. No. Even if the cost of the tickets could be characterized as an expense Tyler incurred in carrying on his business – a highly dubious proposition to begin with – he could not legitimately claim that attending the game was "directly related to . . . the active conduct of [his] . . . business," and thus a deduction for (any part of) the cost of the tickets would be disallowed by § 274(a)(1)(A).

2. Some of the toys that Tyler Taxpayer sells are manufactured, pursuant to Tyler's designs and specifications, by a factory located in China. The manager of the factory is coming to Los Angeles later this year, in part for a vacation, and in part to meet with Tyler to review his designs and specifications for a new toy, and to discuss manufacturing techniques and costs. The factory manager is a huge fan of Yao Ming, the Chinese basketball player who plays for the Houston Rockets of the NBA. As it happens, the Rockets will be playing the Clippers in Los Angeles on the same day that Tyler will be meeting with the factory manager. Tyler has no interest in basketball at all, nor does Tyler's girlfriend. But knowing that the factory manager is a fan of Yao Ming, Tyler has purchased four of the most expensive tickets available for the Clippers-Rockets game: two for the factory manager and his wife; and two for Tyler and his girlfriend. May Tyler deduct (any part of) the cost of the tickets to the game?

    a. Yes. Tyler could legitimately take the position that taking factory manager to the game was "directly related to . . . the active conduct of [Tyler's] . . . business," and thus (at least some part of) the cost of all four tickets is deductible under § 162(a) and not disallowed by § 274(a)(1)(A).

    b. Answer "a" above is only partially correct; (at least some part of) the cost of the factory manager's one ticket is deductible; but the cost of the other three is not.

    c. No. Even though the cost of the tickets is an expense Tyler incurred in carrying on his business, a deduction for the cost of the tickets would be disallowed by § 274(a)(1)(A).

    d. No. The cost of the tickets cannot be characterized as an expense Tyler incurred in carrying on his business, and thus would not be deductible under § 162(a) to begin with.

Read (in Posin & Tobin) re Limits on Deductibility of Business Meals [and Entertainment Expenses]

Pages 403 - 404

Internal Revenue Code provisions re Limits on Deductibility of Business Meals [and Entertainment Expenses]

> **§ 274. Disallowance of certain entertainment, etc., expenses**
>
> (k) *Business meals*
>
> (1) In general. No deduction shall be allowed under this chapter for the expense of any food or beverages unless -
>
> (A) such expense is not lavish or extravagant under the circumstances, and
>
> (B) the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages.
>
> . . .
>
> (n) *Only 50 percent of meal and entertainment expenses allowed as deduction*
>
> (1) In general. The amount allowable as a deduction under this chapter for -
>
> (A) any expense for food or beverages, and
>
> (B) any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such activity,
>
> shall not exceed 50 percent of the amount of such expense or item which would (but for this paragraph) be allowable as a deduction under this chapter.

3. In addition to taking the Chinese factory manager and his wife to the Clippers-Rockets game, Tyler will be taking them (and his girlfriend) to dinner before the game. May Tyler deduct (any part of) the cost of the cost of the pre-game dinner?

   a. Yes. Tyler could legitimately take the position that taking the factory manager to dinner was "directly related to . . . the active conduct of [Tyler's] . . . business," and thus (at least some part of) the cost of all four dinners is deductible under § 162(a) and not disallowed by § 274(k).

   b. Answer "a" above is only partially correct; (at least some part of) the cost of the factory manager's dinner is deductible; but the cost of the other three is not.

   c. No. Even though the cost of the dinners is an expense Tyler incurred in carrying on his business, a deduction for the cost of the dinner would be disallowed by § 274(k).

   d. No. The cost of the dinners cannot be characterized as an expense Tyler incurred in carrying on his business, and thus would not be deductible under § 162(a) to begin with.

4. Tyler prepares his own tax returns, and regardless of how *you* answered Questions 2 and 3, he thinks the tickets to the Clippers-Rockets game and the pre-game dinner are deductible expenses. If he's right, what portion of those expenses may he deduct?
   a. 25%
   b. 50%
   c. 75%
   d. 100%

Read (in Posin & Tobin) re Substantiation

Pages 404 - 405

Internal Revenue Code provisions re Substantiation

> **§ 274. Disallowance of certain entertainment, etc., expenses**
> (d) Substantiation required. No deduction or credit shall be allowed -
> (1) under section 162 or 212 for any traveling expense (including meals and lodging while away from home),
> (2) for any item with respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, or with respect to a facility used in connection with such an activity,
> . . .
> unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement (A) the amount of such expense or other item, (B) the time and place of the travel, entertainment, amusement, recreation, or use of the facility or property . . . (C) the business purpose of the expense or other item, and (D) the business relationship to the taxpayer of persons entertained, using the facility or property. . .

Question re Substantiation

5. What sort of written records, if any, should Tyler maintain to substantiate his deduction of his expenses for the Clipper-Rockets game and the pre-game dinner?
   a. Despite the language of § 274(d), taxpayers don't usually maintain any written records to substantiate entertainment and meal expenses, and yet they take business deductions for those expenses anyway; so there doesn't appear to be any reason for Tyler to keep records either.
   b. All he needs to do is keep his ticket and dinner receipts and write "entertainment of Chinese factory manager" on the back of them (assuming the receipts already show amounts and dates).
   c. He needs to prepare a memo to his "tax records" file, detailing the items specified in clauses "A" through "D" of § 274(d).
   d. He needs to prepare an affidavit, signed under penalty of perjury, detailing the items specified in clauses "A" through "D" of § 274(d).

HOBBY EXPENSES

Read (in Posin & Tobin) re Activities Not Engaged in for Profit

Pages 407 – 412

Internal Revenue Code provisions re Activities Not Engaged in for Profit

§ 183. Activities not engaged in for profit

(a) General rule. In the case of an activity engaged in by an individual . . . , if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) Deductions allowable. In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed -

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity not engaged in for profit defined. For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) Presumption. If the gross income derived from an activity for 3 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting "2" for "3" and "7" for "5".

. . .

§ 162. Trade or business expenses

(a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . .

§ 212. Expenses for production of income

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income. . . .

§ 262. Personal, living, and family expenses

(a) General rule. Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Reg. § 1.183-1 Activities not engaged in for profit

. . .

(b) *Deductions allowable—*

(1) *Manner and extent.* If an activity is not engaged in for profit, deductions are allowable under section 183(b) in the following order and only to the following extent:

(i) Amounts allowable as deductions during the taxable year under Chapter 1 of the Code without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable to the full extent allowed by the relevant sections of the Code, determined after taking into account any limitations or exceptions with respect to the allowability of such amounts. For example, the allowability-of-interest expenses incurred with respect to activities not engaged in for profit is limited by the rules contained in section 163(d).

(ii) Amounts otherwise allowable as deductions during the taxable year under Chapter 1 of the Code, but only if such allowance does not result in an adjustment to the basis of property, determined as if the activity giving rise to such amounts was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivision (i) of this subparagraph.

(iii) Amounts otherwise allowable as deductions for the taxable year under Chapter 1 of the Code which result in (or if otherwise allowed would have resulted in) an adjustment to the basis of property, determined as if the activity giving rise to such deductions was engaged in for profit, are allowed only to the extent the gross income attributable to such activity exceeds the deductions allowed or allowable under subdivisions (i) and (ii) of this subparagraph. Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premium.

. . .

Questions re Activities Not Engaged in for Profit

6. Section 183 of the Code means that:

    a. none of the expenses incurred by taxpayers in connection with their hobbies are deductible, even if the hobby turns out to be profitable.

    b. if taxpayers incur expenses in connection with their hobbies of a type that would otherwise be deductible, those expenses are deductible even if the hobby is not profitable.

    c. if taxpayers incur expenses in connection with their hobbies, any of those expenses that would be deductible even to taxpayers who are not in business may be deducted, even though they were incurred in connection with a hobby, but only to the extent of any revenues the hobby earns (i.e., only up to the amount of the hobby's revenues); hobby expenses may never be deducted against income from other sources.

    d. if taxpayers incur expenses in connection with their hobbies, any of those expenses that would be deductible even to taxpayers who are not in business may be deducted even though they were incurred in connection with a hobby, and in addition, any of those expenses that would be deductible to taxpayers who are in business may be deducted but only to the extent of any revenues the hobby earns (i.e., only up to the amount of the hobby's revenues).

7. Kimberly Taxpayer owns two champion dogs that she enters in dog shows for the pure pleasure of doing so. The dogs are expensive to maintain: they eat a lot, and they need to be cared for by a veterinarian, regularly. Also, dog shows charge entry fees; and travel to and from the shows is costly. The dogs win their fare share of the shows in which Kimberly enters them. But the only thing the dogs and Kimberly get for those victories are ribbons and trophies. Dog shows don't pay cash prizes; nor do Kimberly's dogs generate income in any other way. Kimberly does, however, have income from her employment and investments. May Kimberly deduct any part of the cost of maintaining her dogs and entering them in shows?

    a. Yes, she may deduct all of her dog costs, because they are expenses that would be deductible even to those who are not in business for themselves.

    b. No, none of her dog costs are deductible, because they are personal expenses.

    c. Her dog show entry fees and travel expenses are deductible; but her other dog costs are not.

    d. Her dog food and veterinarian expenses are deductible; but her other dog expenses are not.

8. Kimberly has decided to breed her champion dogs and sell the pups. The offspring of champion show dogs are quite valuable. And their value increases in direct proportion to the number of shows a show dog wins. In other words, when Kimberly begins to breed her dogs, the dog shows will no longer be for pure pleasure: the shows will be the primary way in which she increases the price she can charge for her dogs' pups. May Kimberly deduct any part of her dog costs now?

   a. No, none of her dog costs are deductible, because they're still personal expenses.

   b. Yes, if but only if her gross income from selling pups exceeds her expenses for 3 years out of the next 5, or perhaps 2 years out of the next 7. (If this is the answer, which is it: 3 out of 5, or 2 out of 7?)

   c. Yes, she may deduct her dog costs, but only to the extent of her gross income from selling pups; if her expenses exceed her gross income from selling pups, she cannot deduct the excess from her income from her employment or investments.

   d. Answer "c" is correct only if breeding and showing dogs is merely her hobby; if she quits her job and devotes all of her time to raising and showing dogs – so that her occupation becomes "dog breeder" – then her expenses may be deductible (from her investment income) even if her expenses exceed, for a while, her gross income from selling pups.

9. Kimberly has not yet quit her job. But she has determined that her backyard – where until now she has housed and trained her dogs – is not big enough to breed her dogs and care for their pups until she sells them. As luck would have it, the house next door to hers has been listed for sale, and she has decided to buy it, tear the house down, remove the fence between the that house and hers, and turn the entire next-door property into a side-yard where she will have enough room to train and breed her dogs and care for their pups. Of course, once she buys the next-door property, she will have additional property taxes to pay, and interest on the mortgage. May Kimberly deduct any part of her dog costs now?

   a. No, none of her dog costs are deductible – not even her property taxes and mortgage interest – because they're still personal expenses.

   b. Her property taxes and mortgage interest will be deductible, but only to the extent of her gross income from pup sales; she won't be able to deduct even those expenses from her employment or investment income.

   c. She may deduct her taxes and mortgage interest in full, even against her employment and investment income, and even if those expenses exceed her gross income from pup sales. But her other expenses may be deducted only if her gross income from pup sales exceeds her property taxes and interest expenses, and then, only up to the amount by which her income from pup sales exceeds her property tax and interest expenses.

   d. She will be able to deduct all of her dog expenses, even if they exceed her gross income from pup sales.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2009

(99) IRS Use Only—Do not write or staple in this space.

Label

(See instructions on page 14.)

Use the IRS label. Otherwise, please print or type.

LABEL HERE

For the year Jan. 1–Dec. 31, 2009, or other tax year beginning , 2009, ending , 20

OMB No. 1545-0074

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see page 14.	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 14.		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 14) ▶ ☐ **You** ☐ **Spouse**

Filing Status

Check only one box.

1 ☐ Single

2 ☐ Married filing jointly (even if only one had income)

3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶

4 ☐ Head of household (with qualifying person). (See page 15.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶

5 ☐ Qualifying widow(er) with dependent child (see page 16)

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a . . . . .

b ☐ **Spouse** . . . .

Boxes checked on 6a and 6b ____

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 17)
			☐
			☐
			☐
			☐

No. of children on 6c who:
- **lived with you** ____
- **did not live with you due to divorce or separation (see page 18)** ____

Dependents on 6c not entered above ____

If more than four dependents, see page 17 and check here ▶ ☐

d Total number of exemptions claimed . . . .

Add numbers on lines above ▶ ☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 22.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	
8a	**Taxable** interest. Attach Schedule B if required	8a	
b	**Tax-exempt** interest. **Do not** include on line 8a . . . 8b		
9a	Ordinary dividends. Attach Schedule B if required	9a	
b	Qualified dividends (see page 22) 9b		
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 23) . .	10	
11	Alimony received	11	
12	Business income or (loss). Attach Schedule C or C-EZ	12	
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
14	Other gains or (losses). Attach Form 4797	14	
15a	IRA distributions . 15a — b Taxable amount (see page 24)	15b	
16a	Pensions and annuities 16a — b Taxable amount (see page 25)	16b	
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
18	Farm income or (loss). Attach Schedule F	18	
19	Unemployment compensation in excess of $2,400 per recipient (see page 27) . . .	19	
20a	Social security benefits 20a — b Taxable amount (see page 27)	20b	
21	Other income. List type and amount (see page 29)	21	
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	

Adjusted Gross Income

23	Educator expenses (see page 29)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889 .	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE .	27	
28	Self-employed SEP, SIMPLE, and qualified plans . .	28	
29	Self-employed health insurance deduction (see page 30)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see page 31)	32	
33	Student loan interest deduction (see page 34)	33	
34	Tuition and fees deduction. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35	36	
37	Subtract line 36 from line 22. This is your **adjusted gross income** . . . . . . ▶	37	

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 97. Cat. No. 11320B Form **1040** (2009)

Tax and Credits

38	Amount from line 37 (adjusted gross income)	38	
39a	Check if: ☐ **You** were born before January 2, 1945, ☐ Blind. ☐ **Spouse** was born before January 2, 1945, ☐ Blind. } **Total boxes checked ▶ 39a** ☐		
b	If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here ▶ **39b** ☐		
40a	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)	40a	
b	If you are increasing your standard deduction by certain real estate taxes, new motor vehicle taxes, or a net disaster loss, attach Schedule L and check here (see page 35) . ▶ **40b** ☐		
41	Subtract line 40a from line 38	41	
42	**Exemptions.** If line 38 is $125,100 or less and you did not provide housing to a Midwestern displaced individual, multiply $3,650 by the number on line 6d. Otherwise, see page 37	42	
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-	43	
44	**Tax** (see page 37). Check if any tax is from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972	44	
45	**Alternative minimum tax** (see page 40). Attach Form 6251	45	
46	Add lines 44 and 45 ▶	46	
47	Foreign tax credit. Attach Form 1116 if required	47	
48	Credit for child and dependent care expenses. Attach Form 2441	48	
49	Education credits from Form 8863, line 29	49	
50	Retirement savings contributions credit. Attach Form 8880	50	
51	Child tax credit (see page 42)	51	
52	Credits from Form: **a** ☐ 8396 **b** ☐ 8839 **c** ☐ 5695	52	
53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐ ______	53	
54	Add lines 47 through 53. These are your **total credits**	54	
55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶	55	

Standard Deduction for—

- People who check any box on line 39a, 39b, or 40b **or** who can be claimed as a dependent, see page 35.
- All others:

Single or Married filing separately, $5,700

Married filing jointly or Qualifying widow(er), $11,400

Head of household, $8,350

Other Taxes

56	Self-employment tax. Attach Schedule SE	56	
57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919	57	
58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
59	Additional taxes: **a** ☐ AEIC payments **b** ☐ Household employment taxes. Attach Schedule H	59	
60	Add lines 55 through 59. This is your **total tax** ▶	60	

Payments

61	Federal income tax withheld from Forms W-2 and 1099	61	
62	2009 estimated tax payments and amount applied from 2008 return	62	
63	Making work pay and government retiree credits. Attach Schedule M	63	
64a	**Earned income credit (EIC)**	64a	
b	Nontaxable combat pay election **64b**		
65	Additional child tax credit. Attach Form 8812	65	
66	Refundable education credit from Form 8863, line 16	66	
67	First-time homebuyer credit. Attach Form 5405	67	
68	Amount paid with request for extension to file (see page 72)	68	
69	Excess social security and tier 1 RRTA tax withheld (see page 72)	69	
70	Credits from Form: **a** ☐ 2439 **b** ☐ 4136 **c** ☐ 8801 **d** ☐ 8885	70	
71	Add lines 61, 62, 63, 64a, and 65 through 70. These are your **total payments** ▶	71	

If you have a qualifying child, attach Schedule EIC.

Refund

72	If line 71 is more than line 60, subtract line 60 from line 71. This is the amount you **overpaid**	72	
73a	Amount of line 72 you want **refunded to you.** If Form 8888 is attached, check here ▶ ☐	73a	
▶ b	Routing number ▶ **c** Type: ☐ Checking ☐ Savings		
▶ d	Account number		
74	Amount of line 72 you want **applied to your 2010 estimated tax** ▶	74	

Direct deposit? See page 73 and fill in 73b, 73c, and 73d, or Form 8888.

Amount You Owe

75	**Amount you owe.** Subtract line 71 from line 60. For details on how to pay, see page 74 ▶	75	
76	Estimated tax penalty (see page 74)	76	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 75)? ☐ **Yes.** Complete the following. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Joint return? See page 15. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no.	

SCHEDULE A (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Itemized Deductions

▶ Attach to Form 1040. ▶ See Instructions for Schedule A (Form 1040).

OMB No. 1545-0074

2009

Attachment Sequence No. 07

Name(s) shown on Form 1040 | Your social security number

Medical and Dental Expenses		**Caution.** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see page A-1)	1	
	2	Enter amount from Form 1040, line 38 [2]		
	3	Multiply line 2 by 7.5% (.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid (See page A-2.)	5	State and local **(check only one box):**		
		a ☐ Income taxes, **or** / b ☐ General sales taxes	5	
	6	Real estate taxes (see page A-5)	6	
	7	New motor vehicle taxes from line 11 of the worksheet on back. Skip this line if you checked box 5b	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8		9
Interest You Paid (See page A-6.) **Note.** Personal interest is not deductible.	10	Home mortgage interest and points reported to you on Form 1098	10	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-7 and show that person's name, identifying no., and address ▶	11	
	12	Points not reported to you on Form 1098. See page A-7 for special rules	12	
	13	Qualified mortgage insurance premiums (see page A-7)	13	
	14	Investment interest. Attach Form 4952 if required. (See page A-8.)	14	
	15	Add lines 10 through 14		15
Gifts to Charity If you made a gift and got a benefit for it, see page A-8.	16	Gifts by cash or check. If you made any gift of $250 or more, see page A-8	16	
	17	Other than by cash or check. If any gift of $250 or more, see page A-8. You **must** attach Form 8283 if over $500	17	
	18	Carryover from prior year	18	
	19	Add lines 16 through 18		19
Casualty and Theft Losses	20	Casualty or theft loss(es). Attach Form 4684. (See page A-10.)		20
Job Expenses and Certain Miscellaneous Deductions (See page A-10.)	21	Unreimbursed employee expenses—job travel, union dues, job education, etc. Attach Form 2106 or 2106-EZ if required. (See page A-10.) ▶	21	
	22	Tax preparation fees	22	
	23	Other expenses—investment, safe deposit box, etc. List type and amount ▶	23	
	24	Add lines 21 through 23	24	
	25	Enter amount from Form 1040, line 38 [25]		
	26	Multiply line 25 by 2% (.02)	26	
	27	Subtract line 26 from line 24. If line 26 is more than line 24, enter -0-		27
Other Miscellaneous Deductions	28	Other—from list on page A-11. List type and amount ▶		28
Total Itemized Deductions	29	Is Form 1040, line 38, over $166,800 (over $83,400 if married filing separately)?		
		☐ **No.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 28. Also, enter this amount on Form 1040, line 40a. ▶		29
		☐ **Yes.** Your deduction may be limited. See page A-11 for the amount to enter.		
	30	If you elect to itemize deductions even though they are less than your standard deduction, check here ▶ ☐		

Worksheet for Line 7—New motor vehicle taxes

Use this worksheet to figure the amount to enter on line 7.

(Keep a copy for your records.)

Before you begin:

✓ You cannot take this deduction if the amount on Form 1040, line 38, is equal to or greater than $135,000 ($260,000 if married filing jointly).

✓ See the instructions for line 7 on page A-6.

1	Enter the state and local sales and excise taxes you paid in 2009 for the purchase of any new motor vehicle(s) **after** February 16, 2009 (see page A-6)	1	
2	Enter the purchase price **(before taxes)** of the new motor vehicle(s)	2	
3	Is the amount on line 2 more than $49,500? ☐ **No.** Enter the amount from line 1. ☐ **Yes.** Figure the **portion** of the tax from line 1 that is attributable to the first $49,500 of the purchase price of each new motor vehicle and enter it here (see page A-6).	3	
4	Enter the amount from Form 1040, line 38	4	
5	Enter the total of any— • Amounts from Form 2555, lines 45 and 50; Form 2555-EZ, line 18; and Form 4563, line 15, and • Exclusion of income from Puerto Rico . . .	5	
6	Add lines 4 and 5	6	
7	Enter $125,000 ($250,000 if married filing jointly)	7	
8	Is the amount on line 6 more than the amount on line 7? ☐ **No.** Enter the amount from line 3 above on Schedule A, line 7. **Do not** complete the rest of this worksheet. ☐ **Yes.** Subtract line 7 from line 6	8	
9	Divide the amount on line 8 by $10,000. Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000	9	.
10	Multiply line 3 by line 9	10	
11	**Deduction for new motor vehicle taxes.** Subtract line 10 from line 3. Enter the result here and on Schedule A, line 7	11	

SCHEDULE B (Form 1040A or 1040)

Department of the Treasury Internal Revenue Service (99)

Interest and Ordinary Dividends

► Attach to Form 1040A or 1040. ► See instructions on back.

OMB No. 1545-0074

2009

Attachment Sequence No. 08

Name(s) shown on return

Your social security number

Part I Interest

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ►	1	
2	Add the amounts on line 1	2	
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ►	4	

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

Note. If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

			Amount
5	List name of payer ►	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ►	6	

Note. If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See instructions on back.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2009, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See instructions on back for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ►		
8	During 2009, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		

SCHEDULE C (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Profit or Loss From Business

(Sole Proprietorship)

▶ **Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B.**

▶ **Attach to Form 1040, 1040NR, or 1041.** ▶ **See Instructions for Schedule C (Form 1040).**

OMB No. 1545-0074

2009

Attachment Sequence No. **09**

Name of proprietor | **Social security number (SSN)**

A Principal business or profession, including product or service (see page C-2 of the instructions)

B Enter code from pages C-9, 10, & 11 ▶

C Business name. If no separate business name, leave blank.

D Employer ID number (EIN), if any

E Business address (including suite or room no.) ▶

City, town or post office, state, and ZIP code

F Accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ▶

G Did you "materially participate" in the operation of this business during 2009? If "No," see page C-3 for limit on losses ☐ **Yes** ☐ **No**

H If you started or acquired this business during 2009, check here . . . ▶ ☐

Part I Income

1	Gross receipts or sales. **Caution.** See page C-4 and check the box if: • This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or • You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see page C-3 for limit on losses. . . ▶ ☐	1	
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	
4	Cost of goods sold (from line 42 on page 2)	4	
5	**Gross profit.** Subtract line 4 from line 3	5	
6	Other income, including federal and state gasoline or fuel tax credit or refund (see page C-4)	6	
7	**Gross income.** Add lines 5 and 6 ▶	7	

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8		18	Office expense	18	
9	Car and truck expenses (see page C-4)	9		19	Pension and profit-sharing plans	19	
				20	Rent or lease (see page C-6):		
10	Commissions and fees	10		a	Vehicles, machinery, and equipment	20a	
11	Contract labor (see page C-4)	11		b	Other business property	20b	
12	Depletion	12		21	Repairs and maintenance	21	
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-5)	13		22	Supplies (not included in Part III)	22	
				23	Taxes and licenses	23	
				24	Travel, meals, and entertainment:		
				a	Travel	24a	
14	Employee benefit programs (other than on line 19)	14		b	Deductible meals and entertainment (see page C-6)	24b	
15	Insurance (other than health)	15		25	Utilities	25	
16	Interest:			26	Wages (less employment credits)	26	
a	Mortgage (paid to banks, etc.)	16a		27	Other expenses (from line 48 on page 2)	27	
b	Other	16b					
17	Legal and professional services	17					

28	**Total expenses** before expenses for business use of home. Add lines 8 through 27 ▶	28	
29	Tentative profit or (loss). Subtract line 28 from line 7	29	
30	Expenses for business use of your home. Attach **Form 8829**	30	
31	**Net profit or (loss).** Subtract line 30 from line 29. • If a profit, enter on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (if you checked the box on line 1, see page C-7). Estates and trusts, enter on **Form 1041, line 3.** • If a loss, you **must** go to line 32.	31	

32 If you have a loss, check the box that describes your investment in this activity (see page C-7).

- If you checked 32a, enter the loss on both **Form 1040, line 12,** and **Schedule SE, line 2,** or on **Form 1040NR, line 13** (if you checked the box on line 1, see the line 31 instructions on page C-7). Estates and trusts, enter on **Form 1041, line 3.**
- If you checked 32b, you **must** attach **Form 6198.** Your loss may be limited.

32a ☐ All investment is at risk.
32b ☐ Some investment is not at risk.

Part III Cost of Goods Sold (see page C-8)

33 Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)

34 Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . ☐ Yes ☐ No

35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	

Part IV Information on Your Vehicle. Complete this part **only** if you are claiming car or truck expenses on line 9 and are not required to file Form 4562 for this business. See the instructions for line 13 on page C-5 to find out if you must file Form 4562.

43 When did you place your vehicle in service for business purposes? (month, day, year) ► ___ / ___ / ___

44 Of the total number of miles you drove your vehicle during 2009, enter the number of miles you used your vehicle for:

a Business ________ b Commuting (see instructions) ________ c Other ________

45 Was your vehicle available for personal use during off-duty hours? . . . ☐ Yes ☐ No

46 Do you (or your spouse) have another vehicle available for personal use? . . . ☐ Yes ☐ No

47a Do you have evidence to support your deduction? . . . ☐ Yes ☐ No

b If "Yes," is the evidence written? . . . ☐ Yes ☐ No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.

48 **Total other expenses.** Enter here and on page 1, line 27	48	

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2009

Attachment Sequence No. 12

Name(s) shown on return | Your social security number

Part I **Short-Term Capital Gains and Losses—Assets Held One Year or Less**

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						

2	Enter your short-term totals, if any, from Schedule D-1, line 2	2		
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)	3		
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4		
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5		
6	Short-term capital loss carryover. Enter the amount, if any, from line 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	6	( )	
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f)	7		

Part II **Long-Term Capital Gains and Losses—Assets Held More Than One Year**

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-7 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8						

9	Enter your long-term totals, if any, from Schedule D-1, line 9	9		
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)	10		
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11		
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12		
13	Capital gain distributions. See page D-2 of the instructions	13		
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions	14	( )	
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back	15		

Part III Summary

16 Combine lines 7 and 15 and enter the result **16**

If line 16 is:

- A **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- A **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- **Zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

17 Are lines 15 and 16 **both** gains?

☐ **Yes.** Go to line 18.

☐ **No.** Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** on page D-8 of the instructions . . . . ▶ **18**

19 Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-9 of the instructions . . . . ▶ **19**

20 Are lines 18 and 19 **both** zero or blank?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 39 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). **Do not** complete lines 21 and 22 below.

☐ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Schedule D Tax Worksheet** on page D-10 of the instructions. **Do not** complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of:

- The loss on line 16 or
- ($3,000), or if married filing separately, ($1,500)

. . . . **21** ( )

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?

☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** on page 39 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR).

☐ **No.** Complete the rest of Form 1040 or Form 1040NR.

SCHEDULE E (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Supplemental Income and Loss

(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)

▶ **Attach to Form 1040, 1040NR, or Form 1041.** ▶ **See Instructions for Schedule E (Form 1040).**

OMB No. 1545-0074
2009
Attachment Sequence No. 13

Name(s) shown on return | **Your social security number**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note.** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see page E-3). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

1	List the type and address of each **rental real estate property:**
A	
B	
C	

2 For each rental real estate property listed on line 1, did you or your family use it during the tax year for personal purposes for more than the greater of: • 14 days **or** • 10% of the total days rented at fair rental value? (See page E-3)		Yes	No
	A		
	B		
	C		

Income:		Properties A	Properties B	Properties C		Totals (Add columns A, B, and C.)
3 Rents received	3				3	
4 Royalties received	4				4	
Expenses:						
5 Advertising	5					
6 Auto and travel (see page E-4)	6					
7 Cleaning and maintenance	7					
8 Commissions	8					
9 Insurance	9					
10 Legal and other professional fees	10					
11 Management fees	11					
12 Mortgage interest paid to banks, etc. (see page E-5)	12				12	
13 Other interest	13					
14 Repairs	14					
15 Supplies	15					
16 Taxes	16					
17 Utilities	17					
18 Other (list) ▶	18					
19 Add lines 5 through 18	19				19	
20 Depreciation expense or depletion (see page E-5)	20				20	
21 Total expenses. Add lines 19 and 20	21					
22 Income or (loss) from rental real estate or royalty properties. Subtract line 21 from line 3 (rents) or line 4 (royalties). If the result is a (loss), see page E-5 to find out if you must file **Form 6198**	22					
23 Deductible rental real estate loss. **Caution.** Your rental real estate loss on line 22 may be limited. See page E-5 to find out if you must file **Form 8582.** Real estate professionals **must** complete line 43 on page 2	23	( )	( )	( )		

24 **Income.** Add positive amounts shown on line 22. **Do not** include any losses	24	
25 **Losses.** Add royalty losses from line 22 and rental real estate losses from line 23. Enter total losses here	25	( )
26 **Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, IV, and line 40 on page 2 do not apply to you, also enter this amount on Form 1040, line 17, or Form 1040NR, line 18. Otherwise, include this amount in the total on line 41 on page 2	26	

Name(s) shown on return. Do not enter name and social security number if shown on other side. | **Your social security number**

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II Income or Loss From Partnerships and S Corporations

Note. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(e)** on line 28 and attach **Form 6198.** See page E-1.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see page E-7 before completing this section. ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if any amount is not at risk
A			☐		☐
B			☐		☐
C			☐		☐
D			☐		☐

	Passive Income and Loss		Nonpassive Income and Loss		
	(f) Passive loss allowed (attach **Form 8582** if required)	**(g)** Passive income from **Schedule K–1**	**(h)** Nonpassive loss from **Schedule K–1**	**(i)** Section 179 expense deduction from **Form 4562**	**(j)** Nonpassive income from **Schedule K–1**
A					
B					
C					
D					
29a Totals					
b Totals					

30	Add columns (g) and (j) of line 29a	30	
31	Add columns (f), (h), and (i) of line 29b	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	

Part III Income or Loss From Estates and Trusts

33	**(a)** Name	**(b)** Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach **Form 8582** if required)	**(d)** Passive income from **Schedule K–1**	**(e)** Deduction or loss from **Schedule K–1**	**(f)** Other income from **Schedule K–1**
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a	35	
36	Add columns (c) and (e) of line 34b	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36. Enter the result here and include in the total on line 41 below	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38 **(a)** Name	**(b)** Employer identification number	**(c)** Excess inclusion from **Schedules Q,** line 2c (see page E-8)	**(d)** Taxable income (net loss) from **Schedules Q,** line 1b	**(e)** Income from **Schedules Q,** line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39	

Part V Summary

40	Net farm rental income or (loss) from **Form 4835**. Also, complete line 42 below	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18 ▶	41	
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code U; and Schedule K-1 (Form 1041), line 14, code F (see page E-8)	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see page E-2), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43	

SCHEDULE EIC
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit

Qualifying Child Information

Complete and attach to Form 1040A or 1040 only if you have a qualifying child.

1040A
1040
EIC

OMB No. 1545-0074

2009

Attachment Sequence No. **43**

Name(s) shown on return | **Your social security number**

Before you begin:

- See the instructions for Form 1040A, lines 41a and 41b, or Form 1040, lines 64a and 64b, to make sure that **(a)** you can take the EIC, and **(b)** you have a qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

CAUTION

- If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See back of schedule for details.
- It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.

Qualifying Child Information

Qualifying Child Information	Child 1	Child 2	Child 3
1 Child's name If you have more than three qualifying children, you only have to list three to get the maximum credit.	First name / Last name	First name / Last name	First name / Last name
2 Child's SSN The child must have an SSN as defined on page 45 of the Form 1040A instructions or page 51 of the Form 1040 instructions unless the child was born and died in 2009. If your child was born and died in 2009 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate, death certificate, or hospital medical records.			
3 Child's year of birth	Year ___ ___ ___ ___ *If born after 1990* ***and*** *the child was younger than you (or your spouse, if filing jointly), skip lines 4a and 4b; go to line 5.*	Year ___ ___ ___ ___ *If born after 1990* ***and*** *the child was younger than you (or your spouse, if filing jointly), skip lines 4a and 4b; go to line 5.*	Year ___ ___ ___ ___ *If born after 1990* ***and*** *the child was younger than you (or your spouse, if filing jointly), skip lines 4a and 4b; go to line 5.*
4 a Was the child under age 24 at the end of 2009, a student, and younger than you (or your spouse, if filing jointly)?	☐ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*	☐ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*	☐ **Yes.** *Go to line 5.* ☐ **No.** *Continue.*
b Was the child permanently and totally disabled during any part of 2009?	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.	☐ **Yes.** *Continue.* ☐ **No.** The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, foster child, etc.)			
6 Number of months child lived with you in the United States during 2009 • If the child lived with you for more than half of 2009 but less than 7 months, enter "7." • If the child was born or died in 2009 and your home was the child's home for the entire time he or she was alive during 2009, enter "12."	______ months *Do not enter more than 12 months.*	______ months *Do not enter more than 12 months.*	______ months *Do not enter more than 12 months.*

Purpose of Schedule

After you have figured your earned income credit (EIC), use Schedule EIC to give the IRS information about your qualifying child(ren).

To figure the amount of your credit or to have the IRS figure it for you, see the instructions for Form 1040A, lines 41a and 41b, or Form 1040, lines 64a and 64b.

Taking the EIC when not eligible. If you take the EIC even though you are not eligible and it is determined that your error is due to reckless or intentional disregard of the EIC rules, you will not be allowed to take the credit for 2 years even if you are otherwise eligible to do so. If you fraudulently take the EIC, you will not be allowed to take the credit for 10 years. You may also have to pay penalties.

TIP You may also be able to take the additional child tax credit if your child was your dependent and under age 17 at the end of 2009. For more details, see the instructions for line 42 of Form 1040A or line 65 of Form 1040.

Qualifying Child

A qualifying child for the EIC is a child who is your . . .

Son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, your grandchild, niece, or nephew)

AND

was . . .

Under age 19 at the end of 2009 and younger than you (or your spouse, if filing jointly)
or
Under age 24 at the end of 2009, a student, and younger than you (or your spouse, if filing jointly)
or
Any age and permanently and totally disabled

AND

Who is not filing a joint return for 2009
(or is filing a joint return for 2009 only as a claim for refund)

AND

Who lived with you in the United States for more than half of 2009. If the child did not live with you for the required time, see *Exception to time lived with you* on page 44 of the Form 1040A instructions or page 50 of the Form 1040 instructions.

CAUTION *If the child was married or meets the conditions to be a qualifying child of another person (other than your spouse if filing a joint return), special rules apply. For details, see page 45 of the Form 1040A instructions or page 51 of the Form 1040 instructions.*

Do you want part of the EIC added to your take-home pay in 2010? To see if you qualify, get Form W-5 from your employer, call the IRS at 1-800-TAX-FORM (1-800-829-3676), or go to *www.irs.gov.*

SCHEDULE SE (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedule SE (Form 1040).**

OMB No. 1545-0074

2009

Attachment Sequence No. **17**

Name of person with **self-employment** income (as shown on Form 1040)	Social security number of person with **self-employment** income ▶	

Who Must File Schedule SE

You must file Schedule SE if:

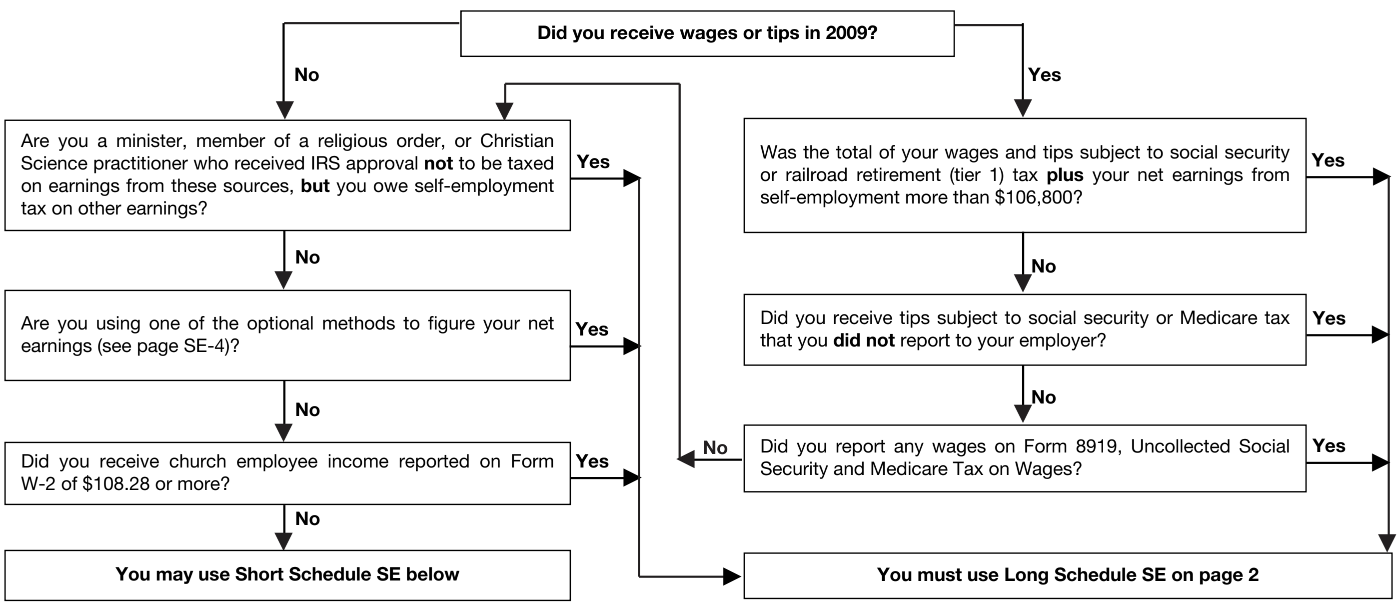
- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of $400 or more, **or**
- You had church employee income of $108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income (see page SE-1).

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE (see page SE-4).

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt—Form 4361" on Form 1040, line 56.

May I Use Short Schedule SE or Must I Use Long Schedule SE?

Note. Use this flowchart **only if** you must file Schedule SE. If unsure, see *Who Must File Schedule SE,* above.



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1a	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	**1a**	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code Y	**1b**	( )
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-3 for other income to report	**2**	
3	Combine lines 1a, 1b, and 2	**3**	
4	**Net earnings from self-employment.** Multiply line 3 by 92.35% (.9235). If less than $400, **do not** file this schedule; you do not owe self-employment tax . . . . ▶	**4**	
5	**Self-employment tax.** If the amount on line 4 is: • $106,800 or less, multiply line 4 by 15.3% (.153). Enter the result here and on **Form 1040, line 56.** • More than $106,800, multiply line 4 by 2.9% (.029). Then, add $13,243.20 to the result. Enter the total here and on **Form 1040, line 56.**	**5**	
6	**Deduction for one-half of self-employment tax.** Multiply line 5 by 50% (.50). Enter the result here and on **Form 1040, line 27** **6**		

Name of person with **self-employment** income (as shown on Form 1040)

Social security number of person with **self-employment** income ▶

Section B—Long Schedule SE

Part I Self-Employment Tax

Note. If your only income subject to self-employment tax is **church employee income,** skip lines 1 through 4b. Enter -0- on line 4c and go to line 5a. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

A	If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . ▶ ☐			
1a	Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A. **Note.** Skip lines 1a and 1b if you use the farm optional method (see page SE-4)	1a		
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 6b, or listed on Schedule K-1 (Form 1065), box 20, code Y	1b	(	)
2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see page SE-1 for types of income to report on this line. See page SE-3 for other income to report. **Note.** Skip this line if you use the nonfarm optional method (see page SE-4)	2		
3	Combine lines 1a, 1b, and 2	3		
4a	If line 3 is more than zero, multiply line 3 by 92.35% (.9235). Otherwise, enter amount from line 3	4a		
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here . .	4b		
c	Combine lines 4a and 4b. If less than $400, **stop**; you do not owe self-employment tax. **Exception.** If less than $400 and you had **church employee income,** enter -0- and continue ▶	4c		
5a	Enter your **church employee income** from Form W-2. See page SE-1 for definition of church employee income. **5a**			
b	Multiply line 5a by 92.35% (.9235). If less than $100, enter -0-	5b		
6	**Net earnings from self-employment.** Add lines 4c and 5b	6		
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2009	7	106,800	00
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $106,800 or more, skip lines 8b through 10, and go to line 11 **8a**			
b	Unreported tips subject to social security tax (from Form 4137, line 10) **8b**			
c	Wages subject to social security tax (from Form 8919, line 10) **8c**			
d	Add lines 8a, 8b, and 8c	8d		
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 . ▶	9		
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (.124)	10		
11	Multiply line 6 by 2.9% (.029)	11		
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Form 1040, line 56**. . . .	12		
13	**Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (.50). Enter the result here and on **Form 1040, line 27** . **13**			

Part II Optional Methods To Figure Net Earnings (see page SE-4)

Farm Optional Method. You may use this method **only** if **(a)** your gross farm income[1] was not more than $6,540, **or (b)** your net farm profits[2] were less than $4,721.

14	Maximum income for optional methods	14	4,360	00
15	Enter the **smaller** of: two-thirds (2/3) of gross farm income[1] (not less than zero) **or** $4,360. Also include this amount on line 4b above	15		

Nonfarm Optional Method. You may use this method **only** if **(a)** your net nonfarm profits[3] were less than $4,721 and also less than 72.189% of your gross nonfarm income,[4] **and (b)** you had net earnings from self-employment of at least $400 in 2 of the prior 3 years. **Caution.** You may use this method no more than five times.

16	Subtract line 15 from line 14	16		
17	Enter the **smaller** of: two-thirds (2/3) of gross nonfarm income[4] (not less than zero) **or** the amount on line 16. Also include this amount on line 4b above	17		

[1] From Sch. F, line 11, and Sch. K-1 (Form 1065), box 14, code B.

[2] From Sch. F, line 36, and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method.

[3] From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1.

[4] From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2.

Form **4562**

Department of the Treasury
Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)

▶ See separate instructions. ▶ Attach to your tax return.

OMB No. 1545-0172

2009

Attachment Sequence No. **67**

Name(s) shown on return	Business or activity to which this form relates	**Identifying number**

Part I **Election To Expense Certain Property Under Section 179**
Note: *If you have any listed property, complete Part V before you complete Part I.*

1	Maximum amount. See the instructions for a higher limit for certain businesses	1	$250,000
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	$800,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost

7	Listed property. Enter the amount from line 29	7	
8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2008 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	
13	Carryover of disallowed deduction to 2010. Add lines 9 and 10, less line 12 ▶	13	

Note: *Do not use Part II or Part III below for listed property. Instead, use Part V.*

Part II **Special Depreciation Allowance and Other Depreciation (Do not** include listed property.**)** (See instructions.)

14	Special depreciation allowance for qualified property (other than listed property) placed in service during the tax year (see instructions)	14	
15	Property subject to section 168(f)(1) election	15	
16	Other depreciation (including ACRS)	16	

Part III **MACRS Depreciation (Do not** include listed property.**)** (See instructions.)

Section A

17	MACRS deductions for assets placed in service in tax years beginning before 2009	17	
18	If you are electing to group any assets placed in service during the tax year into one or more general asset accounts, check here ▶ ☐		

Section B—Assets Placed in Service During 2009 Tax Year Using the General Depreciation System

(a) Classification of property	(b) Month and year placed in service	(c) Basis for depreciation (business/investment use only—see instructions)	(d) Recovery period	(e) Convention	(f) Method	(g) Depreciation deduction
19a 3-year property						
b 5-year property						
c 7-year property						
d 10-year property						
e 15-year property						
f 20-year property						
g 25-year property			25 yrs.		S/L	
h Residential rental property			27.5 yrs.	MM	S/L	
			27.5 yrs.	MM	S/L	
i Nonresidential real property			39 yrs.	MM	S/L	
				MM	S/L	

Section C—Assets Placed in Service During 2009 Tax Year Using the Alternative Depreciation System

20a Class life					S/L	
b 12-year			12 yrs.		S/L	
c 40-year			40 yrs.	MM	S/L	

Part IV **Summary** (See instructions.)

21	Listed property. Enter amount from line 28	21	
22	**Total.** Add amounts from line 12, lines 14 through 17, lines 19 and 20 in column (g), and line 21. Enter here and on the appropriate lines of your return. Partnerships and S corporations—see instructions	22	
23	For assets shown above and placed in service during the current year, enter the portion of the basis attributable to section 263A costs	23	

Part V **Listed Property** (Include automobiles, certain other vehicles, cellular telephones, certain computers, and property used for entertainment, recreation, or amusement.)

Note: *For any vehicle for which you are using the standard mileage rate or deducting lease expense, complete* ***only*** *24a, 24b, columns (a) through (c) of Section A, all of Section B, and Section C if applicable.*

Section A—Depreciation and Other Information (Caution: *See the instructions for limits for passenger automobiles.***)**

24a Do you have evidence to support the business/investment use claimed? ☐ **Yes** ☐ **No** **24b** If "Yes," is the evidence written? ☐ **Yes** ☐ **No**

(a) Type of property (list vehicles first)	**(b)** Date placed in service	**(c)** Business/ investment use percentage	**(d)** Cost or other basis	**(e)** Basis for depreciation (business/investment use only)	**(f)** Recovery period	**(g)** Method/ Convention	**(h)** Depreciation deduction	**(i)** Elected section 179 cost
25 Special depreciation allowance for qualified listed property placed in service during the tax year and used more than 50% in a qualified business use (see instructions)						**25**		
26 Property used more than 50% in a qualified business use:								
		%						
		%						
		%						
27 Property used 50% or less in a qualified business use:								
		%				S/L –		
		%				S/L –		
		%				S/L –		
28 Add amounts in column (h), lines 25 through 27. Enter here and on line 21, page 1 . . .						**28**		
29 Add amounts in column (i), line 26. Enter here and on line 7, page 1							**29**	

Section B—Information on Use of Vehicles

Complete this section for vehicles used by a sole proprietor, partner, or other "more than 5% owner," or related person. If you provided vehicles to your employees, first answer the questions in Section C to see if you meet an exception to completing this section for those vehicles.

	(a) Vehicle 1		**(b)** Vehicle 2		**(c)** Vehicle 3		**(d)** Vehicle 4		**(e)** Vehicle 5		**(f)** Vehicle 6	
30 Total business/investment miles driven during the year (**do not** include commuting miles)												
31 Total commuting miles driven during the year												
32 Total other personal (noncommuting) miles driven												
33 Total miles driven during the year. Add lines 30 through 32												
	Yes	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**	**Yes**	**No**
34 Was the vehicle available for personal use during off-duty hours?												
35 Was the vehicle used primarily by a more than 5% owner or related person?												
36 Is another vehicle available for personal use?												

Section C—Questions for Employers Who Provide Vehicles for Use by Their Employees

Answer these questions to determine if you meet an exception to completing Section B for vehicles used by employees who **are not** more than 5% owners or related persons (see instructions).

	Yes	**No**
37 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
38 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? See the instructions for vehicles used by corporate officers, directors, or 1% or more owners . . .		
39 Do you treat all use of vehicles by employees as personal use?		
40 Do you provide more than five vehicles to your employees, obtain information from your employees about the use of the vehicles, and retain the information received?		
41 Do you meet the requirements concerning qualified automobile demonstration use? (See instructions.) . .		

Note: *If your answer to 37, 38, 39, 40, or 41 is "Yes," do not complete Section B for the covered vehicles.*

Part VI **Amortization**

(a) Description of costs	**(b)** Date amortization begins	**(c)** Amortizable amount	**(d)** Code section	**(e)** Amortization period or percentage	**(f)** Amortization for this year
42 Amortization of costs that begins during your 2009 tax year (see instructions):					
43 Amortization of costs that began before your 2009 tax year				**43**	
44 **Total.** Add amounts in column (f). See the instructions for where to report				**44**	

2009 Tax Table

CAUTION

See the instructions for line 44 that begin on page 37 to see if you must use the Tax Table below to figure your tax.

Example. Mr. and Mrs. Brown are filing a joint return. Their taxable income on Form 1040, line 43, is $25,300. First, they find the $25,300–25,350 taxable income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the taxable income line and filing status column meet is $2,964. This is the tax amount they should enter on Form 1040, line 44.

Sample Table

At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
25,200	**25,250**	3,366	2,949	3,366	3,186
25,250	**25,300**	3,374	2,956	3,374	3,194
25,300	**25,350**	3,381	2,964	3,381	3,201
25,350	**25,400**	3,389	2,971	3,389	3,209

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
0	**5**	0	0	0	0
5	**15**	1	1	1	1
15	**25**	2	2	2	2
25	**50**	4	4	4	4
50	**75**	6	6	6	6
75	**100**	9	9	9	9
100	**125**	11	11	11	11
125	**150**	14	14	14	14
150	**175**	16	16	16	16
175	**200**	19	19	19	19
200	**225**	21	21	21	21
225	**250**	24	24	24	24
250	**275**	26	26	26	26
275	**300**	29	29	29	29
300	**325**	31	31	31	31
325	**350**	34	34	34	34
350	**375**	36	36	36	36
375	**400**	39	39	39	39
400	**425**	41	41	41	41
425	**450**	44	44	44	44
450	**475**	46	46	46	46
475	**500**	49	49	49	49
500	**525**	51	51	51	51
525	**550**	54	54	54	54
550	**575**	56	56	56	56
575	**600**	59	59	59	59
600	**625**	61	61	61	61
625	**650**	64	64	64	64
650	**675**	66	66	66	66
675	**700**	69	69	69	69
700	**725**	71	71	71	71
725	**750**	74	74	74	74
750	**775**	76	76	76	76
775	**800**	79	79	79	79
800	**825**	81	81	81	81
825	**850**	84	84	84	84
850	**875**	86	86	86	86
875	**900**	89	89	89	89
900	**925**	91	91	91	91
925	**950**	94	94	94	94
950	**975**	96	96	96	96
975	**1,000**	99	99	99	99
1,000					
1,000	**1,025**	101	101	101	101
1,025	**1,050**	104	104	104	104
1,050	**1,075**	106	106	106	106
1,075	**1,100**	109	109	109	109
1,100	**1,125**	111	111	111	111
1,125	**1,150**	114	114	114	114
1,150	**1,175**	116	116	116	116
1,175	**1,200**	119	119	119	119
1,200	**1,225**	121	121	121	121
1,225	**1,250**	124	124	124	124
1,250	**1,275**	126	126	126	126
1,275	**1,300**	129	129	129	129

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
1,300	**1,325**	131	131	131	131
1,325	**1,350**	134	134	134	134
1,350	**1,375**	136	136	136	136
1,375	**1,400**	139	139	139	139
1,400	**1,425**	141	141	141	141
1,425	**1,450**	144	144	144	144
1,450	**1,475**	146	146	146	146
1,475	**1,500**	149	149	149	149
1,500	**1,525**	151	151	151	151
1,525	**1,550**	154	154	154	154
1,550	**1,575**	156	156	156	156
1,575	**1,600**	159	159	159	159
1,600	**1,625**	161	161	161	161
1,625	**1,650**	164	164	164	164
1,650	**1,675**	166	166	166	166
1,675	**1,700**	169	169	169	169
1,700	**1,725**	171	171	171	171
1,725	**1,750**	174	174	174	174
1,750	**1,775**	176	176	176	176
1,775	**1,800**	179	179	179	179
1,800	**1,825**	181	181	181	181
1,825	**1,850**	184	184	184	184
1,850	**1,875**	186	186	186	186
1,875	**1,900**	189	189	189	189
1,900	**1,925**	191	191	191	191
1,925	**1,950**	194	194	194	194
1,950	**1,975**	196	196	196	196
1,975	**2,000**	199	199	199	199
2,000					
2,000	**2,025**	201	201	201	201
2,025	**2,050**	204	204	204	204
2,050	**2,075**	206	206	206	206
2,075	**2,100**	209	209	209	209
2,100	**2,125**	211	211	211	211
2,125	**2,150**	214	214	214	214
2,150	**2,175**	216	216	216	216
2,175	**2,200**	219	219	219	219
2,200	**2,225**	221	221	221	221
2,225	**2,250**	224	224	224	224
2,250	**2,275**	226	226	226	226
2,275	**2,300**	229	229	229	229
2,300	**2,325**	231	231	231	231
2,325	**2,350**	234	234	234	234
2,350	**2,375**	236	236	236	236
2,375	**2,400**	239	239	239	239
2,400	**2,425**	241	241	241	241
2,425	**2,450**	244	244	244	244
2,450	**2,475**	246	246	246	246
2,475	**2,500**	249	249	249	249
2,500	**2,525**	251	251	251	251
2,525	**2,550**	254	254	254	254
2,550	**2,575**	256	256	256	256
2,575	**2,600**	259	259	259	259
2,600	**2,625**	261	261	261	261
2,625	**2,650**	264	264	264	264
2,650	**2,675**	266	266	266	266
2,675	**2,700**	269	269	269	269

If line 43 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
2,700	**2,725**	271	271	271	271
2,725	**2,750**	274	274	274	274
2,750	**2,775**	276	276	276	276
2,775	**2,800**	279	279	279	279
2,800	**2,825**	281	281	281	281
2,825	**2,850**	284	284	284	284
2,850	**2,875**	286	286	286	286
2,875	**2,900**	289	289	289	289
2,900	**2,925**	291	291	291	291
2,925	**2,950**	294	294	294	294
2,950	**2,975**	296	296	296	296
2,975	**3,000**	299	299	299	299
3,000					
3,000	**3,050**	303	303	303	303
3,050	**3,100**	308	308	308	308
3,100	**3,150**	313	313	313	313
3,150	**3,200**	318	318	318	318
3,200	**3,250**	323	323	323	323
3,250	**3,300**	328	328	328	328
3,300	**3,350**	333	333	333	333
3,350	**3,400**	338	338	338	338
3,400	**3,450**	343	343	343	343
3,450	**3,500**	348	348	348	348
3,500	**3,550**	353	353	353	353
3,550	**3,600**	358	358	358	358
3,600	**3,650**	363	363	363	363
3,650	**3,700**	368	368	368	368
3,700	**3,750**	373	373	373	373
3,750	**3,800**	378	378	378	378
3,800	**3,850**	383	383	383	383
3,850	**3,900**	388	388	388	388
3,900	**3,950**	393	393	393	393
3,950	**4,000**	398	398	398	398
4,000					
4,000	**4,050**	403	403	403	403
4,050	**4,100**	408	408	408	408
4,100	**4,150**	413	413	413	413
4,150	**4,200**	418	418	418	418
4,200	**4,250**	423	423	423	423
4,250	**4,300**	428	428	428	428
4,300	**4,350**	433	433	433	433
4,350	**4,400**	438	438	438	438
4,400	**4,450**	443	443	443	443
4,450	**4,500**	448	448	448	448
4,500	**4,550**	453	453	453	453
4,550	**4,600**	458	458	458	458
4,600	**4,650**	463	463	463	463
4,650	**4,700**	468	468	468	468
4,700	**4,750**	473	473	473	473
4,750	**4,800**	478	478	478	478
4,800	**4,850**	483	483	483	483
4,850	**4,900**	488	488	488	488
4,900	**4,950**	493	493	493	493
4,950	**5,000**	498	498	498	498

* This column must also be used by a qualifying widow(er).

(Continued on page 78)

If line 43 (taxable income) is— / And you are— / Your tax is—

At least	But less than	Single	Married filing jointly *	Married filing sepa-rately	Head of a house-hold
95,000					
95,000	**95,050**	20,327	16,131	20,739	18,609
95,050	**95,100**	20,341	16,144	20,753	18,621
95,100	**95,150**	20,355	16,156	20,767	18,634
95,150	**95,200**	20,369	16,169	20,781	18,646
95,200	**95,250**	20,383	16,181	20,795	18,659
95,250	**95,300**	20,397	16,194	20,809	18,671
95,300	**95,350**	20,411	16,206	20,823	18,684
95,350	**95,400**	20,425	16,219	20,837	18,696
95,400	**95,450**	20,439	16,231	20,851	18,709
95,450	**95,500**	20,453	16,244	20,865	18,721
95,500	**95,550**	20,467	16,256	20,879	18,734
95,550	**95,600**	20,481	16,269	20,893	18,746
95,600	**95,650**	20,495	16,281	20,907	18,759
95,650	**95,700**	20,509	16,294	20,921	18,771
95,700	**95,750**	20,523	16,306	20,935	18,784
95,750	**95,800**	20,537	16,319	20,949	18,796
95,800	**95,850**	20,551	16,331	20,963	18,809
95,850	**95,900**	20,565	16,344	20,977	18,821
95,900	**95,950**	20,579	16,356	20,991	18,834
95,950	**96,000**	20,593	16,369	21,005	18,846
96,000					
96,000	**96,050**	20,607	16,381	21,019	18,859
96,050	**96,100**	20,621	16,394	21,033	18,871
96,100	**96,150**	20,635	16,406	21,047	18,884
96,150	**96,200**	20,649	16,419	21,061	18,896
96,200	**96,250**	20,663	16,431	21,075	18,909
96,250	**96,300**	20,677	16,444	21,089	18,921
96,300	**96,350**	20,691	16,456	21,103	18,934
96,350	**96,400**	20,705	16,469	21,117	18,946
96,400	**96,450**	20,719	16,481	21,131	18,959
96,450	**96,500**	20,733	16,494	21,145	18,971
96,500	**96,550**	20,747	16,506	21,159	18,984
96,550	**96,600**	20,761	16,519	21,173	18,996
96,600	**96,650**	20,775	16,531	21,187	19,009
96,650	**96,700**	20,789	16,544	21,201	19,021
96,700	**96,750**	20,803	16,556	21,215	19,034
96,750	**96,800**	20,817	16,569	21,229	19,046
96,800	**96,850**	20,831	16,581	21,243	19,059
96,850	**96,900**	20,845	16,594	21,257	19,071
96,900	**96,950**	20,859	16,606	21,271	19,084
96,950	**97,000**	20,873	16,619	21,285	19,096
97,000					
97,000	**97,050**	20,887	16,631	21,299	19,109
97,050	**97,100**	20,901	16,644	21,313	19,121
97,100	**97,150**	20,915	16,656	21,327	19,134
97,150	**97,200**	20,929	16,669	21,341	19,146
97,200	**97,250**	20,943	16,681	21,355	19,159
97,250	**97,300**	20,957	16,694	21,369	19,171
97,300	**97,350**	20,971	16,706	21,383	19,184
97,350	**97,400**	20,985	16,719	21,397	19,196
97,400	**97,450**	20,999	16,731	21,411	19,209
97,450	**97,500**	21,013	16,744	21,425	19,221
97,500	**97,550**	21,027	16,756	21,439	19,234
97,550	**97,600**	21,041	16,769	21,453	19,246
97,600	**97,650**	21,055	16,781	21,467	19,259
97,650	**97,700**	21,069	16,794	21,481	19,271
97,700	**97,750**	21,083	16,806	21,495	19,284
97,750	**97,800**	21,097	16,819	21,509	19,296
97,800	**97,850**	21,111	16,831	21,523	19,309
97,850	**97,900**	21,125	16,844	21,537	19,321
97,900	**97,950**	21,139	16,856	21,551	19,334
97,950	**98,000**	21,153	16,869	21,565	19,346
98,000					
98,000	**98,050**	21,167	16,881	21,579	19,359
98,050	**98,100**	21,181	16,894	21,593	19,371
98,100	**98,150**	21,195	16,906	21,607	19,384
98,150	**98,200**	21,209	16,919	21,621	19,396
98,200	**98,250**	21,223	16,931	21,635	19,409
98,250	**98,300**	21,237	16,944	21,649	19,421
98,300	**98,350**	21,251	16,956	21,663	19,434
98,350	**98,400**	21,265	16,969	21,677	19,446
98,400	**98,450**	21,279	16,981	21,691	19,459
98,450	**98,500**	21,293	16,994	21,705	19,471
98,500	**98,550**	21,307	17,006	21,719	19,484
98,550	**98,600**	21,321	17,019	21,733	19,496
98,600	**98,650**	21,335	17,031	21,747	19,509
98,650	**98,700**	21,349	17,044	21,761	19,521
98,700	**98,750**	21,363	17,056	21,775	19,534
98,750	**98,800**	21,377	17,069	21,789	19,546
98,800	**98,850**	21,391	17,081	21,803	19,559
98,850	**98,900**	21,405	17,094	21,817	19,571
98,900	**98,950**	21,419	17,106	21,831	19,584
98,950	**99,000**	21,433	17,119	21,845	19,596
99,000					
99,000	**99,050**	21,447	17,131	21,859	19,609
99,050	**99,100**	21,461	17,144	21,873	19,621
99,100	**99,150**	21,475	17,156	21,887	19,634
99,150	**99,200**	21,489	17,169	21,901	19,646
99,200	**99,250**	21,503	17,181	21,915	19,659
99,250	**99,300**	21,517	17,194	21,929	19,671
99,300	**99,350**	21,531	17,206	21,943	19,684
99,350	**99,400**	21,545	17,219	21,957	19,696
99,400	**99,450**	21,559	17,231	21,971	19,709
99,450	**99,500**	21,573	17,244	21,985	19,721
99,500	**99,550**	21,587	17,256	21,999	19,734
99,550	**99,600**	21,601	17,269	22,013	19,746
99,600	**99,650**	21,615	17,281	22,027	19,759
99,650	**99,700**	21,629	17,294	22,041	19,771
99,700	**99,750**	21,643	17,306	22,055	19,784
99,750	**99,800**	21,657	17,319	22,069	19,796
99,800	**99,850**	21,671	17,331	22,083	19,809
99,850	**99,900**	21,685	17,344	22,097	19,821
99,900	**99,950**	21,699	17,356	22,111	19,834
99,950	**100,000**	21,713	17,369	22,125	19,846

$100,000 or over — use the Tax Computation Worksheet on page 89

* This column must also be used by a qualifying widow(er)

2009 Tax Rate Schedules

CAUTION

The Tax Rate Schedules are shown so you can see the tax rate that applies to all levels of taxable income. Do not use them to figure your tax. Instead, see the instructions for line 44 that begin on page 37.

Schedule X—If your filing status is **Single**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$8,350	---------- **10%**	**$0**
8,350	33,950	**$835.00 + 15%**	**8,350**
33,950	82,250	**4,675.00 + 25%**	**33,950**
82,250	171,550	**16,750.00 + 28%**	**82,250**
171,550	372,950	**41,754.00 + 33%**	**171,550**
372,950	--------	**108,216.00 + 35%**	**372,950**

Schedule Y-1—If your filing status is **Married filing jointly** or **Qualifying widow(er)**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$16,700	---------- **10%**	**$0**
16,700	67,900	**$1,670.00 + 15%**	**16,700**
67,900	137,050	**9,350.00 + 25%**	**67,900**
137,050	208,850	**26,637.50 + 28%**	**137,050**
208,850	372,950	**46,741.50 + 33%**	**208,850**
372,950	---------	**100,894.50 + 35%**	**372,950**

Schedule Y-2—If your filing status is **Married filing separately**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$8,350	---------- **10%**	**$0**
8,350	33,950	**$835.00 + 15%**	**8,350**
33,950	68,525	**4,675.00 + 25%**	**33,950**
68,525	104,425	**13,318.75 + 28%**	**68,525**
104,425	186,475	**23,370.75 + 33%**	**104,425**
186,475	---------	**50,447.25 + 35%**	**186,475**

Schedule Z—If your filing status is **Head of household**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$11,950	---------- **10%**	**$0**
11,950	45,500	**$1,195.00 + 15%**	**11,950**
45,500	117,450	**6,227.50 + 25%**	**45,500**
117,450	190,200	**24,215.00 + 28%**	**117,450**
190,200	372,950	**44,585.00 + 33%**	**190,200**
372,950	---------	**104,892.50 + 35%**	**372,950**