

Personal Income Tax Discussion Problems Fall 2009

This problem set contains questions that illustrate the basic issues. We will discuss all assigned problems in class, so do work them out ahead of time. The problems below take two forms: Some frame the issue, and provide a discussion of the answer. Most just ask questions, but I also provide citations to the appropriate regulations, which can be extremely useful. Cases in your reading will also be helpful in answering questions. *In answering these problems, you should get used to consulting and learning the general Internal Revenue Code section numbers.*

Note that often I don't ask for a numeric solution to a problem; usually, I want you only to understand the formula, rule, or principle.

I have arranged the problems in the order we will cover them. They are numbered by the appropriate topic number. (Some topics will take more than one class hour.)

Problem 1-1 U.S. Public Finance

The federal income tax began small in 1913, and grew into a “mass” tax after World War II, when Congress instituted withholding on wages. To understand how the federal income tax is created and administered, consider the allocation of authority among the three branches –

1. The legislative branch (*Congress*) writes statutes. The Internal Revenue Code (the *Code*) is the compilation of many revenue acts written in the last 80 years. Under the Constitution, tax legislation must originate in the House of Representatives. Once the House sends over a tax bill, however, the Senate is free to amend it any way it pleases; any differences between the two bills are ironed out by a Conference Committee of representatives and senators. (In 1984, the Senate took a short House bill containing a boating tax, struck all the language, and added a 1,500 page “amendment”! This made for a very odd conference, as staff members had to orally explain each provision to the House conferees.) The conference bill must then be resubmitted to each house for approval before being sent to the President for signature.
2. The executive branch “enforces” the law. In practice, it is more complicated!
 - The *President*, either in his name or through the Secretary of the Treasury, can propose new legislation to Congress – if he gets a congressman to introduce it. Whether the President belongs to a different political party from the controlling party in either house obviously has a huge effect on the ability of the President to

achieve legislative success in Congress.

- The *Treasury Department*, with the assistance of the Internal Revenue Service (a bureau of the Treasury Department), issues regulations and other published guidance that explain the Code. These regulations first issue in proposed form, so that the public may comment. Public input is especially helpful in complex industries, such as the financial markets, and final regulations may look very different from proposed regulations.
 - The *Internal Revenue Service* (the “IRS” or the “Service”) administers the Code. The IRS has about 100,000 employees. They process, and occasionally examine, taxpayer returns, and litigate disputes with taxpayers. A mechanism is available for taxpayers to obtain from the IRS a ruling in advance of a transaction, setting forth the tax consequences.
3. The *courts* have a limited role in areas where Congress has legislated thoroughly. As you know, the United States has a common law tradition. However, there is no common law of federal income taxation! Thus, courts decide a dispute between a taxpayer and the IRS based on the court’s interpretation of the law.

Of course, what the “law” is depends on what prior courts have decided. Note that the Treasury regulations have the force and effect of law.

4. The cycle repeats: Because the courts merely interpret the statute, Congress can always over-ride a court opinion by changing the statute – unless a constitutional issue was involved, which is very rare. Congress, of course, can also over-ride a Treasury regulation with which it disagrees.

Problem 2-1 Reality Check

For some reason, many students approach tax courses with all the eagerness of anticipating root canal work. There may be two misconceptions about these courses: first, that the rules bear no relation to what people of common sense might come up with; and, second, that we use no words at all, merely numbers.

As to the first point, remember above all that these rules are written by members of congress and judges – while these people might suffer from lapses of judgment, they are by no means arbitrary. Every rule in the Internal Revenue Code came about, at some point over the last 90 years, by someone who wanted a particular dollar result. Think normal people. Think greed.
Follow the money!

As to the second qualm, we talk more about concepts than numbers. We use numbers

only to illustrate the concepts. Problems help you understand the rules, and make it easy to see what's at stake. You don't have to be a math wizard or an accountant (indeed, I was a comparative literature major in college). However, this is a statute-based course: The numbers we use most annoyingly are the "Code sections" as a short-hand reference to a rule. Before long, you too will be saying "section 61" or "section 1001" without batting an eye.

To illustrate how approachable this course will be, here is a short "common sense tax quiz" on one aspect of this course – these are sample items under the question "what is income?" Jot down your answers to these questions today. Put this list away until you study for the exam. You will be surprised to see how much you knew already – and in places where the law is actually different from what you thought, you should have a conceptual understanding of why the law takes a different tack.

So, take a guess. Which of the following items are "income" subject to income tax?

1. You earn \$300 from writing a Will for a client (after, of course, you are admitted to the bar).
2. You write a Will for your dentist in return for a new crown.
3. You write your own Will.
4. You find \$100 cash in the street.
5. You are a flight attendant, and your employer lets you fly free on any empty seat.
6. You inherit \$1,000 from your great-grandmother.
7. You collect \$1,000 worth of life insurance on the death of your great-grandmother.
8. You win a \$1 million lottery, payable at the rate of \$50,000 a year for 20 years.
9. You earn \$100 interest on your checking account, but you don't draw out the money.
10. Your Microsoft stock, which you have owned for years and continue to own, is worth \$1,000 more on December 31 than it was at the beginning of the year.
11. You sell your house at a \$300,000 profit (over the \$20,000 you paid 25 years ago).
12. You borrow \$1,000 from the bank.
13. Because you turn out to be such a deadbeat, the bank agrees to forgive \$200 of the loan, reducing your debt to \$800.

14. You embezzle \$1,000 from your employer.
15. You receive alimony of \$1,500 a month.
16. You suffer personal physical injuries in a car accident, and recover \$1,000 in compensatory damages.
17. After being unfairly fired from your job, you recover \$10,000 for lost wages.

Problem 2-2 Windfalls

Dave finds a paper bag with \$10,000 cash in it on the street. He keeps it and does not report it to the police. Is the cash included in Dave's gross income? (See Reg. § 1.61-14.)

Problem 2-3 Income Tax Treatment of Debt

Naomi borrows \$1,000 from the bank and spends it. Although you won't find the rule anywhere in the Code, the money borrowed is not income. Because of Naomi's offsetting obligation to repay the bank, we do not view Naomi as being any richer. What is Naomi's tax treatment when she repays the \$1,000? Again, nothing. Naomi may not deduct her repayment – because repayment also extinguishes her obligation to the bank, Naomi is not any poorer.

Problem 3-1 “Realization Event” Required for Sales of Property

“When” aspect: A taxpayer *generally* does not have income from appreciation in value until she or he sells the property. (See Code section 1001.) As a result, two taxpayers earning a \$20,000 salary will have the same taxable income even if one of them also owns property that increased in value by \$50,000 that year. Congress adopted the realization requirement for two reasons. First, is the valuation issue: Other than in cases of publicly traded stock, how can we have confidence that the correct amount of unrealized gain is being taxed (or loss allowed)? The second reason is liquidity: If we tax unrealized gains, where will the taxpayer find the money to pay the tax? (Again, this is not really a problem for publicly traded stock.)

“What” aspect: When property is sold, only the profit (or loss) is recognized. To measure profit (or loss), the tax laws adopt the concept of “basis.” Basis is generally what the taxpayer paid to buy (or construct) the property. (See Code section 1012.) On sale, the taxpayer subtracts basis from the consideration (called “amount realized” in tax-ese). This prevents the taxpayer from being taxed again on the original amount invested (and, for a sale at a loss, allows a full cost recovery).

Problem 3-2 Effect of Basis on Sale

Jane buys a tract of vacant land for \$1,000 at the beginning of Year 1. What is her “basis” in the land? (See Code section 1012.)

She stills owns the land at the end of Year 1, by which time it has gone up in value to \$1,500. How much income does she have in Year 1 from the land? (See Code section 61(a)(3) and Reg § 1.61-6(a).)

In Year 2 Jane sells the land for \$1,800. How much income does she have in Year 2 from the land? (See Code section 1001.)

Problem 3-3 Exchange of Assets as a Realization Event

John owns \$1,000 worth of Microsoft stock. Janine owns \$1,000 worth of IBM stock. They decide to swap their stock in an even exchange. If John’s basis in the Microsoft stock were \$200, does John recognize gain? Yes; a realization event is either a “sale” for cash or an “exchange” of assets. (See section 1001(a) & (b)(1).) Janine also has gain or loss on her IBM stock, depending on whether her basis in it was lower or higher than \$1,000, the value of the Microsoft stock she received in return.

What is John’s “basis” in the IBM stock he receives from Janine? Because he recognized an \$800 gain in his Microsoft stock, and John had originally paid \$200 for it, John’s after-tax investment in the IBM stock is its fair market value of \$1,000. (See Code section 1012 and Reg. § 1.1012-1(a).)

Hint: When faced with a non-cash exchange, I find it helpful to insert a fictitious cash transaction. Thus, I pretend that first John actually sold his stock to a third party for \$1,000 in cash. This gives John \$800 of gain. Then I pretend that John took \$1,000 of cash and bought the IBM stock from Janine. This gives him a \$1,000 cost basis in the IBM stock. Do you see that in this fictitious purchase John has to come up with some additional cash to pay the full \$1,000 price? – after all, because of tax on the \$800 gain, he didn’t net \$1,000 of cash from his fictitious sale of Microsoft. Accordingly, it’s fair to treat this full \$1,000 amount as his investment in the stock; he invests \$1,000 on which he has already paid taxes.

Problem 3-4 Satisfaction of Debt

Nina borrowed \$1,000 from Dmitri. He agrees to cancel the debt in exchange for \$1,000 worth of Microsoft stock that Nina has owned for many years. She had purchased the stock for \$400. What are the tax consequences to Nina? To Dmitri?

Problem 3-5 Exchange of Assets Off an Established Market

Mia owns a Hemingway manuscript that Lee would like to acquire. She had paid \$20,000 for it at auction many years ago. If Lee pays her \$180,000 in cash, what tax result to Mia? What is Lee's basis in the manuscript?

Assume instead that Lee has no cash, but he does have \$180,000 worth of Microsoft stock. If he exchanges this stock for Mia's manuscript, what tax result to Mia? Assuming Lee had paid \$35,000 for his stock, what tax result to Lee?

Finally, assume instead that Lee has no cash and no publicly-traded assets, but he does own an antique Rolls Royce that Mia accepts in an even exchange for her Hemingway manuscript. If Lee had paid \$35,000 for this car, what tax results to the parties?

Problem 4-1 Taxpayer Choice

You own two assets, IBM stock worth \$100 in which your basis is \$90, and Microsoft stock worth \$100 in which your basis is \$20. You bought both several years ago. If you need some cash, which stock are you better off selling now? (Remember, you're trying to minimize taxes; assume you think both have equal economic prospects.)

Problem 4-2 Tax Treatment of Stockholders

Bruce buys some Microsoft stock. He winds up owning .0001% of the company. Microsoft is a very successful corporation. Let's say Microsoft earns \$1 billion this year, after taxes, and so (if the law worked this way) Bruce's "share" is \$1,000. Assume Microsoft distributes 20% of its after-tax earnings to the shareholders as a dividend, and retains the rest of earnings to reinvest in the business. Can you see that these retained earnings increase the value of Bruce's stock?

Bruce must recognize his \$200 dividend as ordinary income, although dividends currently enjoy a top tax rate of only 15%. (See Code sections 61(a)(7) and 1(h).) As we will see in Assignments 27 and 28, he cannot claim capital gains treatment for these dividends because he has not sold a capital asset (his stock). We thus think of dividends as the "periodic" income from an investment in stock.

But Bruce's stock is also worth \$800 more on account of the retained earnings. (For simplicity, we assume that the corporation is worth what its assets are worth, not necessarily true.) On a sale of stock, any gain or loss recognized is capital gain or loss. This is true even though Bruce would have had dividend treatment had the corporation instead distributed its retained earnings. If he sells his stock, he recognizes a capital gain of \$800. In effect, the capital

gains tax serves as a surrogate tax on the corporation's failure to distribute its earnings to the selling shareholder. While the top capital gains rate is currently the same as the top rate on dividends, dividends are not capital gains, and so he cannot offset dividends by any capital losses. (We discuss capital gains in Assignment 27.)

You will cover these issues in detail if you study corporate tax.

Problem 4-3 The Value of the Realization Doctrine

You have been promised \$100 exactly one year from now. If prevailing interest rates are 10 percent, what is the "present value" of that future \$100? (See the Present Value Table in the Appendix.) What if instead you will not receive the \$100 for 10 years? 20 years?

Now think about the opportunity in the tax laws to choose the timing of a realization event. Assume you own Microsoft stock, for which you paid \$50 three years ago and which is now worth \$150. It is late in December, and you need \$150 cash by January 10 of next year. Thus, from an economic point of view, you do not care whether you sell your stock in late December or early January. But under our annual tax collection, it makes a difference. How much tax do you save if you sell in January, assuming a tax rate of 15% and interest rates of 10%?

Gain is \$100 (sale price of \$150 minus \$50 tax basis); at a 15% top capital gains rate, tax due is \$15. For individuals, taxes income received during the calendar year are due on April 15 of the following year. Thus, delaying the sale by a few days that straddle a calendar year results in a one-year deferral of tax. (For simplicity, we ignore the requirement to make quarterly payments of estimated tax.) At a 10% interest rate, you can earn \$1.50 on the deferred tax. Of course, you would have to pay taxes on that investment income! *The value of tax deferral is the after-tax investment income you can earn on the amount involved.*

What if you didn't need \$150 in January of next year? Many investors hold capital assets for years before selling them. Think of an asset that grows in value by 10% a year for 10 years, before the investor sells it. Can you see that the value is compounding at a pre-tax rate during this period? Economists call this feature of capital assets "inside build-up." The realization doctrine is what makes holding capital assets so desirable, even more than the low top tax rate. Corporate investors also benefit from inside build-up. (Inventory assets share this feature, except that businesses rarely want to hold inventory for long terms.)

Another way to think about the value of deferring tax is to calculate the "effective" tax rate on the income. Assume you earn income of \$100, and you face a statutory tax rate of 15%. If you had to pay the tax today, you would owe \$15. If, instead, you could pay the tax in one year, and interest rates were 10%, the present value of \$15 tax is about \$13.75. In other words, your effective tax rate is only 13.75% instead

of the statutory 15%. The longer the period of deferral, and/or the higher the discount rate, the lower the effective tax rate.

What happened to the “value” of tax deferral when Congress cut the capital gains rate from, generally, 28% to 20% in 1997 and then to 15% in 2003?

There is a “flip side” to deferral – if you have suffered a *loss* instead of enjoyed a profit. The longer you defer claiming that loss, the lower the value of the deduction. This is why, as a basic rule, taxpayers prefer to realize losses as soon as possible and defer gains as long as possible. Taxpayers’ ability (to the extent allowed) to realize losses immediately but defer realization of gains reduces the effective tax rate on capital investments. As we will see, Congress tries to make taxpayers match losses to gains in order to reduce this “elective selectivity.”

Problem 4-4 Trading in Bonds

A bond is a loan. If you buy a \$100 bond from IBM, that means that IBM has promised to pay you \$100 at maturity, plus interest at a rate stated up front. Assume the when-issued interest rate for your bond was 5%.

You (called the “bondholder” rather than the “lender”) can sell your bond. As current interest rate changes, the value of a bond will change. Assume that sometime later market interest rates fall to 4%. What does this do to the value of your bond? Can you see that someone will be willing to pay you a “premium” to obtain a 5% return?

Or assume the opposite – what happens to the value of your bond if market interest rates rise to 6%? Can you see that a buyer will pay you less than \$100 to obtain your bond? Your bond would trade only at a “discount.”

The other big factor in pricing bonds is, of course, default risk. Perhaps you have heard of AAA-rated bonds, and the lesser ratings, such as AA, A or AB. Bond-rating agencies, such as Moody's or Standard & Poors, will be hired by the issuing corporation – can you see that the corporation desires as strong a rating as possible, so that it can market its bond at as low as possible an interest rate? Over time, the fortunes of the issuer might decline, and the agency will downgrade the rating to reflect the risk that the holder will not be paid all of the principal, or even interest, due on the bond.

The market discount (and market premium) rules are beyond the scope of this course.

Problem 5-1 Barter of Services

Tony and Nancy are neighbors and good friends. Tony is a real estate lawyer, and Nancy is a family law practitioner. They agree to swap services – Tony handles Nancy’s house closing, and Nancy handles Tony’s (amicable) divorce. What are the tax consequences? Why is this a hard case?

Problem 5-2 Property for Services

Tom and Noreen are neighbors and good friends. Tom is a real estate lawyer, and Noreen is an artist. They agree to a swap – Tom handles Noreen’s house closing, and Noreen gives Tom a print that sells for \$2,500. What are the tax consequences to Tom? Do you see why he takes a “cost” basis in the print equal to its fair market value?

Hint: Again, when faced with a non-cash exchange, I find it helpful to insert a fictitious cash transaction. Thus, I pretend that first Noreen actually paid Tom \$2,500 for his legal services. This gives Tom \$2,500 of income. Then I pretend that Tom took the \$2,500 of cash and bought the painting from Noreen. This gives him a \$2,500 cost basis in the painting. It’s fair to treat this full amount as his investment in the painting; after all, he also had to pay the taxes on the \$2,500 of service income.

And what are the tax consequences to Noreen?

Problem 5-3 Payment of Employee’s Housing

Justin’s employer pays him \$2,000 a month. Justin’s rent is \$500 a month. One day Justin comes up with a bright idea: Why not ask his employer to pay his rent directly to his landlord, thereby reducing his taxable compensation to \$1,500 a month? Before he approaches his boss, though, he asks you if you think this will work. What do you tell him?

Problem 6-1 Gifts

Mary gives her son John a new car as a gift. Is the value of the car included in John's gross income? (See Code section 102.)

Problem 6-2 Transfers: The Matrix of Income Tax Possibilities

We are now concentrating on the recipient of a transfer, and we later study the tax treatment of the payor. Take a look at this “matrix,” which we will return to throughout the semester, to see the combined possible tax consequences from transfers. If wages are taxed once (see upper left box) and if gifts are taxed once (see lower right box), then what were the parties

fighting about in *Duberstein*?

	INCOME	NOT INCOME
DEDUCTIBLE	<u>Example</u> : Wages paid by IBM. <u>Result</u> : <i>Taxed once</i> (payee's rate).	<u>Example</u> : Qualified fringe benefits. <u>Result</u> : <i>Taxed no times</i> .
NOT DEDUCTIBLE	<u>Example</u> : Payments to home gardener. <u>Result</u> : <i>Taxed twice</i> (at both payor's and payee's rate).	<u>Example</u> : Gifts. <u>Result</u> : <i>Taxed once</i> (payor's rate).

Problem 6-3 Support

State law requires parents to support their minor children. Do the children have taxable income as a result?

Problem 6-4 Tips

On vacation in Washington, D.C., you have just enjoyed a sumptuous meal at the Palm D'Or restaurant. On your last night, you're feeling magnanimous. You decide to leave a \$50 tip to a waiter you will never see again. Can the waiter exclude the \$50 from income as a gift?

Problem 6-5 Bequest vs. Compensation

Mortimer was the long-time attorney of Bernice, never charging for his work. They enter into a written agreement that for any future legal services she shall require, he will never bill her, but upon her death she will leave him 1,000 shares of Big Corp. When she later died, Bernice's will bequeathed Mortimer the 1,000 shares, now worth \$20,000. While he had not performed any subsequent legal services beyond revising her will, Mortimer had not charged her for these. Does Mortimer have \$20,000 of taxable income? (Ignore any prohibition against the drafter of a will taking under the will.)

Problem 7-1 No-Additional-Cost Fringe

George works for Up-And-Away Airlines. His employer permits employees to fly free on

any empty seat. George flies from New York to Tokyo at no cost. The regular coach fare is \$1,500. Does George have taxable income from this free flight? (Compare Reg. § 1.61-21 with Code section 132(b).)

Problem 7-2 Employee Discount

Anita works at J.C. Penney's. She is permitted a 10% employee discount on all J.C. Penney goods. If she uses this discount, does she have additional taxable compensation? (See Code section 132(c).)

Problem 7-3 Working Condition Fringe

Jack, a salesman for Motorola, flies to Seattle to call on customers. He works all day Thursday and Friday. Assume that if he were to return to Chicago on Sunday instead of Saturday, he would cost Motorola an additional \$150 in hotel and meals, but he would save his employer \$250 on the cheaper plane flight. Should Jack choose to stay until Sunday, would he have \$150 of taxable income? (See Code section 132(d); the IRS said "no" in Private Letter Ruling 9237014.)

Problem 7-4 Parking

Claire works as an associate for Bendini, Lambert & Locke. The firm pays for her parking in the lot next door to the office, saving her \$100 a month. The firm does not pay for secretaries' parking. Does Claire have income as a result of this perk? (See Code section 132(f) and (j)(1).) What if the firm offers Claire a choice of \$100 extra cash compensation a month or free parking? (See Code section 132(f)(4).)

Problem 7-5 Tax Expenditures

Who "pays" for the fact that certain fringe benefits are excluded from the taxable income of employees? Are there certain industries or sectors that enjoy a higher or lower than average level of fringe benefits? How would these industries react if Congress repealed these exclusions?

Problem 8-1 Health Care

Professor Jones is employed by Illinois Institute of Technology. IIT pays \$4,000 in this year to Blue Cross/Blue Shield for health insurance for Professor Jones and her family. How much income does Professor Jones have as a result of this payment? (See Code section 106.)

Also this year, Blue Cross/Blue Shield paid \$1,000 of medical bills for Professor Jones, her husband and her children. Does she have income as a result of this payment? (See Code section 105(b).)

Problem 8-2 Contract Claim

Steve has a three-year contract to play for the Cubs. In the middle of the second year of his contract, the club releases him. Steve sues for breach of contract, and a jury awards him damages of \$750,000. The damages equal the wages he would have been paid had he finished out his contract. Is this amount taxable to Steve?

Problem 8-3 Personal Physical Injury

Joe is injured in a car accident. In settlement, the wrong-doer pays Joe \$60,000. Of this, \$15,000 is for Joe's medical bills, \$20,000 is for Joe's pain and suffering, and \$25,000 represents Joe's lost wages for having to be out of work recuperating for six months. Is any of this amount taxable?

Problem 8-4 Personal Non-Physical Claim

Rod has a three-year contract to play for the White Sox. In the middle of the second year of his contract, the club releases him. Steve sues under Title VII for racial discrimination, and a jury awards him damages of \$750,000. The damages equal the wages he would have been paid had he finished out his contract. Is this amount taxable to Steve?

Problem 10-1 Self-Produced Property

If a farmer grows food and eats it herself, is the value of the food included in her income? If instead the farmer grows alfalfa and swaps some for food, does she have income? (See Reg. § 1.61-4(a).)

Problem 10-2 Homemakers

Ellie is a tax associate at a large law firm, and her husband Albert is a carpenter. When Ellie is expecting twins, the couple sits down with their financial advisor to discuss the impact of their new family responsibilities. They realize that if both of them continue to work outside the home, their child-care costs of \$20,000 a year will eat up all of Albert's income of \$20,000. Worse, Albert's income is taxable, so they would really be out-of-pocket in paying someone else

to take care of the babies. Accordingly, Albert stops working outside the home. Does the family have imputed taxable income?

Problem 10-3 Owner-Occupied Housing

If you buy a house for cash and live in it, do you have income equal to the rental value of the house? If you sold the house, put the money in the bank, and used the interest you earned on your bank account to rent a house, could you deduct the rent you pay to offset the interest income you earn? (See Reg. § 1.262-1(b)(3).)

Problem 10-4 Life Insurance

Akil pays \$3,000 a year for a life insurance policy that would pay \$200,000 if he were to die. The policy is a type of insurance product known as a “whole life” policy. Unlike “term” insurance, which just protects against the risk of death and so is much cheaper, a whole life policy is part risk insurance and part a savings instrument. Whole life insurance is a tax-favored form of saving. The insurance company uses the investment income earned on the premiums paid to reduce the future amount of premiums required (actually, the investment income just keeps the premiums level, even though the risk of death increases with time) – without resulting in taxable income to the policyholder.

If Akil were unfortunate to “win” his bet, the insurance company would pay \$200,000 to whomever he had designated. If he did not select a beneficiary, the money is paid to his estate. In any case, Code section 101(a) excludes the payoff from taxable income. The theory is that because Akil could not take a tax deduction for the premiums he paid, he should not be taxed when the contract “matures.” The flaw in this argument is that Akil benefited from the untaxed investment feature of the whole life policy. The tax treatment of whole life policies is very controversial.

Whole life insurance policies build up a “cash surrender value.” This generally represents the amounts paid in over the term cost of insuring the risk of death. The cash surrender value is much less than the amount the insurance company would pay if the insured actually died. But some policyholders need money, and so cash out (or borrow against) the cash surrender value in the contract.

In recent years, some compassionate insurance companies have gone further, and made available an amount greater than the cash surrender value (but still less than the face amount of the policy) to those expecting to die soon from AIDS. Obviously, you can see why the insured, whose estate (or beneficiary) would soon receive \$200,000, would rather have (or might need), say, \$150,000 now. But are such “accelerated death” benefits “payable by reason of the death of the insured” as required by Code section 101(a)? Even before the 1996 addition of section

101(g), in a proposed regulation the IRS answered yes.

But, as your reading discusses, the IRS reached a different conclusion if instead the insured sells the contract to a third party (called a “viatical company”). Why? Some observers thought that the IRS believed it had the authority to make the first ruling, but Congress must make the other. See how Congress addressed this in the new legislation.

Problem 11-1 Basis for Gifts

Sue buys some stock in a corporation for \$1,000 at the beginning of Year 1. The stock has gone up in value to \$1500 by the end of Year 1. Does Sue have income in Year 1 from the stock? In Year 2, when the stock is worth \$1,500, she gives it to her son Martin. Does Sue have income in Year 2 from giving away the stock? Later in Year 2 Martin sells the stock for \$2,000. How much income does Martin have when he sells the stock? What is his basis at the time he sells it? (See Code section 1015(a).)

Problem 11-2 Gift vs. Sale

Case loves his daughter Mollie very much, and wants to make her a gift. However, he also needs some cash. He owns two assets: Apple Computer stock worth \$100,000 in which his basis is \$120,000 and Microsoft stock worth \$100,000 in which his basis is \$80,000. Which stock should he sell and which stock should he give to Mollie? (See also Reg. § 1.1015-1(a)(2) (Example) for the rule that applies when a gifted *loss* asset is later sold for a *gain*.)

Problem 11-3 Basis for Bequests

Gary buys some stock for \$1,000 at the beginning of Year 1. In Year 2, when the stock is worth \$2,000, Gary dies and leaves the stock to his daughter Marcia in his will. Later in Year 2 Marcia sells the stock for \$2,000. How much income does Marcia have when she sells the stock? What is her basis in it at the time she sells it? (See Code section 1014(a).) By the way, what is the purpose of Code section 1014(e)(1)?

Problem 11-4 Bequest vs. Sale

Kurt loves his granddaughter Julie very much, and wants to provide for her in his will. However, he also needs cash to live on. He owns three blocks of stock: Apple Computer stock worth \$100,000 in which his basis is \$120,000; Microsoft stock worth \$100,000, basis of \$20,000; and ADM stock worth \$100,000, basis of \$80,000. Any tax advice for Kurt?

Hint: If Kurt sells one block, is he better off selling two? As we will see, Congress limits a taxpayer's ability to deduct a large net capital loss in any one year. (Also, before Kurt buys back some IBM stock, he needs to think about the "wash sale" rules, which basically result in ignoring a realized capital loss if you quickly buy back the same stock.)

Problem 12-1 Calculation of Tax

Mary Smith, who is single, earned a \$70,000 salary this year. She also received \$1,000 in interest from a bank account. She had no other income. She rents an apartment and does not itemize deductions. Her employer withheld a total of \$15,000 in federal income tax from her paychecks.

- What is her gross income? (Look at Code section 61.)
- What is her adjusted gross income? (Code section 62.)
- What is the standard deduction she is allowed? (Why is the amount in Code § 63(b)(2) different from the 2009 amount in the table in Appendix F?)
- What is she allowed to deduct as a personal exemption? (Code § 151(a) & (d)(1); again you need to go to the tax table.) (We study personal exemptions in Assignment 36.)
- What is her taxable income? (Code sections 63(a), 63(b), and 63(c).)
- How would you figure out her tax liability? (Code section 1(c) is also adjusted in the 2009 Tax Rates Table in Appendix F.)
- What is the net amount of tax she owes to the IRS? That is, what amount does she put on the check? Or does Mary get a refund? (Compare Code sections 31 and 275.)
- What is her marginal tax rate? (How much tax did she pay on her last dollar of income?)
- How is this different from her average tax rate? (Take her total tax and divide it by her adjusted gross income.)

Problem 12-2 Comparing Standard Deduction with Itemized Deduction

What is the function of the standard deduction? How does it differ from the personal exemption? How do itemized deductions fit in? When you find yourself reading the same sentence in the Code over and over again, it's time to look at the tax form!

By the way, if your eyes glaze over, you have good company. In 1952, Learned Hand wrote: “In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.”

So, consult the Form 1040. It’s near the beginning of the Appendix. On the front, in line 6, you see that there’s one personal exemption per person in the family. Now turn the form over. With details that we discuss in Assignment 35, you will see that on lines 38 and 39 you subtract the personal exemptions from your income. It’s money you and your family can live on tax-free. (Real generous, aren’t we?)

Wait, there’s more. Even though Code section 262 denies any deduction for “personal, living, and family expenses,” each taxpayer gets an additional deduction for these costs. Code section 63 gives the rules, but it’s again easier to follow on the tax form. Look at line 36. The taxpayer can **choose** to claim (deduct) either the “standard deduction” or “itemized deductions.” We call a taxpayer who claims the standard deduction a “non-itemizer” and a taxpayer who chooses the itemized deductions an “itemizer.” Taxpayers generally add up their itemized deductions, and claim them if they exceed the standard deduction (which is granted without the taxpayer having to prove these expenses, or even incur them).

Take a look at Schedule A to the Form 1040, for a one-page summary of the itemized deductions. We will study most of these in detail in Assignments 23, 24, and 25. Generally, these expenditures are for “personal, family, and living expenses.” (Business expenses are – generally – deductible in full “above-the-line” on line 12 of the Form 1040.) Thus, whether the taxpayer itemizes or claims the standard deduction, Congress grants an additional amount to live on tax-free.

In sum, every taxpayer gets the personal exemption, plus the taxpayer may choose the standard deduction or the itemized deductions. Recognize that the dollar figures that Congress selects have real economic consequences. For example, if it sets the standard deduction at \$100,000, few people would pay any tax. Moreover, few people would spend as much as they do now on the expenditures “subsidized” by permitting itemized deductions. For example, if you are in the 35% tax bracket and you have \$10,000 of home mortgage interest expense, it really only costs you \$6,500 (because you saved \$3,500 in taxes). If you couldn’t benefit from the deduction, you would have to pay the entire \$10,000 in interest, and might not buy such a big house. (We discuss this, and other effects of the mortgage interest deduction, in Assignment 25.)

In the 1986 Tax Reform Act, Congress deliberately simplified tax compliance by raising the amount of the standard deduction. Now only about one-third of taxpayers itemize. The 2001 tax act created a temporary increase in the standard deduction for married couples; this will also

reduce the number of itemizers while it is in effect.

Problem 12-3 What Is an Exclusion or Above-the-Line Deduction Worth?

What is a \$100 above-the-line deduction “worth” to a single individual with taxable income of \$120,000? What is the same deduction worth to a single individual with taxable income of \$18,000?

More generally, what happened to the “tax expenditure budget” when tax rates were cut?

Problem 12-4 What Is a Below-the-Line Deduction Worth? A Tax Credit?

What is a \$100 below-the-line deduction “worth” to a single individual with taxable income of \$120,000 who itemizes deductions rather than claims the standard deduction (looking only at Code section 1)?

What is a \$100 below-the-line deduction “worth” to a single individual with taxable income of \$18,000 who itemizes deductions rather than claims the standard deduction?

What is a \$100 below-the-line deduction “worth” to a single individual with taxable income of \$18,000 who claims the standard deduction rather than itemizes deductions?

As we will see in Assignment 36, where we discuss the child-care credit and the per-child tax credit, some tax subsidies take the form of a credit against tax rather than a deduction from income. What is a \$100 tax credit worth to each of these three taxpayers?

Problem 14-1 Constructive Receipt

Both the cash method of accounting and the realization requirement can be manipulated by the taxpayer. Accordingly, various doctrines have been created over the years to require the taxpayer to take items into account in the proper year.

The best-known rule is the doctrine of constructive receipt. Simply put, this means that the taxpayer cannot turn her back on income that is made available to her without restriction. For example, assume a taxpayer deposits \$100 in a bank account on January 1, and the account bears 10% interest. She makes no withdrawals or additional deposits that year. By December 31 the account contains \$110, including \$10 interest. In litigation with the IRS, taxpayers tried to argue that they had no income until they withdrew the interest credited to their account. However, the Internal Revenue Service successfully argued that the taxpayers constructively earned the income that is unconditionally made available to them.

Problem 14-2 Methods of Accounting; Payment for Services

You are a partner in a law firm on the cash method of accounting and having a calendar year. Your client XYZ Corp., also on the calendar year, uses the accrual method of accounting. The law firm sends out bills for all legal services rendered in Year 1 in December of Year 1. XYZ pays its bill in January of Year 2. For what year does the law firm include the amount billed in income? For what year does XYZ deduct this amount? What if XYZ calls your firm on Tuesday, December 31, and says that the check is ready to be picked up? (Assume the firm could send a messenger to pick up the check but decides not to.) (See Reg. § 1.451-2.)

Problem 14-3 Wages

You are an employee of a company that issues paychecks one month late. Thus, you get paid for your work in December on the following January 31. As of the end of December of Year 1, your employer has an enforceable legal obligation to pay you for this work at the end of January of Year 2. Are your wages for December included in income in Year 1 or Year 2?

Problem 14-4 Lottery

On December 31 you receive a notice in the mail that you have just won the million dollar lottery. Congratulations! The notice is accompanied by a check for \$100,000, and a schedule of future payments: you are to receive \$100,000 on December 31 of each of the next 9 years. What is your tax treatment? –

- Income of \$100,000 this year and in each of the next 9 years.
- Income of \$1 million this year.
- Income of \$100,000 next year, and in each of the 9 years after, because even if you deposited the check right away, it wouldn't clear for a few days and your bank won't let you draw on an uncleared check.
- Income this year equal to the present discounted value of \$100,000 payable each year over 10 years starting today.
- No income because lottery winnings aren't taxable.

Problem 14-5 Receipt

On December 31 you receive a check in the mail for \$1 million, for having won the

lottery. Congratulations! You decide to drop out of school and live off the winnings until the money runs out. You remember something, however, about how cash-method taxpayers can reduce the pain of a progressive income tax by spreading payments out over several years. Therefore, you dash over to the lottery office before it closes, return the \$1 million check, and obtain instead a \$100,000 check and the promise to be paid \$100,000 for the next 9 years. Referring back to the choices in Problem 14-4, what is your tax treatment?

Problem 14-6 Charitable Contributions Paid by Check

Like all good tax planners, you know that the important deadline is December 31, not April 15. So on Saturday, December 31, you are sitting at your kitchen table writing out checks to your favorite charities. The total comes to \$8,000. You take the envelopes to a mailbox with a late Saturday pickup, and drop in the letters. In what year do you claim the charitable contribution deduction? What are the merits and disadvantages of the following answers?

- This year, because that's the year you wrote the check.
- This year, because that's the year you mailed the check.
- This year, because that's the year your check will be postmarked.
- Next year, because that's the year the charity will receive your check.
- Next year, because that's the year your check will clear your bank account.

Problem 14-7 Charitable Contributions Paid by Credit Card

On October 31 of Year 1, Marty responds to a public television Halloween fundraising drive. He pledges to donate \$20 a month for 6 months; and he gives his Visa card number. The charity will automatically charge his credit card on the last day of each month, for 6 months, beginning that night. How much and when is Marty's charitable contribution deduction made for tax purposes?

- \$120 in Year 1, because he made his entire pledge on October 31 of Year 1.
- \$40 in Year 1 and \$80 in Year 2, because his credit card bills arrive in the calendar month following the charges. He will be billed a total of \$40 in Year 1, and a total of \$80 in Year 2.
- \$60 in Year 1 and \$60 in Year 2, because he is billed \$20 each month, and has, in effect, at that point borrowed the amount from Visa.

Problem 15-1 Deferred Compensation: Deferral After Performance

Gertrude works as a broker with an investment banking house. On December 26 of Year 1, her firm announces that she has earned a \$500,000 bonus for her extraordinary performance that year. As the firm is about to cut her a check, Gertrude asks it to pay her instead on January 2 of Year 2. The firm agrees. Has Gertrude successfully postponed the tax liability on the bonus until Year 2?

Problem 15-2 Deferred Compensation: Deferral Before Performance

Gertrude works as a broker with an investment banking house. Before the beginning of Year 1, she and her firm agreed that henceforth any annual bonus she earns will be payable on January 2 of the following year. On December 26 of Year 1, her firm announces that she has earned a \$500,000 bonus for her extraordinary performance that year. Has Gertrude successfully postponed the tax liability on the bonus until Year 2? See Code section 409A.

Problem 15-3 Funded Deferred Comp

Gertrude works as a broker with an investment banking house. Her employment contract states that any bonus she earns will be used to purchase an annuity contract in her name, payable beginning in the year she retires. An annuity is a stream of income payments that has a present value (based on the life expectancy of the annuitant) of the purchase price. If the annuitant dies “too soon”, the insurance company makes a big profit; but if the annuitant lives “too long”, the annuitant keeps getting paid. As you can see, this is the opposite of the bet made in a life insurance contract. (The tax treatment of annuities are beyond the scope of this course.)

Gertrude’s firm will administer her annuity (and similar annuities for its other executives), but the firm’s creditors will not be able to reach this asset. On December 26 of Year 1, Gertrude’s firm announces that she has earned a \$500,000 bonus for her extraordinary performance. The firm buys uses the money to buy an annuity. Will Gertrude be taxed on \$500,000 in Year 1? (Assume that this is not part of a “qualified” retirement plan.) (See generally Rev. Rul. 60-31, 1960-1 C.B. 174.)

Problem 15-4 Qualified Plans

A large part of individual tax planning involves the use of tax-qualified retirement plans. The subject is so important and complex that general tax lawyers defer to specialists in the field.

Qualified plans take two basic forms: *defined-benefit plans* (where you employer promises to pay you a specified amount after you retire); and *defined-contribution plans* (where your benefits depend on how wisely you invested the contributions made by you and, on your behalf, by your employer). You might have heard of two popular types of defined-contribution plans: individual retirement accounts (IRA's) and salary reduction plans (also called "401(k) plans," after the Code section). In any qualified plan, the employee (or self-employed worker) has no income until benefits are paid out.

But isn't this the same tax benefit as regular deferred compensation? After all, under Rev. Rul. 60-31, if done right the worker has no income until receipt, which might be many years later. The longer the deferral, the greater the tax savings (assuming the employee is entitled to compensating larger amounts!).

A "qualified" plan adds what the employee really wants: security. Who wants to rely on the continued existence of the employer? Or what if the employer gets into financial trouble, and the creditors seize all of its assets, including the money that was going to pay retirement benefits? As you saw from the revenue ruling, "funding" or "securing" the future payment results in current income to the employee. Under the *qualified* plan rules, not only may the employee get security, but the employee must get security: the employer must fund the plan currently, and plan assets cannot be alienated to anyone but the employee. In order for a plan to achieve qualification, it must not "discriminate" in favor of highly-compensated employees. However, lower-compensated employees understandably tend to have trouble saving; to induce them to participate, employers often match a percentage of employee contributions, or even contribute if the employee does not.

What's in it for the employer? First, the highly paid executives want this benefit, and can't get it if the employer doesn't cover everybody. Moreover, the employer gets a current deduction for amounts contributed to the plan, even if they are not paid out until later.

Meanwhile, the plan is tax-exempt on contributions received, as well as on its investment income. Pension funds have become monster sources of capital in this country, holding trillions of dollars of wealth. They own over one-third of the stock of U.S. publicly traded corporations, and almost half of corporate bonds.

As a result of this regime, we are about halfway between an income tax and a consumption tax. A consumption tax (which can also take many forms, including the "value-added tax") taxes you only when you spend money, not when you earn it. Investing (saving) is not considered spending. Adopting a total consumption tax would effectively eliminate the need for qualified retirement plans, because all interest, dividends, and capital gains would be tax exempt. As a result, many (if not most) qualified plans would terminate, leaving lower-compensated employees to fend for themselves.

Problem 16-1 Clothing

John, an associate with Bendini, Lambert & Locke, hates to wear suits and ties. When he is not at work he always wears inexpensive casual clothes. When he was hired, the firm made it clear to him that it had an unofficial dress code. As a condition of keeping his job, he is expected to wear expensive suits and ties to work. Joe spends \$2,000 per year on clothes that he never wears outside of the office. Can he deduct the cost of his work clothes under Code section 162 as a business expense?

Problem 16-2 Business Losses

The theory of Code section 162 is that an income tax is a tax on profits, not gross receipts. If expenses exceed revenue, Code section 165 allows a deduction for business losses. The theory is that if the government shares in your success, it should share in your bad luck, too, so long as you were motivated by an intent to make a business profit. The rules limiting losses are based on the psychology that people do not deliberately seek to lose money; so that if expenses consistently exceed revenue, something else (like personal consumption) is the dominant motive.

Problem 16-3 Net Operating Loss

You come up with a great idea for marketing purring toy cats. In the first year of manufacturing, you net \$1 million in profits. Happily, you pay, let's say, \$350,000 in tax and live high off the \$650,000 remainder. Unfortunately, the fickle public's fancy is soon caught by your competitor's ribbiting toy frogs, and in year 2 you lose \$1 million. What is your tax result? (See section 172(a) and (b)(1) & (2).)

As part of the recent stimulus legislation, in February 2009 Congress created a 5-year carryback of 2008 NOLs suffered by a small business (income of \$15 million or less). Instead of the normal two-year carryback for that year, Revenue Procedure 2009-26 explains, eligible small businesses may elect a 3-, 4-, or 5-year NOL carryback. See the effect: Firms were filing their 2008 returns then, and so could file amended returns for those earlier years and get a quick refund of taxes paid. By the way, what industries had paid significant taxes for the last few years and then tanked? (Hint: think mortgage crash – yup, homebuilders and financial institutions. Ah, better living through tax policy)

By the way, the staff of Congress's Joint Committee on Taxation must review all claims for "quickie refunds" that exceed \$1,000,000; in November 2004, the Joint Committee approved an NOL carryback for Lucent Technologies resulting in an \$816 million tax refund – plus interest.

Problem 16-4 Gambling Loss

Jerry bets \$1,200 at the race track during the year. He wins \$500 that same year. What loss, if any, can he claim? That is, how much taxable income does he have from gambling? (See Code section 165(d).)

Problem 16-5 Hobby Losses

Hal is fanatic about his pet pugs, and started spending more and more money traveling around the country, showing his pugs at dog shows. One thing led to another, and Hal began breeding his animals. In calculating his income tax liability for this year, Hal realizes that he has spent \$15,000 on vet bills, travel, and food and other expenses for the dogs. He also won \$300 in prize money. How much of Hal's \$15,000 in expenses can he deduct?

Problem 17-1 Travel Expenses: Schematic Summary of Rules:

A. TRANSPORTATION:

IF PERSONAL:	IF MIXED:	IF BUSINESS:
Home to work (commuting) is not deductible. Reg. sec. 1.162-2(e).	If primary purpose is business, then all transportation is deductible; but if primary purpose is personal, then only business expenses at destination are deductible. Reg. sec. 1.162-2(b).	Work to work ("business trip") is deductible. See Reg. sec. 1.162-2(a).
For reimbursement for cab ride home from late night at office, see sec. 132 (working-condition fringe? de minimis fringe?).		Note: Includes "commuting" at temporary job site. (So why did <i>Hantzis</i> lose?)

B. LODGING: Deductible if primary purpose for being away from "tax home" is business.

C. MEALS: *Note: Any deductible meal is only 50% deductible. Section 274(n).*

PERSONAL	MIXED	BUSINESS
1. <u>Not “away from home”</u> :		Discussion with client over meal (“business meal”).
* Regular lunch during working day		But <u>not</u> lunch every day with colleagues, even if discussing work.
* Dinner <u>if</u> return home to sleep. <i>Correll.</i>		

But what about reimbursed dinner while working late?
(Again, see § 132.)

2. Overnight away from home:

If personal trip, no deduction.

Look to primary purpose of being overnight away from home at mealtime; if for business, see next column; if personal, only any actual business costs at destination are deductible.

Deductible even if eating alone or with friends or family (but only taxpayer’s expense, please!).

Problem 17-2 Business Meals

John, a partner in Bendini, Lambert & Locke, takes a client to lunch, where they discuss business. John’s lunch came to \$45, and the client’s lunch came to \$35. John picked up the tab. How much can John deduct? Why?

Assume instead John is traveling on business from Memphis to Washington, D.C., returning at the end of a very long day. He eats lunch by himself. Can he deduct his lunch? Could he deduct his lunch (and dinner) if he stayed overnight in Washington and returned the next morning? Would your answer change if I told you that he had dinner with an old friend, and he could have taken a convenient return flight at 6:00 pm?

Problem 17-3 Away From Home

Joan, a law professor in New York, accepts an invitation to be a visiting professor in Texas for a year. Can she deduct the cost of travel from New York to Texas? (See also the 1-year limit on “away from home” expenses in the last sentence of Code section 162(a).) Can she deduct the cost of her apartment in Texas? (Ditto.) What about the cost of driving from her apartment in Texas to her office in Texas (wouldn’t it be “commuting” if she lived there)? How about the cost of her meals in Texas? (And what does Code section 274(n) do?) In Assignment 23 we will study the effect of Code section 67 on the entire deductible amount.

Problem 17-4 Primary Purpose

Ben, a patent lawyer, lives in St. Louis. In January, his close friend, Fred, invited him to be his best man at his wedding in San Francisco. The festivities will cover four days, from the last Thursday through Sunday of March. Ben happens to have a client in San Francisco, Marla, for whom he’s done legal work in the past. Ben calls up Marla and arranges to have lunch with her and take her to a Giant’s game on the same Friday he will be in town for the wedding. They discuss old times, the clients’ current business activities, and baseball. Ben picks up the tab. When they part, Marla indicates that she’ll give Ben a call about some future legal work.

The cost of the lunch is \$100; the baseball tickets are \$25; Ben’s airfare is \$550; his total hotel costs are \$600; and all the rest of his meals come to \$350. His wedding gift cost \$250. (Fred does not have a business relationship with either Fred or his wife.) What, if any, of Ben’s costs are deductible? (See Reg. § 1.162-2, and Reg. § 1.274-2(b)(1), (c)(3).)

Problem 17-5 Two-Career, Two City Couples

Barney lives and works in Detroit; his wife, Wilma, lives and works in Minneapolis. An opportunity arises for Wilma to travel to Detroit on business. Can she deduct her traveling costs for this trip, even if she stays with her husband?

Problem 18-1 Civil Fines

Assume Exxon paid \$400 million in civil fines for the Exxon Valdez oil spill. Can Exxon claim a business expense deduction for this payment? Should it? What if Exxon paid \$1 billion as clean-up costs? If Exxon could have prevented the spill by spending an extra \$100 million for a double-hulled tanker instead of a single-hulled tanker, what calculation is Exxon making? (Come back to this question when we study depreciation deductions, next class.)

Problem 19-1 Real Estate

You buy Trump Tower for \$400 million. This project consists of land, retail space, office space, and residences. How would you apportion your \$400 million aggregate basis among these assets? Based on their recovery periods, which asset would you most prefer to allocate basis to? Least prefer?

Problem 19-2 Cost Recovery: Effect on Basis

Microsoft pays \$80,000 for a new piece of equipment this year. Assume that under Code sections 167 and 168, the first year's depreciation deduction is \$15,000. What is Microsoft's "adjusted basis" in this machine at the end of the year? (See Code section 1016.)

Do you see why basis must be reduced? Cost may only be recovered once! If the machine is really wearing out and losing value at the same rate as the tax deduction, but if Microsoft doesn't have to reduce basis, it could get a double benefit: a \$15,000 depreciation deduction, and a \$15,000 loss (on a sale for \$65,000 when basis is still \$80,000).

Note: In February 2008, Congress adopted a temporary provision allowing businesses to write off fifty percent of the cost of depreciable property (e.g., equipment, tractors, computers) acquired in 2008. (Congress has extended this provision to 2009.) In subsequent years, the taxpayer will continue to depreciate the remaining basis of depreciable property under the current-law depreciation schedule. The committee report provides the following example:

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2008, a taxpayer purchases new depreciable property and places it in service.¹⁴ [14 Assume that the cost of the property is not eligible for expensing under section 179.] The property's cost is \$1,000, and it is 5-year property subject to the half-year convention. The amount of additional first-year depreciation allowed under the provision is \$500. The remaining \$500 of the cost of the property is deductible under the rules applicable to 5-year property. Thus, 20 percent, or \$100, is also allowed as a depreciation deduction in 2008. The total depreciation deduction with respect to the property for 2008 is \$600. The remaining \$400 cost of the property is recovered under otherwise applicable rules for computing depreciation.

Problem 19-3 Section 179 Expensing

Note: Until the end of 2010, small business taxpayers are allowed to write off up to \$125,000 (indexed for inflation; \$128,000 in 2008) of capital expenditures subject to a phase-out once capital expenditures exceed \$500,000 (indexed for inflation; \$510,000 in

2008). In February 2008, Congress “doubled” (i.e., without indexing for inflation) the maximum write off to \$250,000 for capital expenditures incurred in 2008 and the phase-out threshold to \$800,000 in 2008. Congress extended these amounts to 2009.

Loretta installs a new donut-processing machine in her bakery business. She pays \$150,000 for it. (This is fancy equipment!) How much may she expense (deduct) in 2009 under Code section 179? What if she instead bought it in 2010 (ignore any further the inflation adjustment). What happens to rest of her cost? In either year, what happens to her basis in the oven?

Problem 19-4 Intangibles

Nick moves to New York, and wants to drive a cab. He learns that he has to have a taxi “medallion” in order to legally drive for hire. The number of medallions is, of course, limited. The going rate for a medallion is \$250,000. If Nick buys a medallion, how can he recover his cost? (See Code section 197.)

Note: The “Tax Reduction and Reform Act,” introduced by Ways & Means Chairman Rangel in October 2007, proposes to extend the recovery period under section 197 to 20 years, in order to help raise revenue to pay for taxpayer-favorable provisions in the bill.

Problem 19-5 Nonwasting Tangible Assets

Code section 197, which decrees a 15-year useful life, applies only to purchased intangible business or investment assets (other than corporate stock!). Section 197 has no effect on tangible assets lacking an ascertainable useful life. Because of Code section 167, land still may not be depreciated. (See also Code section 197(e)(2).) Nor are works of art depreciable. Rather, the investor must wait until sale of the property to recover the cost. Do you agree with the *Liddle* and *Simon* results?

Problem 20-1 Capitalization

Sometimes the question of deductibility versus nondeductibility is not a “what is deductible?” issue but rather a “when is it deductible?” Many business expenses are clearly profit-motivated, but the deduction must be spread out over time.

The point of requiring taxpayers to “capitalize” the costs of long-lived assets is to *match* the expenses with the income they produce. In effect, it is the reverse of depreciation deductions: capital improvements *increase* basis under Code section 1016. (Compare the “cost basis” rule in Code section 1012.) The cost is then recovered under the regular depreciation rules. What is the

line between a capital outlay and a current expense?

First, assume Joe's restaurant has a leaky roof and he spends \$1,000 to repair it. Can he deduct the cost of repairs under section 162? (See Prop. Reg. § 1.162-3(f)(3), Example 3, and Prop. Reg. § 1.263(a)-3(f)(3), Examples 9, 10, and 11 [complicated enough for you?!].)

Problem 20-2 Consequences of Capitalization

Assume instead that the roof of Joe's restaurant is worn out and cannot be repaired. He pays to have a new roof put on it. Can he deduct the cost of the new roof as a business expense under section 162, or must he capitalize it? (If he must capitalize it, he must treat the improvement as new property; this means that even if the original building had 5 years left to go on its depreciable life, he has to start fresh for the improvement. Newly acquired nonresidential real estate has a statutorily-decreed useful life of 39 years.)

Problem 20-3 Advertising

Coca Cola Co. introduces a new product, "New Coke," and spends millions of dollars advertising it. Can Coca Cola deduct the cost of this advertising blitz under section 162? (See Temp. Reg. § 1.263A-1T(b)(2)(v)(A) [not in your selected statutes & regs book]; the IRS is very generous to advertising expenses in Rev. Rul. 92-80.)

Problem 20-4 Investment Expenses

Sue, an investor, pays commissions to brokers when she buys stocks and bonds. Can she deduct these commissions under Code section 212? (Compare Reg. § 1.212-1(d) & (g) with Prop. Reg. § 1.263(a)-2(d)(3)(iv), Example 1.)

Problem 20-5 Closing Costs

You just bought a new house, stretching your resources to the limit. Among your closing costs are attorney's fees of \$2,000. How do you treat this expenditure for tax purposes? (See the proposed 263 regs.)

Problem 20-6 Improvement? Environmental Cleanup Expenditures

Buyer acquires land, which she knows to be contaminated with a leaking underground storage tank. Buyer pays Seller \$750,000, and pays a third party an additional \$250,000 to

remove the tank and clean up the site. Assume that the cleaned-up site is now worth \$1 million. What arguments can you make for why Buyer should be permitted to expense this cost? What arguments against? Assuming both the Buyer and Seller knew about the problem, and were in negotiations, would it make a difference who incurred the costs? Should it? (See the examples in Prop. Reg. § 1.263(a)-3(f)(3), Examples 1, 2, 4, 7, & 8, and -3(h)(2), Example 4.)

Problem 21-1 Effect of Debt on Basis

Coca-Cola Company borrows \$1,000 and buys a building. Coca-Cola's basis in the building includes the amount borrowed. (This was confirmed in a famous case, *Crane v. Commissioner*, 331 U.S. 1 (1947).) Thus, Coca-Cola can claim depreciation deductions on the bank's money. (Of course, as we already learned, because it did not have income when it borrowed the money, Coca-Cola must later repay the debt with after-tax income.)

Assume Coca-Cola sells the building for \$1,000 after fully depreciating the building for tax purposes. That is, Coca-Cola has a \$0 basis in the building. Accordingly, Coca-Cola has \$1,000 of taxable gain – but no cash to pay the tax, because (assuming no principal amortization) Coca-Cola must pay all \$1,000 to the bank in repayment of the loan. (We will discuss the tax rate that applies to this gain in Assignment 31.)

What happens if, instead, Coca-Cola had made a cash downpayment of \$40 and borrowed only \$960; and in the period it owned the building, Coca-Cola had claimed only \$100 of depreciation deductions, and had repaid \$250 of the debt principal? Do you see that gain is \$100 (\$1,000 - \$900) and net cash is \$290 (\$1,000 - \$710)? See Treas. Reg. § 1.1001-2(c), Ex. 1.

Problem 21-2 Transfer of Property Where Buyer Assumes Debt

Assume that Coca-Cola Company borrows \$1,000; buys a building for \$1,000; and sells it before claiming any depreciation deductions. Assume further that the buyer "assumes" (agrees to repay) the debt (this usually requires the lender's permission). If the building is worth \$1,200, how much will the buyer pay Coca-Cola in cash for the building? Do you see why the answer is \$200? After all, the \$1,200 building comes with a \$1,000 string attached!

How much is Coca-Cola's gain on the sale? We know Coca-Cola's basis (\$1,000), so the real question is what is the "amount realized" (tax-ese for consideration). The amount realized is *not* \$200!! Granted, that is the amount of cash in the deal, but Coca-Cola also benefited from the \$1,000 of debt taken over by the buyer. (See Reg. § 1.1001-2(a) & (c) (Example 1).) The amount realized is \$1,200; basis is \$1,000; and so gain is \$200.

Finally, do you see why – regardless of whether Buyer pays \$1,200 cash or instead pays \$200 and assumes the debt – Buyer's basis is \$1,200?

Confused? For some reason, the economics of debt assumption is one of the most difficult concepts for non-business people to grasp. Look at it this way: the building is worth \$1,200. Coca-Cola is indifferent between –

- (i) receiving \$1,200 from the buyer, and using \$1,000 of it to pay off the bank, and
- (ii) receiving \$200, with the buyer now responsible for paying off the bank.

In either case, Coca-Cola is \$200 to the good. (Gain would be higher if Coca-Cola had in the meantime taken depreciation deductions, which reduce basis; as we saw in Problem 21-1, however, tax gain and cash profit are two different questions when debt is involved.)

Still confused? Perhaps you have bought (or sold) a house with an assumable mortgage. The house is worth what the house is worth; it does not matter if there is debt on the property. Rather, the existence of debt, and who has to pay it off, instead affects the amount of *cash* in the deal. A \$100,000 house with no debt on it will require the buyer to bring \$100,000 to the closing (probably funded by the buyer's own borrowing!); a \$100,000 house with a \$20,000 assumable debt will (if the buyer assumes the debt) require the buyer to come up with only \$80,000 in cash at closing. In either case, the seller's amount realized is \$100,000. The seller's *gain* depends, of course, on the seller's basis.

Problem 22-1 Discharge of Indebtedness

Sue has a large balance on her VISA card. She declares bankruptcy. All of her debts, including her VISA balance, are discharged in bankruptcy court. Does Sue have income as a result? (Compare Code section 61(a)(12) with Code section 108(a)(1)(A).)

Problem 22-2 Debt Buy-Back

Corporation X issued 1,000 bonds with a face amount of \$1,000 each. Corporation X received \$1,000 in cash for each bond issued (total \$1 million). The bonds are now trading for \$300 in the market because many investors think that Corporation X will never be able to pay off the bonds. Corporation X buys back all of the bonds for \$300 each (total \$300,000). In general, debt forgiven is treated as income to the borrower. But, as you know by now, nothing in the tax world is simple. Look at Code section 108, and tell me how much taxable income (if any) Corporation X has if, immediately *before* the debt buy-back, Corporation X –

- Had assets of \$1.3 million and no other liabilities (that is, the corporation was not “insolvent” within the meaning of Code section 108(a)(1)(B) & (d)(3)).
- Had assets of \$400,000 and no other liabilities.

[Note: As part of the recent stimulus legislation, Congress adopted a temporary provision – not in your Selected Stats & Regs – dealing with debt buybacks. Section 108(i) provides, generally, for deferral of immediate COD until 5 years after the taxpayer reacquires the business indebtedness; the COD is to be included in income ratably over the next 5 years. This result is elective, and applies to a reacquisition of an applicable debt instrument in 2009 or 2010. You are not responsible for this special provision.]

Problem 22-3 Reduction of Purchase Price

Seller sells his apartment building to Buyer in exchange for a \$2 million promissory note (bearing adequate interest) payable by Buyer to Seller. Buyer subsequently discovers that the property is contaminated with asbestos, and, as a result, Buyer will be forced to incur \$500,000 of asbestos removal costs. Seller had warranted the property to be free from asbestos. Seller agrees to reduce the amount of Buyer's debt by \$500,000 in order to avoid a lawsuit. Does this result in cancellation of debt ("COD") income to B? (See Code section 108(e)(5).) What happens to B's basis in the property? (See Code section 1016; Code sections 108(b) and 1017(a) apply only if the taxpayer has COD income.)

What should happen when B subsequently spends the \$500,000 to correct the problem?

Problem 23-1 A.G.I. Floors

Ah, the good old days, when everyone deducted their Wall Street Journal subscriptions as a business expense. Then in 1986, Congress imposed a "floor" under employee business expenses and investment expenses. Section 67(a) adopts a "2% floor."

For some time Congress had already imposed floors under two types of personal itemized deductions. Look at Code section 213(a) for medical expenses. It adopts a "7.5% floor." Look at Code section 165(h)(2) for casualty losses that arise outside the business setting. It adopts a "10% floor." What's going on?

Read these sections carefully. Most important, see what the base is – we're not talking about disallowing 2% or 7.5% or 10% of the *expense*. Rather, we're talking about disallowing all of the expense until it exceeds 2% or 7.5% or 10% of *adjusted gross income* (AGI). Once the taxpayer's relevant expense exceeds the applicable percentage of AGI, all of the excess expenses qualifies as an itemized deduction. Obviously, the higher the taxpayer's AGI, the more of the expense that will be disallowed. As a practical matter, few taxpayers can actually deduct *any* of their employee business expenses, medical expenses, or personal casualty losses.

Look again at the Form 1040 in the appendix to the materials. AGI is the last number on the first page; and it is repeated as the first line on the back. All deductions from gross income to

arrive at adjusted gross income show up on the front of the form. We call these “above-the-line” deductions. Everybody gets these deductions. Then the taxpayer (on the back of the form) chooses between the standard deduction and the itemized deductions.

Look at Schedule A (Itemized Deductions), and find the sections for medical expenses, for casualty losses, and for job costs. Do you see how the IRS has you calculate your allowable itemized deductions?

Congress pretends that it adopted the AGI floors just to save us all the trouble of having to keep track of our nickle-and-dime business expenses. Only one problem with this explanation: Even if you exceed the floor, you can never deduct that base amount. Can you think of reasons for these various floors, and why Congress selected the percentages it did?

Problem 23-2 Miscellaneous Itemized Deductions

Technically, Code section 67 applies to “miscellaneous itemized deductions.” The temporary regulations describe four main categories of affected expenses (see Treasury Reg. § 1.67-1T):

1. ***Employee business expenses.*** Believe it or not, being an employee is itself a trade or business under Code section 162. For example, you might work for IBM, and take a customer out to lunch, and are not reimbursed. What else? Subscriptions to professional journals, dues for trade or professional associations, uniforms, job hunting costs, and the business use of your home (these are subject to additional rules that we don’t study).
2. ***Investment expenses.*** These Code section 212(1) & (2) expenses include investment advisory fees and the costs of safe deposit boxes.
3. ***Tax preparation costs.*** These Code section 212(3) expenses include legal and appraisal fees, and the cost of having H&R Block do your tax return.
4. ***“Hobbies.”*** Deductions allowed under Code section 183.

Problem 23-3 Employee Business Expense versus Self-Employed Business Expense

Joan is a new associate with Bendini, Lambert & Locke. Her AGI this year is \$50,000. She paid, out of her own pocket, \$300 for bar association dues and memberships, and \$150 for subscriptions to professional journals. She had also incurred \$600 in job hunting costs (assume she was already a lawyer looking to change firms). If she itemizes her deductions, how much of these costs can she deduct?

1. What is 2% of her AGI? \$1,000.
2. By how much do her total miscellaneous itemized deductions exceed the 2% floor?
 $\$1,050 - \$1,000 = \$50$

Yikes! Joan gets no deduction for the first \$1,000 of employee business expenses.

A floor of this sort suggests that taxpayers should “bunch” their miscellaneous itemized deductions so that they fall in the same year. The rest of us who can’t get employers to reimburse us just give up. Do you think *Wall Street Journal* subscriptions fell after Congress enacted Code section 67?

What if instead Joan were a sole practitioner? Sole practitioners are self-employed. Their business expenses show up “above-the-line.” She could deduct all \$1,050 in calculating her “Schedule C” (self-employed) income, which shows up on Line 12 on the front of the Form 1040. The same result is true for partners in partnerships (see Line 17). Does it strike you as fair that partners can deduct bar dues, but associates (effectively) cannot?

Problem 23-4 Reimbursement vs. Unreimbursed Employee Business Expenses

Mandy is employed by Boeing Aircraft Company. It takes him nearly a year, and a great deal of effort, to sell one airplane. (Yes, I’m making all this up.) Assume that he’s paid entirely on commission, a flat one percent of the sales price. If an airplane sells for \$5 million each, a good year (three planes) gives Mandy an income of \$150,000. In order to butter up his customers, Mandy travels to, and wines and dines, them. For this purpose Boeing gives him an expense account of \$20,000 a year.

Expense accounts basically work in one of two ways. The employer might say: “Do good work. If you need this money to make money, go ahead and spend it; otherwise, you can keep it.” Wow! Why wouldn’t Mandy just keep all \$20,000?

The other type of expense account requires the employee to “account” to the employer. This means supplying records of how the money is spent, and returning any amounts not spent for business purposes.

If Mandy incurs \$19,000 of employee business expenses, which mechanism would Mandy prefer? In the absence of tax laws, the first: he winds up with an additional \$1,000 in cash. But now consider the impact of Code section 67, the 2% floor.

If Mandy can keep the \$20,000 without accounting to Boeing, he has another \$20,000 of gross income. This increases his AGI from \$150,000 to \$170,000. Two percent of AGI is thus \$3,400. But where can he claim his \$19,000 of business expenses? Below the line, and only to

the extent they exceed \$3,400. Thus, he can deduct \$15,600, while he has to “eat” the other \$3,400. But, you say, at least he has \$1,000 more cash from his employer. Don’t forget, though, that Mandy also has to pay tax on his additional compensation. His taxable income (ignoring other adjustments) is $\$170,000 - \$15,600 = \$154,400$. His cash position is $\$170,000 - \$19,000 = \$151,000$. At a 28% marginal tax rate, the tax on the extra \$4,400 is $\$1,232 - \232 more than the extra \$1,000 cash. (Ignore section 68, which sets a *separate* floor under most itemized deductions of high-income taxpayers.)

Mandy would have been better off “accounting” to Boeing, and returning the additional \$1,000 to them. While he wouldn’t have had any deductible business expenses, his taxable income would have been only \$150,000 and he would have had \$150,000 in cash.

One more wrinkle. We have been speaking of \$19,000 in “business expenses.” What if some of those expenses (as they undoubtedly would be) were attributable to business meals and entertainment? If Mandy does not have to account to Boeing, then he must substantiate the expenses as required by Code section 274. Moreover, the 50% deduction disallowance for meals applies to him. That is, if he spent \$5,000 on meals, only \$2,500 counts as an employee business expense, and that amount is further subject to the 2% floor (along with his other miscellaneous itemized deductions).

If, however, Mandy has to account to Boeing, then the tax system ignores the \$20,000 initially transferred to him, the \$19,000 he spends, and the \$1,000 he returns. In addition, the 50% deduction disallowance for meals applies to Boeing. Mandy can be fully reimbursed by Boeing without tax consequences to Mandy. (See I.R.C. § 62(a)(2) & (c); Reg. § 1.274-2(f).) See Form 2106 (employee business expenses) at the end of the blank tax forms in the Appendix.

Problem 23-5 Medical Expenses: Bunching

Amy’s AGI this year is \$25,000, and she expects to have about the same AGI next year. By mid-December she has incurred \$1,500 in unreimbursed medical expenses. Her doctor has advised her to have her tonsils out very soon, at a cost to her of \$2,000. Assuming that she’s otherwise healthy, does it make a tax difference whether she has the operation by year-end this year, or waits until January?

Problem 23-6 Casualty Loss

Steve’s car is completely destroyed in an accident. The car cost him \$20,000, and has a fair market value of \$15,000 at the time of the accident. Steve is not compensated for his loss through insurance or otherwise. Can he deduct his loss? Does it matter if Steve was at fault? (See Reg. § 1.165-7(a)(3).)

And what is the amount of Steve's "loss" – the \$20,000 he paid for the car, or its value just before he crashed it? What is the purpose of Reg. § 1.165-7(b)'s "lesser of basis or diminution in value" rule for personal use property?

What if I tell you that Steve's AGI is \$100,000, and this is his only casualty loss for the year? What is his deductible casualty loss? [Note the per-casualty \$500 "deductible" for 2009, reverting to \$100 thereafter.]

Problem 24-1 Charitable Contributions

Your client Mary wants to make a gift to charity of \$10,000. She owns two prints, one by Pablo Picasso and one by Andy Warhol, that she no longer enjoys and is thinking of selling. She bought the Picasso many years ago for only \$500. It is now worth \$10,000. She bought the Warhol two years ago for \$12,000. It is now, unfortunately, also worth \$10,000. She has more than \$10,000 in cash in the bank. She asks you, from a tax standpoint, if it matters whether she (a) gives the charity \$10,000 cash, (b) gives the charity the Picasso, or (c) gives the charity the Warhol. The charity tells her it does not care (we can suspect that the charity intends to sell any property contribution it doesn't really want). Does your answer depend on what the charity does with the print or on the nature of the charity?

Note: Basically, Code section 170(a) lets you deduct the current fair market value of donated property, without recognizing gain *or* loss. (See Reg. § 1.170A-1(c)(1).) Code section 170(e), however, reduces the deduction to the taxpayer's basis (unless FMV is lower) if the taxpayer hadn't held the property long-term; if the property is not a capital asset; or, for tangible property, if the charity's use of the donated property is "unrelated" to the charity's exempt purpose – and watch post-gift use (including immediate sale).

Problem 24-2 Quid Pro Quo

Jacqueline bought two \$1,000 tickets to the Metropolitan Opera's benefit performance of *Die Fledermaus* on New Year's Eve, followed by a midnight supper and dance in the atrium. Most of the audience simply bought tickets for the performance, and Jacqueline's seating tickets indicate the price – \$50 each. She also received an acknowledgment from the Met thanking her for her generous contribution. It stated that the fair market value of the dinner-dance is \$100 per person. How much can Jacqueline deduct as a charitable contribution?

Problem 24-3 Contribution of Services

Horton, a successful patent attorney in Hartford, Connecticut, serves as a volunteer member of the board of directors of the Museum of Fine Arts in Boston. He spent 50 hours

preparing for and attending board meetings this year. Horton's normal billing rate for legal services is \$500 an hour. He also incurred \$500 of unreimbursed out-of-pocket costs in traveling costs to attend board meetings. How much may Horton deduct as a charitable contribution to the museum this year? See Treas. Reg. § 1.170A-1(g).

Problem 24-4 Charity or Business?

John, a successful restaurant owner, is planning to build a new restaurant next to a church and is concerned that the church will raise objections to his application for a building permit and his subsequent application for a liquor license. To gain goodwill with the church, he writes a check to the church for \$1,000. Can he deduct this as a charitable contribution? (See Reg. § 1.170A-1(c)(5).)

Is this expenditure instead a business expense? If so, when can John claim the deduction? Hint: how many possible capital assets are there (and what are their useful lives), and which is the most appropriate asset (if any) to assign the cost to?

Problem 25-1 Taxes

Can Richard deduct real property taxes that he pays to Cook County on his house? Can he deduct Illinois state income tax? Illinois sales tax? Both state income and sales tax? (See § 164(b)(5).) [Note: In December 2006, Congress extended § 164(b)(5) for one year, through 2007.]

Can he deduct the \$75 City of Chicago sticker fee that he pays to register his car? (See Reg. § 1.164-3(c).)

Problem 25-2 Interest Deduction

Before 1986, interest paid on any debt, incurred for any purpose, could be deducted from income. As amended by the 1986 tax reform act, Code section 163 separates debt into 3 categories, providing –

- Interest on debt incurred for business purposes remains deductible in full.
- Interest on debt incurred for investment purposes by an individual, however, is deductible in a particular year only to the extent the taxpayer has net investment income in that year. This prevents tax arbitrage. The amount not deductible currently may be carried forward to use against future net investment income.

- Interest on “consumer debt” may not be deducted. This includes debt for personal expenditures, such as automobile loans, student loans (but see Code section 221 and Problem 26-4), and personal purchases using credit cards. Only home mortgages continue to qualify as deductible personal debt.

Why do you suppose Congress permits taxpayers to deduct the interest on their home mortgages, when Code section 265 states explicitly that you cannot deduct interest on borrowings invested in assets that produce tax-exempt income? This provision is designed to prevent taxpayers from leveraging investments in tax-exempt (state and municipal) bonds. But can’t you say the same thing about your house?

Because money is fungible, how do you determine which debt is which? The Internal Revenue Service regulations adopt a “tracing” method – the taxpayer can identify the use of the borrowed funds by tracing it to a particular expenditure. The tracing method is easy to manipulate, as described in examples below.

Finally, Congress has enacted a host of specific provisions requiring taxpayers to “capitalize” interest costs into the basis of property acquired with borrowed funds, or to otherwise match the tax deduction with the income produced with leveraged property. Thus, for example, if a taxpayer borrows money to construct a rental building, he must add his construction-period interest costs to the basis of the building. He will recover these interest costs as additional depreciation deductions, over a period similar to the period that the building produces rental income.

Problem 25-3 Investment Interest Expense

Your client John wants to buy some stock as an investment, but John also wants to take a vacation. The stock costs \$10,000. The vacation also will cost \$10,000. John only has \$10,000 in cash to finance these two expenditures. He plans to borrow the other \$10,000 with a cash advance on his VISA card. Can John deduct the interest he pays on his VISA card on account of this loan? (Compare Code section 163(d)(1) with section 163(h)(1) & (2).) Can you give him any advice as to how to arrange his borrowing and purchases in order to save taxes? (See the tracing rules in Temporary Reg. § 1.163-8T(c)(1).)

Problem 25-4 Principal Residence Interest Expense

Sue buys a house for use as her principal residence, financing the acquisition with a mortgage and a cash downpayment. She borrows the money to make the cash downpayment by taking out an advance on an *unsecured* line of credit with her bank. She can “trace” the downpayment on the house to the loan proceeds. Can she deduct interest on the line of credit

loan on the ground that the loan proceeds were used to buy her principal residence? (See Code section 163(h)(3)(B).)

Problem 25-5 Home Equity Loans

Sue's house goes up in value. She takes out a home equity loan secured by the house and uses the loan proceeds to buy a new car. Can she deduct interest on the home equity loan? (See Code section 163(h)(3)(C).) Her brother Tim does not own a house. He buys a car with a bank new-car loan. Can he deduct interest on this loan?

Problem 25-6 Points

When Sue bought her house she had to pay three “points” to the mortgage lender. Can she deduct these points? If so, when? Can she deduct them in the year that she paid them, or must she “spread” her deduction over the life of the loan? (See Code section 461(g).) Do you get a different result if Sue were merely refinancing an existing mortgage? (Read section 461(g)(2) carefully.)

How should the lender treat the receipt of the points? In this case, the Code follows economic substance and permits the lender to spread the recognition of income over the life of the loan.

Problem 26-1 Preprofessional Education Expenses

Norman, a third-year law student, is daydreaming one day in tax class. He’s thinking to himself, “This is not fun. In fact, I would have to say that very little about law school has been fun. If I didn’t want to be a lawyer so much, I would have been much better off using my college degree to get a job copy-editing at a publishing house.” He then continues thinking, “Well, if I’m not in law school for fun, I must be in it for a business purpose, and so I can either deduct the costs or, at the very least, amortize them over my 40-year expected career.” Just then he hears his professor telling the class, “Open your Code & Regs to Regulations section 1.162-5, particularly (b)(2)(i).” (See also -5(b)(2)(iii), Example 3; and -5(b)(3)(ii), Examples 1 & 2.) Does this burst Norman’s bubble (for now, ignore new Code section 222)? Do you agree with the policy call made in the Regulation?

Problem 26-2 Continuing Professional Education

Walter is a self-employed certified public accountant. He travels to Washington, D.C. to attend a two-day conference sponsored by the American Institute of Certified Public Accountants

on recent developments in the tax law. His total costs come to \$1,675 – \$350 to register, \$600 for airfare, \$400 for hotel, \$250 for meals, and \$75 for taxis. How much of this may Walter deduct under Code section 162? (See Reg. § 1.162-5(e), Example 1 under (e)(2).)

By the way, what dollar figure can Walter deduct for his meals? Don't forget about Code section 274(n).

Finally, what would happen to these expenses if Walter, instead of being self-employed, were an employee (and his employer did not reimburse these expenses)?

Problem 26-3 Primary Purpose

Ben, a patent lawyer, lives in St. Louis. In January, his close friend, Fred, invited him to be his best man at his wedding in San Francisco. The festivities will cover four days, from the last Thursday through Sunday of March. In making his travel arrangements, Ben notices a conference for patent attorneys given in a downtown San Francisco hotel that same Friday, and signs up for it. The cost of the conference is \$300, including lunch; Ben's total hotel costs are \$600; and all of his meals come to \$350. His wedding gift cost \$250. (Fred does not have a business relationship with either Fred or his wife.) What, if any, of Ben's costs are deductible? (See Reg. § 1.162-5(e).)

Problem 26-4 College Loans

Stuart and Barbara have twins, Eric and Susan, who are seniors in high school. Borrowing seems like the only way that Eric and Susan will be able to attend the colleges of their choice. Stuart and Barbara have \$100,000 of "equity" in their house (as defined in Code section 163(h)(3)(C)); that is, they originally bought it with the proceeds of a \$60,000 mortgage and it is now worth \$160,000. As they are about to take out a home-equity loan to pay for their children's schooling, they learn about the provision allowing an above-the-line deduction for student loan interest, and ask your advice. Stuart and Barbara's joint adjusted gross income is \$100,000. Are they better off going against the house? Do they have a choice? (See Code section 221(e)(1).)

Problem 26-5 Scholarships

Eric decides to attend Kellogg College. Because of his track skills, he receives a \$5,000 athletic scholarship in reduction of the \$18,000 cost of tuition. He is expected to try out for the track team, but this is not a condition of his scholarship. What is the tax treatment of Eric's scholarship?

Susan decides to attend State U. In-state tuition is \$4,000 a year; had she come from out-

of-state, her tuition would have been \$9,000. Does Susan have income as a result of this preference?

Problem 26-6 Tuition Tax Credit

In this calendar year, Melanie, a second-year law student, spends \$4,000 for tuition and fees at the State University College of Law. Melanie receives no scholarship. She will have adjusted gross income of \$35,000 for the year. How much of a tax credit can she claim for this expenditure?

Problem 26-7 Higher Education Deduction

Return to Example 26-1. Assume Norman pays \$20,000 of law-school tuition this calendar year. Also assume that Norman's adjusted gross income (on a joint return) is \$125,000. What tax treatment under Code section 222? [Note: in December 2006, Congress extended section 222 through 2007.]

If instead Norman and his wife have joint AGI of \$80,000. Are they he better off taking the section 222 deduction or the Lifetime Learning Credit under section 25A? (You don't get both!) Why didn't Congress just increase the income cap under the credit?!

By the way, does this deduction affect Norman's decision to claim the standard deduction or itemize?

Problem 27-1 Capital Assets

Recall that Code section 61(a)(3) taxes gains from dealings in property, and that gains are taxed only when realized. Now we consider the rate question: How much tax do you pay on realized gains?

Congress generally divides property into two classes – ordinary assets and capital assets. Generally, ordinary assets are those which, if sold for a profit, would result in ordinary income to the taxpayer. By contrast, a taxpayer who sells a capital asset for a profit might be entitled to more favorable tax treatment.

The statute does not define capital assets. Instead, Code section 1221 says that all assets are capital *except* inventory or assets held for sale to customers in the ordinary course of the taxpayer's business (or substitutes for these assets). Of course, Congress can't help itself, and keeps adding to the list – most recently, 2006 tax legislation provides that songs sold by a songwriter are capital assets. Special rules apply to depreciable property or real property used in

the taxpayer's trade or business; see Code section 1231 (which we cover in Assignment 31). Thus, the same asset can be capital or ordinary, depending on the taxpayer's business.

Which of the following are capital assets?

- (a) IBM personal computers held by IBM for sale to customers.
- (b) IBM's accounts receivable (we will discuss what this is in class).
- (c) Stock in IBM held as an investment (that is, the shareholder owns a small percentage of all outstanding IBM stock).
- (d) An IBM home computer used for personal matters.
- (e) A painting in the hands of a collector.
- (f) A painting in the hands of an art dealer.
- (g) A painting in the hands of the professional artist who painted it.
- (h) A house owned and used as the owner's principal residence.
- (i) A condo owned and rented out for investment. (Ignore "depreciation recapture" issues, discussed in Problem 31-1.)
- (j) A house in a development built for sale to individual buyers.

Problem 27-2 Capital Assets – Character and Timing of Gain.

Jane buys a tract of vacant land for \$1,000 at the beginning of the year. She is not a real estate dealer; that is, she holds the land for investment. Jane stills owns the land at the end of the year, by which time it has gone up in value to \$1,500. Does she have income from holding the land? No; there has been no "realization event." In December of the following year, Jane sells the land for \$1,800. How much income does she have from selling the land? At the time of sale, she deducts her \$1,000 investment in the property (her "tax basis") from the \$1,800 sale proceeds to determine her \$800 gain.

Note: We commonly refer to profits from ordinary assets as "income" and to profits from capital assets as "gain." Moreover, the law distinguishes between "long-term" capital gain and "short-term" capital gain. Congress believes that favorable treatment should be offered to investors in capital assets only if they are long-term investors. We will ignore as much as possible the complexities raised by holding-period questions – except where

specifically discussed below, assume that “capital gain” means “long-term capital gain” eligible for the most favorable tax rate (see my *Guide to Capital Gains* in the Materials).

How much tax does Jane pay on the \$800 gain? Under current law, it depends on how much other income she has that year. Individual taxpayers pay federal income tax at progressive marginal rates of 10%, 15%, 25%, 28%, 33%, and 35%. In general, a special rule provides that capital gains (and dividends) cannot be taxed at higher than a 15% rate for someone otherwise in the 25% rate or higher; and capital gains (and dividends) at a zero rate through 2010 for those in the 10% or 15% bracket. (See Code section 1(h).)

Corporations do not get a special capital-gain rate. They pay tax, generally, at 34% (35% for income over \$10 million). Thus, unlike individuals, corporations have no special incentive to generate income in the form of capital gains rather than ordinary income. (Corporations still benefit, of course, from the inside build-up produced by the realization doctrine.)

Problem 27-3 Capital Losses

Losses from investments in capital assets are another story! Congress very much fears the ability of taxpayers to manipulate the realization doctrine. Consider Tom, an investor who owns two shares of stock. Tom bought Apple Computer stock for \$100 and it is now worth \$40. Tom bought Microsoft stock for \$20 and it is now worth \$80. Tom’s potential \$60 loss in his Apple investment is exactly offset by his potential \$60 gain in Microsoft. However, he recognizes neither his loss nor his gain until he sells. Moreover, he can choose which asset to sell. If he sells only the Microsoft stock, he must pay tax on his \$60 profit, notwithstanding his unrealized loss in Apple. On the other hand, he might sell only the Apple stock in order to trigger a \$60 loss, even though he continues to hold a potential \$60 gain on Microsoft.

Congress believes that it generally doesn’t have to worry about the first case – Tom will make sure that if he sells his Microsoft stock, he will also sell his Apple stock, so that he will not have to pay any tax overall. But to prevent the second case – where Tom generates an “artificial” loss for the year by selling only Apple – Congress disallows a deduction for a *net* capital loss. (A net capital loss results if all capital losses for the year exceed all capital gains for the year.) (See Code sections 165(f) and 1211 & 1212.)

This rule, though, is unfair to taxpayers who have made only one capital investment, and have sold it at a loss (or to taxpayers whose unrealized capital losses exceed their unrealized capital gains). The only concession Congress has made to this possibility is to allow individual taxpayers to deduct up to \$3,000 of net capital losses; any remaining capital loss may be carried forward (but not back) to succeeding years until used up by capital gains or deducted at the rate of \$3,000 a year. Thus, if Anne sells a capital asset this year for a \$99,000 loss, and she owns or acquires no other capital assets, she can claim only a \$3,000 loss each year for the next 33 years! This is true even if Anne did have a large capital gain last year, because the recognized capital

loss may only be carried forward, not back.

Corporations are not granted even this small concession of \$3,000 a year in net capital losses, so they potentially suffer from tax “whipsaw” – no favorable rate on capital gains, and capital losses may not be combined with ordinary losses. Unless a corporation has offsetting capital gains, it might never be able to deduct its capital losses. However, unlike individuals, corporations may carry capital losses back 3 years, and then forward (but only for 5 years).

Problem 27-4 Net Capital Loss

In Year 1, Geraldine engaged in two capital transactions. She sold a capital asset that she bought 4 years ago for a \$10,000 gain, and she sold a capital asset that she bought 4 years ago for a \$17,000 loss. She must net the gain against the loss; of her \$7,000 net capital loss, she may claim \$3,000 in Year 1 (as an ordinary deduction), and carry forward the remaining \$4,000 net loss. What result if in Year 2 she has a capital gain of \$5,000? \$2,000?

Problem 27-5 Long-Term versus Short-Term

What is the tax treatment to Bernard, whose other income places him in the 35% tax bracket, if he has a single capital transaction this year consisting of (alternatively):

- 1) A \$10,000 long-term capital gain.
- 2) A \$10,000 short-term capital gain.
- 3) A \$10,000 long-term capital loss.
- 4) A \$10,000 short-term capital loss.

If Bernard has a gain and a loss, he would first offset long-term gains and losses, and short-term gains and losses. In sum, under section 1222, you offset “long against long” and “short against short”. Then you offset a net loss in one category against a net gain in the other. If Bernard has both a \$10,000 long-term capital gain and a \$10,000 short-term capital loss – or a \$10,000 short-term capital gain and a \$10,000 long-term capital loss – he can still zero out. However, only a net long-term capital gain is entitled to the lower capital gains tax rates. So what if Bernard has both a \$10,000 long-term capital gain and a \$10,000 short-term capital gain?

Problem 27-6 Dividends Received by Individuals

In 2003, the Bush administration and others made a variety of proposals to reduce the tax burden on distributed earnings from C corporations. Try to identify the differences in fairness, efficiency, administrability, cost, effect on corporate governance, and political “sale-ability” among the following:

1. Excluding C corp dividends from income. (What about a cap of, say, \$200 per taxpayer?) [One proposal would have applied only to dividends paid by publicly-traded companies.]
2. Allowing individuals a tax credit (at, say, 15%) for dividends received. (Could be capped.)
3. Allowing C corporations to deduct dividends paid.
4. Taxing dividends at capital gains rates. (These proposals also proposed to simplify, if not lower, capital gains rates.)

Why did the final version take to form of a 15% top rate on dividends and long-term capital gains? See § 1(h)(11). (The rate is 5% – zero after 2007 – for those otherwise in the 15% or 10% brackets.) Why do these caps expire at the end of 2010?

Note: While taxed at the same rate, dividends are NOT capital gains – that is, you do not offset dividend income and capital losses.

Note, too, that different holding periods apply: To get long-term capital gain treatment, the gain must be from an asset held for more than one year; to get 15% dividend treatment, the taxpayer must have held the stock for more than 60 days. See § 1(h)(11)(B)(iii)(1) and § 246(c). (How will taxpayers know to comply with this requirement?!)

Problem 28-1 Lock-In vs. Marked-to-Market

Proponents of a capital gains preference traditionally raise four justifications:

1. *Inflation*. Because the nominal amount of gains are taxed, in inflationary times, taxpayers are taxed on artificial gains.
2. *Bunching*. Because of the realization doctrine, all of the gain is recognized in the year of sale. Under a progressive rate structure, this subjects amounts to the highest rates of tax, even though the gain might have accrued evenly and would have been taxed at lower rates.

3. Lock-In. Again, when faced with high progressive rates and the bunching effect, taxpayers hold onto assets longer than might make sense economically. For example, if a taxpayer holds an asset appreciating at a 6% rate, the taxpayer won't sell it to reinvest in an asset appreciating at a 7% rate if the tax "toll charge" will be too high. As a separate example of lock-in, the elderly hold onto appreciated assets until death in order to avoid tax in both their hands and in the hands of their heirs.
4. Double taxation. Many people believe that we double tax savings. After all, we tax the salary income that taxpayers use to buy assets, and we currently all of the periodic payments received from capital assets (dividends, interest, rents, etc.).

Even if you agree that these four problems are real, is a preferential tax rate for capital gains the answer to each identified problem? Consider the following alternative approaches:

1. Inflation. The taxpayer's basis in the asset could be "indexed." This means increasing it by an objective index (like the Consumer Price Index) that measures the rate of inflation. (See the taxpayer's argument in *Hellerman*.) For example, if you buy an asset for \$100, and inflation is 10% in the next year, your basis would become \$110. Thus you would owe no tax on purely inflationary gains. Indexing, however, is very complicated – the first problem is picking the right index; different indices are appropriate to different types of assets. Indexing in a world of debt is even more complicated.
- 2 & 3. Bunching and Lock-In. The realization doctrine is actually taxpayer-favorable, because taxpayers don't pay tax on "paper gains" – that is, on appreciation prior to sale. For this reason, many commentators believe that capital gains are *undertaxed* rather than *overtaxed*. Congress could adopt a completely opposite approach to the realization doctrine: it could tax *unrealized* gains each year (and allow unrealized losses). This process is called "marked to market" – marking the basis of the asset to its market value for tax purposes. Can you think of why a marked-to-market regime would be extremely unpopular?!

In 1993, Congress adopted new Code section 475, requiring "securities dealers" to use a marked-to-market method of inventory. This means that at year-end, a securities dealer must recognize all unrealized gains and losses on its securities inventory. Securities dealers deal primarily in publicly traded property, and so the dual problems of liquidity and valuation do not arise. A securities dealer can avoid marked-to-market tax accounting for a security by identifying it as held for investment. You are not responsible for Code section 475.

4. Double taxation. To those who believe we overtax savings, the right rate on

capital gains is *zero*. Many of the consumption tax proposals are motivated by this belief, and would exempt all returns to savings and investment.

Problem 29-1 Bargain Purchase by Employee

Derrick works as a salesman for Drive-By-Night Motors. Because Derrick was the top salesman of the year, his employer lets him buy a new car for \$10,000 instead of its fair market value of \$30,000. (Ignore Code section 132.) What is Derrick's tax treatment? (See Reg. § 1.61-2(d)(2).) What basis does Derrick take in the car? As we have already seen, Derrick has \$20,000 of taxable compensation, and a \$30,000 basis. Again, it's easiest to pretend that Derrick was paid \$20,000 in cash (taxable compensation), and used this money plus \$10,000 of his own (after-tax) savings to buy the car for \$30,000.

Problem 29-2 Section 83

Meditech, Inc., a start-up corporation, is long on hope and short on cash. It offers a 5-year employment contract to Sam, an extremely talented research chemist, and compensate him by paying \$35,000 plus 100 shares of Meditech common stock, each year. There's one catch. Sam has to agree to stay employed at Meditech for 5 years. That is, on the fifth anniversary date of his employment, his ownership of all 500 shares of Meditech stock will "vest," and he will be allowed to sell or otherwise transfer the shares. Until then, however, he can neither vote the stock nor receive dividends, and if he leaves the company before the 5 years are up, he would forfeit all rights to the stock back to the company.

This is a very common incentive employment arrangement. The idea is that due (at least in part) to Sam's efforts and talent, by the end of 5 years Meditech will be a very successful company, and the stock will be quite valuable. The tax system has to decide *how much* income Sam has; *when* he has it; and what the *character* of that income is (ordinary or capital)? Assume that Congress wants taxpayers to have ordinary from compensation for services, and capital gain from investment profits.

Read Code section 83(a) & (b) carefully. It is because the (hopefully higher) value at time of vesting that controls, employees can wind up with a whopping amount of bunched ordinary income in that year. The Code offers a "gambler's choice." If Sam makes an "83(b)" election, he comes within the following regime: He includes the (presumably low) value of the restricted stock in income when he receives it (but "value" is measured by ignoring his temporary restriction); vesting is not a taxable event; and any subsequent increase (or decline) in value is taxed only when he sells the stock, and qualifies as a capital gain (or loss). (Why wouldn't employees always make this election? – What does the last sentence of Code section 83(b)(1) mean?) Therefore, which answer or answers accurately describe Sam's tax result from this transfer of stock under Code section 83? (Compare Reg. § 1.83-3(c)(4), Example 3.)

- If Sam does nothing, he will have no income until year 5, if and when all 500 shares vest. The income is ordinary, and the amount is the then-fair market value of the stock. This amount becomes Sam's basis in the stock.
- If Sam does nothing, he will have income each year that he receives the restricted stock. The income is ordinary, and the amount is the then-fair market value of the stock. This amount becomes Sam's basis in the stock.
- If Sam elects, he will have no income until year 5, if and when all 500 shares vest. The income is ordinary, and the amount is the fair market value of the stock on the dates issued to him. This amount becomes Sam's basis in the stock.
- If Sam elects, he will have income each year that he receives stock. The income is ordinary, and the amount is the then-fair market value of the stock. This amount becomes Sam's basis in the stock.
- Sam will have no income until he sells the stock. Because his basis is zero, the entire sales proceeds will be ordinary income.
- Sam will have no income until he sells the stock. Because his basis is zero, the entire sales proceeds will be capital gain.

Problem 29-3 Employer Deduction

In Problem 29-1, how much and when is the employer's deduction for compensation paid? How about in Problem 29-2? (See Code section 83(h).)

Problem 31-1 Depreciation Recapture

In Code section 1231, Congress gave business a gift. Depreciable property and land used in a trade or business get chameleon-like treatment: if sold at a gain, it's a capital gain, but if sold at a loss it's an ordinary loss. (Note the double benefit of an ordinary loss – not only does it reduce taxes at the taxpayer's marginal rate, but it, unlike a net capital loss, doesn't have to be dribbled out at the rate of \$3,000 a year!)

There's only one thing that bothered Congress. Depreciable business property often doesn't appreciate economically – think about equipment. Therefore, if it is sold at a gain, much (if not all) of that gain arises because the taxpayer was permitted generous depreciation deductions, which reduced basis. Hmmm.... depreciation deductions are ordinary, but the gain is capital. Something doesn't look right.

For example, Judith buys a new compact-disc processing machine for \$100,000. If tax depreciation matched economic depreciation, she would be allowed deductions for cost recovery only as the machine fell in value. So if she claimed \$20,000 in deductions, reducing her basis to \$80,000, but the property also declined in value to \$80,000, she would have no gain (or loss) on sale of the machine.

But if Code section 168 permitted Judith \$40,000 in depreciation deductions, reducing her basis to \$60,000, while the machine declined in value only to \$80,000, she would have \$20,000 in gain on sale. Code section 1231 treats this as capital gain. “No fair,” says Congress in Code section 1245 – “to the extent the gain represents prior depreciation deductions, the gain is recharacterized as ordinary.” (This rule also applies to depreciable investment property held as a capital asset under Code section 1221.)

Two rules still favor taxpayers. First, even if *all* of the depreciation deductions are recaptured on eventual sale, the taxpayer still wins, because of the time value of money. Second, Code section 1245 applies only to personal property, not real property. If a taxpayer sells a building used in the trade or business, all of the gain remains capital gain. However, section 1(h) taxes the amount of gain on the sale of real property that *would have been* depreciation recapture at a 25% rate.

To understand recapture, remember that Code section 1245 does not create gain; it merely recharacterizes gain (from capital back to ordinary). In addition, Code section 1245 only “recaptures” prior depreciation deductions; any excess gain is real gain that Congress is perfectly happy to give capital gain treatment to. Finally, losses are unaffected: a loss means that Congress didn’t grant generous enough depreciation deductions. If the depreciable property or real estate sold at a loss is business property, then the loss is ordinary; if the property is held for investment, then the loss is capital. (The distinction can be hard to make in the case of rental real estate.)

In the following fact patterns, how much gain or loss results, and what its character?

- a. Machine purchased for \$100; adjusted basis is now \$40; sale for \$60.
- b. Machine purchased for \$100; adjusted basis is now \$40; sale for \$120.
- c. Machine purchased for \$100; adjusted basis is now \$40; sale for \$20.
- d. Manufacturing facility purchased for \$100 (ignore the cost of the land); adjusted basis is now \$40; sale for \$120.

Problem 32-1 Realization vs. Recognition

Students often get confused by the rules that apply to the disposition of property. If you

keep all of the steps separate – *and always do each step in order* – you won't go wrong.

1. **Is gain (or loss) “realized”?** Code section 1001(a) speaks of the gain or loss on the “sale or other disposition” of property. This covers just about everything you can think of. For our purposes, the only “nonrealization” events are gifts (and dying) and partitions of jointly owned property. Interestingly, these are not excluded anywhere in the Code.
2. **Is the realized gain (or loss) recognized?** Gain or loss is **always** recognized unless you can find a “nonrecognition” rule somewhere in the Code. (See § 1001(c).) We study several nonrecognition rules: like-kind exchanges (§ 1031), involuntary conversions (§ 1033), and transfers of property between spouses and divorcing spouses (§ 1041).

Under these rules (except the one on spousal transfers), to the extent the taxpayer keeps any cash or other “**boot**” received from the other party, gain will be recognized.

3. **What is the taxpayer’s basis in the property received?** This is the final, and crucial step. The nonrecognition rules are not a gain forgiveness regime – they are a gain *deferral* regime. The tax system has to have a way of making sure that the gain that was realized but went unrecognized on the exchange is preserved, to be realized in a future recognition event. The nonrecognition regimes achieve this result by giving the taxpayer the **same** basis in the property received that the taxpayer had in the property given up (decreased by any “boot” received and increased by any gain recognized).

If the taxpayer recognizes any gain (or, if section 1033 applies, loss), the regular rules apply. The character of the gain or loss depends on the character of the asset in the hands of the taxpayer giving it up. Don't forget that loss cannot be recognized if the asset is a personal-use asset (see discussion of principal residences, in Assignment 33).

Problem 32-2 Simple Like-Kind Exchange

“City,” who owns a downtown apartment building, and “Country,” who owns a farm, have always envied each other's way of life. They get to talking one day, and realize that their properties have equal value (each worth \$100), and agree to swap. If City's basis is \$40 and Country's basis is \$75, what tax effect to each? (See Code section 1031(a) and (d).) Do each taxpayer separately. The result to City does not depend on the result to Country; and vice versa.

First, City:

1. **Is gain realized?** Yes. Code section 1001(a) tells us that gain is realized when the amount realized exceeds basis. Code section 1001(b) tells us that the amount realized equals the amount of money plus the fair market value of property received in the

exchange. So, City's amount realized is \$100 (the fair market value of the farm); gain realized is \$100 minus City's \$40 basis = \$60.

2. **Is gain recognized?** Code section 1031 says no, if City gives up property held for productive use in a trade or business or for investment (which the apartment building is) solely in exchange for property of a like kind which is to be held for productive use in a trade or business or for investment (which a farm is). Treas. Reg. § 1.1031(a)-1(b) & (c). So, none of City's \$60 realized gain is recognized.
3. **What is City's basis in the farm?** Now we get to the rule that makes everything work. What should City's basis in the farm be in order to preserve the \$60 of realized but unrecognized gain for a future recognition event (such as the sale of the farm)? Well, the farm is worth \$100, so City's basis should be \$40. Code section 1031(d) achieves this result by giving City a substituted basis in the farm: that is, City's basis in the new asset equals City's basis in the old asset (ignore references to boot and gain for now).

Now figure out the tax consequences to Country.

Problem 32-3 Boot

Taxpayers engaging in a like-kind exchange can rarely find an asset they want that is worth exactly the same as the asset they are giving up. In such a case, one side or the other has to throw in some cash (or other property not of like-kind) in order to even up the exchange. This type of consideration does not bust the like-kind exchange, but it does have current tax consequences. See Code section 1031(b). Follow three simple steps and you won't go wrong:

1. **How much gain was realized?** Students sometimes get confused by this, but you can never recognize more gain than you realize! That is, if City (in Problem 32-2) receives \$70 of cash along with \$30 of productive real estate, he can't recognize \$70 of gain. After all, if he had simply sold his apartment building for \$100 of cash, he would have had only \$60 of gain.
2. **How much boot did the taxpayer receive?** Boot equals the amount of money and the fair market value of property not of like-kind (such as IBM stock).
3. **Which number is LESS?** The amount of gain recognized is the *lesser* of the amount of gain realized and the amount of boot. Gain "recognized" is TAXED.

Obviously, the receipt of boot affects basis, but in a way that initially seems surprising. Under Code section 1031(d), basis in the new asset equals old basis minus boot plus gain recognized. Often these two numbers are the same. See the next problem.

Problem 32-4 Boot Received

Return to Problem 32-3, except that Country's farm is worth only \$85, and so Country throws in \$15 of cash. What are the tax results to City?

1. Amount realized = \$85 FMV of farm + \$15 cash = \$100.
Gain realized = \$100 amount realized - \$40 basis = \$60.
2. Boot = \$15.
3. Which is less? The \$15 of boot. Thus, this is the amount of gain recognized. See Reg. § 1.1031(b)-1(a) & (b).

Now let's figure out City's basis in the farm:

$$\$40 \text{ (basis in the property given up)} - \$15 \text{ (boot)} + \$15 \text{ (gain recognized)} = \$40.$$

Hey, why isn't it different? Look carefully. What is the number that *did* change? City gave up property worth \$100 for property of a like kind worth \$85 and cash of \$15. On the exchange, City recognizes \$15 of the \$60 realized gain. This leaves \$45 of gain to be recognized in the future. If City were to sell his new farm immediately for \$85, and he has a basis of \$40, he will recognize the other \$45 of gain at that time.

In any case where boot is less than or equal to gain realized, new basis will always be the same as old basis. If boot exceeds gain realized, though, the taxpayer triggers all the realized gain, but then is recovering basis tax-free. Look again at step 1 in Problem 32-3. If City receives \$70 of boot, what is City's basis in the farm, and why is this the right answer?

Appreciate that the boot rule is about as taxpayer unfavorable as you can get within the general nonrecognition regime: Realized gain is recognized dollar for dollar as boot is received, and boot reduces basis only once the taxpayer runs out of realized gain. Where boot exceeds realized gain, you might as well sell the property for all cash – you can't recognize more gain than you realize!

Problem 32-5 Boot Paid

In the previous problem, what are the tax consequences to Country? She gave up an \$85 farm, in which her basis is \$75, plus \$15 cash in exchange for an apartment building worth \$100. Country did not receive any boot, so none of her realized gain is recognized. But she does get credit for the boot she paid. Treas. Reg. § 1.1031(d)-1(a), last sentence.

Look at it this way: What is Country's after-tax investment in the apartment building?

She has \$75 invested in the farm and she just threw in another \$15 of after-tax cash. Her basis in the apartment building equals the basis in the property she gave up plus the amount of boot paid, or \$90. Let's do the problem in steps.

1. Amount realized = \$100 FMV apartment building.
Basis in property given up = \$75 basis in farm + \$15 cash = \$90.
Gain realized = \$100 - \$90 = \$10.
2. Boot received = \$0.
3. Which is less? \$0
4. Basis in apartment building = \$90 (basis in property given up) - \$0 boot + \$0 gain recognized = \$90. Why is this the right answer? If she were to sell her \$100 apartment building she would then recognize the \$10 of gain that was realized but went unrecognized when she gave up the farm.

Another way to look at this is to split the transaction into two smaller transactions: (1) the exchange of a farm worth \$85 (basis of \$75) for a building worth \$85; and (2) the purchase of a farm worth \$15 for \$15 of cash. Thus, Country's basis in the farm is the \$75 exchanged basis plus \$15 of cost basis = \$90. None of Country's \$80 gain realized in the farm (\$85 FMV - \$75 basis) is recognized, and is preserved for when Country sells the building (now worth \$100).

Problem 32-6 Noncash Boot

Finally, look what happens if Country doesn't have \$15 of cash, but she has some IBM stock worth \$15, in which her basis is \$10. Here, we are in the ordinary world of Code section 1001. See examples in Treas. Reg. § 1.1031(d)-1(c) & (e).

From Country's point of view: Because stock for real property is not a like-kind exchange, she triggers \$5 of gain. (By the way, if her basis in the stock were \$20, she would recognize a \$5 loss.) Remember how to do these taxable exchanges – first pretend that she sold the stock for cash and then used the cash to engage in the like-kind exchange. So her basis in the apartment building she gets is still \$90.

From City's point of view: Because he pays tax on the full \$15 fair market value of boot received, his basis in the stock is \$15. Again, it's just like Country gave him \$15 cash and he took the cash to buy the stock. *A taxpayer's basis in boot is **always** the fair market value of the boot.*

Problem 33-1 Rollover Concept

Code section 1031 has a “touch cash and you die” result: Even if City *immediately* uses the \$15 of boot to buy other real estate, the boot triggers gain. To qualify for a like-kind exchange, like-kind properties must actually be exchanged. (To be precise, three-party exchanges are common for “deferred” like-kind exchanges, and a “qualified intermediary” can hold the cash.)

By contrast, the rules for involuntary conversion under Code section 1033 employ a “rollover” concept. The taxpayer can receive cash for the old property, and nonrecognition treatment applies so long as she reinvests the cash into the right kind of property within the time period specified in the statute. To the extent the taxpayer does not roll over the proceeds, however, she will have cashed out gain, with tax results similar to the Code section 1031 boot rules.

The nonrecognition result in Code section 1033 is elective. It applies only to gains. If a taxpayer realizes a loss on an involuntary conversion, the loss is recognized.

Problem 33-2 Involuntary Conversion

Tim’s restaurant building has a basis of \$10,000 and a fair market value of \$100,000. It is destroyed by a fire. He received \$100,000 from his insurance company. Does he realize gain? (Code section 1001.) Does he recognize gain? (Code section 1033(a).) Does it matter whether he builds a new restaurant or just accepts the cash? What if instead Tim used the money to build a bowling alley? Assuming he rebuilds a restaurant for \$80,000; what tax result, and what is his basis in the new restaurant? What if the new restaurant costs \$130,000? (Code section 1033(b).)

Problem 33-3 General Principles for Home-owners

The rules for sales of principal residences used to be quite complex, albeit generally taxpayer-favorable. Current law is even better: It *excludes* the first \$500,000 of gain (on a joint return) on the sale of a principal residence. (I.R.C. § 121.) The amount of gain excluded on a single return is \$250,000. You can use this rule as many times as you want (but only once every two years), and there are no age requirements. However, in general, you must have owned the residence and lived in it as your principal residence for at least two of the last five years prior to the sale.

On the downside, the old rule permitting “rollover” of sale proceeds is gone: Gain in excess of \$500,000 (\$250,000 for singles) is TAXABLE.

Notice that this is \$500,000 of *gain*, not \$500,000 of sale proceeds. So you can sell your

house for \$800,000 and have a taxable gain only to the extent your basis is less than \$300,000. Obviously, the more often you move, the less likely you are to pay tax. Someone living in an area with high housing inflation who purchased many years ago for \$50,000 (or who rolled over sale proceeds under the old law) is not excited about this new law.

To the extent the taxpayer has excess gain, it is a capital gain. Why? Because a house is a capital asset. (Recall Problem 27-1(h), above.)

If the taxpayer sells the old house at a loss, no loss is recognized. Why not? Because Code section 165 disallows losses on the sale of personal-use assets. See the next problem.

Problem 33-4 Sale at a Loss

Leona paid \$500,000 for her house in 2001. She finally found a buyer who will pay her \$350,000 for it. Before accepting the offer, she comes to you for advice: Will she be able to deduct her loss? (See Reg. § 1.165-9(a).)

After hearing your bad news, Leona comes up with a brilliant plan. She decides to move out of the house, convert it to rental use (an income-producing activity, rather than a personal-use activity), and sell it to the buyer soon thereafter. Does this change the result? What's going on in paragraphs (b) and (c) of Regulations section 1.165-9?

Problem 34-1 Marriage Penalty

Your clients Sam and Sue are planning to get married. They have not picked the exact date yet. They are deciding between December 2009 and January 2010. They ask you whether the date that they choose will have any effect on their federal tax liability for 2009. Sam and Sue each earns \$70,000 per year and will not itemize deductions. (Ignore the standard deduction and personal exemptions – that is, assume the \$70,000 figures are taxable income.) From a tax standpoint, would they be better off getting married in December or January? Why? Compare Code sections 1(a) and 1(c); for simplicity, for all these calculations, look at the 2009 tax tables 1 and 3 in Appendix F. What's going on in section 1(f)?

Does Code section 1(d) change the answer? (Use table 4.)

Problem 34-2 Marriage Bonus

Like Sam and Sue, your clients John and Mary are planning to marry and are deciding between December 2009 and January 2010. Mary earns \$140,000 per year, and John, a student, earns nothing. They also have no dependents and do not itemize deductions. From a tax

standpoint, would they be better off marrying in December or January? Why? (Compare Code sections 1(a) and 1(c), looking at the 2009 tax tables; ignore the standard deduction and personal exemptions – that is, assume the \$140,000 is taxable income.)

Does Code section 1(d) change the answer?

Problem 36-1 Dependency Exemption

Carol and your client Steve are divorcing. They have one child, Pam. Pam will live with Carol, but Steve will pay \$1,000 per month child support. Who can claim the dependency exemption for Pam? (See Code section 152(e).) Carol otherwise expects to have taxable income of \$20,000 per year and Steve expects to have taxable income of \$100,000. What advice would you give Steve in negotiating with Carol regarding the exemption?

Problem 36-2 Dependent-Care Credit

Juanita and Luis, a married couple, both work full-time. Their combined taxable income is \$60,000. They pay \$4,000 a year to place their daughter in daycare.

Ferdinand and Isabella, another married couple, also both work full-time and have one child. Their taxable income is \$200,000. They also pay \$4,000 a year for daycare.

Ignore Code section 21. Instead, assume that the Code allows working parents either to deduct the costs of child care in full above-the-line or to claim a tax credit equal to 20% of the child-care expenditure. Which alternative will these two couples prefer?

- a. Juanita and Luis will prefer the deduction; Ferdinand and Isabella will prefer the credit.
- b. Juanita and Luis will prefer the credit; Ferdinand and Isabella will prefer the deduction.
- c. Both couples will prefer the deduction.
- d. Both couples will prefer the credit.

Now look at Code section 21. How much of a tax credit does each couple get? (I'll explain why the credit rate is 20% for both couples.)

Problem 36-3 The Kid (Per-Child) Credit

Section 24 offers \$1,000 tax credit for each qualifying child. This is in addition to the personal exemption that the parents can claim for the child. Under political pressure, in 1997 the Republicans agreed to phase out the credit for high-income families, and the Democrats agreed not to make the credit fully refundable to low-income taxpayers. For 2008, the credit is refundable to working families with children, for families earning more than \$8,500; for 2009 and 2010 the amount is \$3,000. (This takes into account an interaction with the earned-income tax credit.) Special rules apply to taxpayers caught in the alternative minimum tax.

Who wins and who loses from a provision like this? Why does the amount drop down in years later years – and how likely do you think this will change (it has already!)?

Problem 37-1 Income Shifting: Family Business

Joe, a self-employed doctor, earns \$200,000 a year from his practice after all expenses. In June, Joe hires his son Mark to work in his office as a receptionist. Mark had just graduated from high school and wanted a summer job to earn money before starting college in the fall. Joe paid Mark \$2,000 per week for 10 weeks. Can Joe deduct Mark's salary as a business expense under Code section 162?

Problem 37-2 Income Shifting: Timing of Gift

Howard buys a lottery ticket for \$1. Before the drawing, he gives the ticket to his 15-year-old son, George. That night the family gathers around the TV to watch the drawing – just in time to see the ticket win \$10,000. Who is taxed on the winnings? Would your answer change if Howard gives George the ticket after the drawing, and George cashes it in?

Problem 37-3 Assignment of Income: Fruit and Tree

Elizabeth owns an office building. She makes her son, Charles, a gift of the rental income that will be earned, over the next five years, from the office leases. At the end of the year, the tenants have paid \$15,000 in rental income directly to Charles, as instructed by Elizabeth. What are the tax consequences of this arrangement?

How does your change, if at all, if Elizabeth makes an outright gift of the office building to Charles?

What if instead at the same time that Elizabeth gives the next 5 years' rental income to Charles, she gives the remainder interest to her daughter, Anne?

Problem 37-4 Kiddie Tax

Your client Sara has about \$1 million in the bank earning interest of \$60,000 per year. She would like to reduce the tax burden on her interest income by giving some or all of the money in her savings account to her daughter Pam, who is five years old. Sara believes that if the interest income is reported by Pam, it will be taxed at a lower rate. Pam has no other income. Is Sara's belief right? Can she get any tax benefit by putting some of her savings in Pam's name? (See Code section 1(g)(1), (2) & (3)(A) & (B), the "kiddie tax"; Code section 63(c)(5); and Code section 151(d)(2).) What *nontax* consideration should Sara think about?

Problem 38-1 Divorce and Child Support

After years of judicial rule-making, Congress totally revamped the rules that apply to spousal transfers on account of divorce. They adopt the following three categories:

1. **Property Transfers**: Code section 1041 provides that no gain or loss is recognized on transfers of property between spouses (including happily married ones) or incident to a divorce. Note the implication of this mandatory rule: Married and divorced people cannot sell property to each other. If W transfers IBM stock worth \$5,000 to H for \$5,000 in cash, they have simply made reciprocal gifts (he takes her basis). If W wants to recognize gain (or, more likely, loss – see generally section 267, which denies losses in sales to related parties), she has to sell her stock to someone else.
2. **Child Support**: Do parents get a deduction for supporting their kids? Unfortunately, not. These are nondeductible "personal, family, and living expenses" under Code section 262. The answer does not change after divorce. Child support payments are not deductible.
3. **Alimony**: If, pursuant to a divorce, one spouse makes alimony or separate maintenance payments to the other, the payor gets a deduction (section 215) and the recipient has income (section 71). Do you see the effect? Which spouse is likely to be in the higher tax bracket? In case the paying spouse is in a lower bracket, the Code provides couples with the flexibility to elect out of this regime. (See 71(b)(1)(B).) In such a case, the paying spouse gets no deduction, but the recipient spouse has no income – just like a gift.

Problem 38-2 "Alimony"

Steve and Carol are divorced. Carol has custody of their child. In a written agreement governing property settlement, child support and alimony, they agreed that Steve would pay Carol the following amounts –

- (i) \$5,000 per month for 10 years. If Carol dies before the 10-year period is over, Steve must make these payments to whomever she designates in her will; plus
- (ii) \$2,000 per month until Carol dies or remarries; plus
- (iii) \$3,000 per month until their child reaches age 18.

This separation agreement labels the entire \$10,000 per month as alimony. Under Code section 215, how much of the payment can Steve deduct? Under Code section 71(a) through (d), how much must Carol include in income? (See also Temporary Reg. § 1.71-1T(c), Q.15 through Q.18.)

Problem 38-3 Transfer of Property

Fred and Ginger are divorced. Pursuant to their written agreement, Fred is obligated to pay Ginger \$2,000 a month until she finishes college two years from now. They have no children. Fred falls behind in his payments. By the end of the year, he has paid her only \$4,000 in cash, but she agrees to accept some of his IBM stock. It is worth \$6,000, and Fred's basis is \$2,000. What are the tax consequences to Fred and Ginger? (Compare Code section 71(b)(1), and Temporary Reg. § 1.71-1T(b), with Code section 1041, and Temporary Reg. § 1.1041-1T(d).)

What if Fred's basis in the IBM stock were \$7,000? (See Code section 1041(b).)

Problem 39-1 Allocation on Sale of Business

Taxpayers who sold all of the assets of a sole proprietorship (as opposed to stock in the business) tried to argue that "the business" is a capital asset, and that they get capital gain. No such luck. Instead, the courts applied a fragmentation approach, looking at the character of each business asset. For example, inventory produced ordinary income, while equipment produced Code section 1231 treatment (capital if gain, ordinary if loss, subject to depreciation recapture). In addition, if the seller agreed to a "covenant not to compete" with the buyer, amounts paid under this covenant received ordinary income treatment, because they are basically a substitute for compensation. By contrast, amounts received for goodwill are capital.

The same fragmentation rule applies to the buyer. The buyer must apportion the purchase price among all the assets; these become his or her basis in each asset. In addition, if the buyer pays for a covenant not to compete, the buyer can take ordinary deductions for these payments. Under Code section 197, however, a covenant not to compete has a statutory 15-year life for tax amortization purposes. This is the price buyers have to pay to also get a 15-year useful life for purchased goodwill, which used to have an indeterminate useful life for tax purposes (and hence

could not be amortized).

Code section 1060(a) allows the buyer and seller to apportion the purchase price under an agreement binding on both (unless the IRS finds the allocation inappropriate). Generally, the IRS doesn't care how the taxpayers divide up the purchase price, so long as the purchase price is allocated first to the liquid and tangible assets (producing a "residual" value for the business intangibles). Often the buyer and seller have opposing interests: the more money paid for inventory, for example, the less ordinary income the buyer will have on the sale of the inventory, but the greater the seller's ordinary income. However, a buyer of goodwill and a covenant-not-to-compete gets a 15-year straightline write-off for either of these assets; to which asset would the seller prefer to allocate purchase price?

As a result, the buyer and seller in most cases should have separate counsel. In addition, appraisals are an art, not a science. If one party can compromise on the amount of the purchase price allocated to one type of asset, the other party might be willing to pay a little bit more.

For example, Tito is selling a bookstore. It has the following assets:

	<u>Adjusted Basis</u>	<u>Appraisal #1</u>	<u>Appraisal #2</u>
Books	20,000	30,000	35,000
Shelving	40,000	45,000	55,000
Building	150,000	170,000	190,000
Goodwill	<u>-0-</u>	<u>50,000</u>	<u>40,000</u>
	210,000	295,000	320,000

Also, the buyer wants Tito to agree to a 5-year covenant not to compete. Tito had originally paid \$75,000 for the shelving. Tito's original purchase price for the building was \$160,000.

Let's say the parties agree to an aggregate price of \$300,000. What does Code section 1060 require? How would Tito prefer to see the purchase price allocated between goodwill and the covenant not to compete? Why would Tito prefer this? What other allocations would help out Tito? What are the buyer's preferences on these? How might they compromise?

Problem 39-2 Sales for Deferred Payment – Installment Sales

You sell a parcel of land for \$24,000. You transfer ownership to the buyer today. The buyer will pay you \$8,000 now, \$8,000 next year, and \$8,000 the year after (plus interest on the deferred payments). Your basis in the land is \$9,000. Thus, your total gain on the sale will be \$15,000 (\$24,000 minus \$9,000). Ignoring the interest payments, *when* do you report the \$15,000 gain on the land? Congress had to choose among several possible tax treatments:

1. **No gain until the payments received exceed your capital investment (basis).** Such a “basis recovery first” regime would result in no taxable income to you this year, because the \$8,000 current payment is less than your \$9,000 basis. Next year, the first \$1,000 would return the rest of your capital, and the other \$7,000 would be gain. The final year's \$8,000 payment would be all gain.
2. A “**gain recognition first**” regime, so that this year's entire \$8,000 payment and the first \$7,000 of next year's payment would be gain; remaining payments would be return of capital.
3. **No deferral:** all \$15,000 gain must be recognized in the year of sale.
4. **Proration of gain.** The total gain of \$15,000 is allocated \$5,000 to each \$8,000 payment; the remaining \$3,000 of each payment is return of capital. (I.e., take each \$8,000 payment and multiply it by the “gross profit percentage” of $\$15,000/\$24,000$.)

In fact, in different parts of the Code, Congress has variously adopted all of these regimes –

The fourth regime – proration – applies for installment sales of capital assets. (See Code section 453(a), (b) & (c); Reg. § 15a.453-1(b)(5) (Example 1).)

Dealers who sell inventory for a deferred payment must follow the third regime. (See Code section 453(b)(2).) A real estate dealer holding the land for sale to customers must report all \$15,000 gain – even if he does not receive any payment up front. (In effect the dealer made a loan to the buyer, who turned around and used the borrowed amount to buy the dealer's land.) The same is true for an installment sale of publicly traded stock. (See Code section 453(k)(2).)

The first regime (basis recovery first) applies in those very rare cases called “open transactions,” where the amount to be paid is so speculative that it cannot be valued until paid. Even in these cases, the regulations mandate a 15-year basis-recovery period. The first regime is also (effectively) the approach adopted for distributions from partnerships to their partners.

Does the second regime (gain first) look familiar? Recall like-kind exchanges where the taxpayer receives boot, or involuntary conversions where the taxpayer doesn't roll over all of the proceeds.

Problem 39-3 Installment Sales – Buyer's Treatment

Barbara buys your land for \$24,000. She pays you \$8,000 now, and will pay you another \$8,000 next year, and the final \$8,000 in two years. What is Barbara's basis in the land today? No special rules apply. Basically, you are “seller-financing” Barbara's acquisition. What if instead Barbara had borrowed \$24,000 from the bank, agreeing to repay in three annual

installments, and paid you \$24,000 for your land?

Of course, for Barbara to get a \$24,000 basis in the land today, she would also have to agree to pay you interest. If no interest is stated, Congress assumes that you are trying to disguise ordinary income (income to you and deductible by Barbara) as additional capital gain. In such a case, the Code will “impute” interest by recharacterizing appropriate portions of the \$8,000 payments.

Finally, what if Barbara buys a depreciable building, rather than land from you? No difference – she is entitled to take depreciation deductions before making full payments, just as if she had borrowed from a third party.

Problem 39-4 Identification of Assets

Robert owns 3 shares of Microsoft stock, which he bought as follows:

<u>Year Purchased</u>	<u>Price</u>	<u>2009 Value</u>	<u>Unrealized Gain</u>
2001	\$ 50	\$200	\$150
2003	100	200	100
2007	<u>75</u>	<u>200</u>	<u>125</u>
Total	\$225	\$600	\$375

In 2009, Robert sells one share of Microsoft. How much is his gain? The answer depends on whether he has sold his 2001 stock, his 2003 stock, or his 2009 stock.

Generally, it is easy to determine which asset a taxpayer has sold. If you own three buildings, and you sell one of them, everyone knows which one you sold. By contrast, where you sell a large number of identical objects, it can be difficult, if not impossible to know which one you sold. For example, if you are a Coca-Cola bottler, which bottle did you sell to which store? The answer can be important, because your costs of bottling Coca-Cola likely change over time.

To deal with these two types of situations, the Code contains two different accounting schemes. For all assets other than “inventory” the taxpayer is free to identify which asset he sold. For inventory, the taxpayer must chose from an approved inventory method, and follow it consistently. (See Code section 471.) Common methods include “first-in, first-out” (FIFO), “last-in, first-out” (LIFO), and a weighted average method.

You might think the shares of stock in the same company are fungible (interchangeable) in the same way inventory is. However, Robert is not a securities dealer; he is an investor. Amazingly, then, the law does not require investors in stock to be consistent in any way. Instead, a taxpayer may designate which share he is selling. In Robert's case, he would pay the least tax if he designated the 2003 stock as the one he sold, since his basis in that stock is the highest. If Robert then sold a second share, he would designate the 2009 stock as the share sold (but watch the question of holding period and the difference between short-term and long-term gain). If a taxpayer fails to designate, the law imposes a FIFO regime, which, in an era of rising stock values, would produce the most gain.

Notes:

(1) President Clinton in January 1996 proposed changing these rules, to substitute a proration requirement for the current rule that lets taxpayers pick. This proposal has gone nowhere, but who knows? Can you think of problems with such an approach?

(2) In October 2007, Ways & Means Committee chairman Rangel introduced H.R. 3970, the Tax Reduction and Reform Act, which would pay for its proposed tax cuts, in part, by repealing the LIFO method of accounting, and taxing the resulting recognition of income over an 8-year period.

Finally, to make things more complicated, even a dealer in a particular type of asset can hold items of that type for investment! For example, a real estate dealer is entitled to capital gain if he sells real estate held for investment.

Problem 39-5 Investments in Mutual Funds

A mutual fund is a convenient and economical way to diversify investments. After all, with corporate stock commonly trading at about \$75 per share, you'd have to have a lot of money before you could afford to buy 100 shares (a "lot") of many different companies. A mutual fund "buys the market" (or desired subsets of the market), and then you buy an interest in the fund. (You can also use mutual funds to invest in bonds.) You do want to watch the fees you pay to a fund.

Unfortunately, what's easy for investment purposes becomes a nightmare for tax purposes. The mutual fund itself (if it does things right) is not a taxpayer. Rather, all of the dividends it receives on its stock, and all of the gains and losses it realizes on sales, flow through to the mutual-fund shareholders. You have to report your share of each of these items (the character is preserved in your hands.) The fund has to send you a Form 1099 information return for this purpose. Understand the consequences of this result: You have income and gain regardless of whether you sell any of your mutual-fund shares. And mutual funds typically churn their portfolios (buying and selling assets) more than 100% each year.

Specifically, a mutual fund pays no tax on income it distributes to its shareholders, but it can't easily determine by December 31 precisely how much income it will have for the year. Thus Congress gives mutual funds a brief period of time to sort things out, and treats dividends paid in January of the following year as having been distributed in that prior year. See Code section 852(b)(7) (dividends declared in October, November, or December and payable to shareholders of record on a specified date in one of those months will be deemed to have been paid on December 31, so long as actually paid during the following January). See also Code section 855. If you're a shareholder in a mutual fund, you might find yourself having to report income you don't receive until the next year.

Mutual funds know that potential individual investors are leery about buying into a mutual fund in the last quarter, because they could be walking into a tax trap. After all, the dividend declared could relate to the fund's performance prior to their investment, yet even new fund shareholders would be liable for tax on the distribution. Indeed, mutual funds worry so much about not letting a large "tax overhang" build up – thus discouraging new investment – that most mutual funds recognize their gains at least annually (much to the disgust of the old shareholders, who want to benefit from a buy-and-hold strategy!).

Also, understand that a shareholder who wants out of a fund can't sell the shares on the open market, but rather must return to the fund to be redeemed. Thus, even if a fund wants to keep its churning low, it might have to sell assets to raise money to redeem those shareholders. Think of the spiraling tax consequences: Shareholders want to bail out of fund that is doing badly, but in order to claim a (possible) loss on the mutual fund shares, the redeemed shareholders force the fund to trigger (possible) gains for everybody.

Caveat: Not only does this produce realized gain that flows through to the investors, but the gain is generally short-term, and thus not eligible for the low tax rates on long-term capital gains. Worse, these short-term gains are not treated as true capital gains (available to soak up capital losses), but rather as ordinary-income dividends (not so bad now!).

Tax-sensitive mutual funds will try to sell loss stocks to soak up the gain from appreciated investments. But they don't have to. In recent years, some new funds have advertised themselves as being particularly tax-sensitive by promising not to churn so much. A good buy-and-hold style investment (and one that's well diversified) can be a "stock index fund." Such a fund, for example, might buy the Standard and Poor's 500, and sit on it, trading only when the components of the index change.

Another tax nightmare comes when you sell your mutual funds. At first, you might think you know your basis in your shares, because you have records of what you paid for them. Don't forget, however, that each year you maintained your investment you paid tax on the dividends and gains. These dividends were reinvested on your behalf by the mutual fund. Therefore, the number of your shares in the mutual-fund shares was increasing each year by these tax-paid amounts. Of course, you're free to report your gain measured off of your original basis, but then

you'd be paying tax twice on the same profit. So if you (or your broker) weren't tracking your basis, you have to dig out all of your quarterly statements, so that you can figure out your correct basis in all of the shares you own.

Problem 39-6 Mutual Fund Investment by Qualified Retirement Account

What if instead of investing your regular savings in a mutual fund, you direct that your IRA, 401(k) plan, or other defined contribution plan invest in a mutual fund? All of the problems described in Problem 39-5 disappear! Your pension plan doesn't care about gain, short-term or otherwise, because your pension plan is exempt from tax on its investments.

So go ahead – have your retirement account buy and sell stocks, bonds, and mutual fund shares all you want. However, many financial advisors still recommend a buy-and-hold strategy regardless of taxes (and watch those fees!).

Example 39-7 Pensions and Income in Respect of a Decedent

While Code section 102 excludes inheritances from income, and Code section 1014 provides fair-market-value basis for inherited property, these rules do not apply to “income in respect of a decedent” (“IRD”). These are tax items that would have been reported as income (or gain) by the decedent had he or she lived to collect them. Code section 691. We call these items “double taxed” because they are, potentially, subject to both income tax and estate tax. (However, in the year you take IRD into income you can claim a deduction for the appropriate portion of estate tax paid. Section 691(c).)

One important item of IRD is an inherited pension. (However, an inherited Roth IRA would not give rise to IRD, because Roth distributions would not have been taxed as income to the decedent.) Estate tax planners often recommend using qualified retirement accounts (other than Roth IRAs) to fund charitable bequests, because the value of the bequest both qualifies as a deduction from the taxable estate and deflects the IRD to a nontaxpayer. This is tricky to do correctly, and professional counsel is essential.