2007 Inflation-Adjusted Casebook Figures

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TAX COMPUTATION

Total Receipts: the fair market value of all money, property and services received during the year.

Exclusions: specified receipts that the Code excludes from gross income, including gifts, scholarships, inheritances, and damage awards for personal physical injuries.

Gross Income: total receipts minus exclusions

Deductions: Expenditures and statutory amounts the taxpayer deducts from gross income to arrive at taxable income. Deductions are categorized as follows:

> **(a) adjustments**: Expenditures such as business expenses and alimony subtracted from gross income to arrive at adjusted gross income (AGI). These deductions are called "above the line" deductions.

Adjusted Gross Income (AGI) ("the line") is gross income minus adjustments. AGI is used to measure the deductibility of other deductions.

> **(b) itemized deductions**: Expenditures, such as mortgage interest, real estate taxes and charitable expenses, the taxpayer deducts from AGI. They are "below the line" deductions because they are subtracted from AGI.
>
> **(c) standard deduction**: A statutory amount a taxpayer deducts from AGI, if itemized deductions are less than the standard deduction. The 2007 standard deduction is $10,700 on a joint return and $5,350 on a single return.
>
> **(d) exemptions:** A statutory amount ($3,400 in 2007) the taxpayer deducts for himself, his spouse, and qualified dependents.

Taxable Income: (gross income minus all deductions) is the amount on which the tax is calculated

Tax: computed based on taxable income with special rates for capital gains

Credits: amounts subtracted from the tax, such as the Lifetime Learning credit and withholding tax, to determine the amount owed for the year.

2007 TAX RATES and PHASEOUTS

PERSONAL EXEMPTIONS

$3,400 each for taxpayer, spouse and qualified dependents. Exemptions are phased out if AGI exceeds $156,400 on a single return or $234,600 on a joint or. A dependent on another's return gets no exemption.

STANDARD DEDUCTION

Joint and surviving spouse: $10,700; single: $5,350; head of household: $7,850.

Dependent on another's return: standard deduction limited to the greater of: (a) $850, or
(b) earned income plus $300, up to the $5,350 maximum.

Over 64 and/or blind: add $1,050 for each condition on a joint return or $1,300 for each on a single return.

2007 TAX RATE SCHEDULES

JOINT

Taxable Income over	but not over	Tax is	Plus	of excess over
0	15,650		10%	0
15,650	63,700	1,565.00	+ 15%	15,650
63,700	128,500	8,772.50	+ 25%	63,700
128,500	195,850	24,972.50	+ 28%	128,500
195,850	349,700	43,830.50	+ 33%	195,800
349,700		94,601.00	+ 35%	349,700

SINGLE

Taxable Income over	but not over	Tax is	Plus	of excess over
0	7,825		10%	0
7,825	31,850	782.50	+ 15%	7,825
31,850	77,100	4,386.25	+ 25%	31,850
77,100	160,850	15,698.75	+ 28%	77,100
160,850	349,700	39,148.75	+ 33%	160,850
349,700		101,469.25	+ 35%	349,700

TRUSTS

Taxable Income over	but not over	Tax is	Plus	of excess over
0	2,150		15%	0
2,150	5,000	322.50	+ 25%	2,150
5,000	7,650	1,035.00	+ 28%	5,000
7,650	10,450	1,777.00	+ 33%	7,650
10,450		2,701.00	+ 35%	10,450

PHASEOUTS

Itemized Deductions: 2% of the amount that AGI exceeds $156,400; the maximum reduction is 80%.

Exemptions: phased out as AGI exceeds $156,400 single; $234,600 joint return; see h/o 50.

Student Loan Interest: $2,500 deduction is phased out over AGI of $55,000-$70,000 single and $110,000-$140,000 joint

§ 222 Tuition Deduction
(a) $4,000 deduction if AGI does not exceed $65,000 single and $130,000 joint
(b) $2,000 deduction if AGI exceeds (a), but does not exceed $80,000 single and $160,000 joint

Hope and Lifetime Learning (LLC) Credits: phased out over AGI of $47,000-$57,000 single; $94,000-$114,000 joint

Child Tax Credit
$1,000 credit phased out by $50 for each $1,000 (or fraction of $1,000) that AGI exceeds $75,000 on a single and head of household return and $110,000 on a joint return

Adoption Exclusion and Credit: $11,390 credit phased out over AGI of $170,820-$210,820

FLEXIBLE SPENDING ARRANGEMENTS (FSA Accounts)

Medical Care Reimbursement Plans §125

Medical expenses are deductible only to the extent they exceed 7½% of AGI. An employee with $100,000 of AGI cannot deduct the first $7,500 of medical expenses. The 7½% floor prevents most taxpayers from deducting medical expenses, unless they have large uninsured expenses. However, if an employer offers a medical reimbursement plan (a flexible spending plan), an employee can obtain a tax advantage from the expenditures.

The plan works as follows. An employee elects to have a specified amount of salary contributed to the medical reimbursement plan. Code § 125 excludes the designated amount from the employee's income. The employer determines the maximum amount an employee can contribute to the plan; there is no statutory maximum. The limit for IIT employees is $4,000 per year.

Prof. Hassan, a single employee of IIT, earns $100,000 in 2005 and specifies that she wants to contribute a total of $4,000 to the medical FSA plan for the year. $333 is withheld from her pay each month ($4,000 ÷ 12 months = $333/month) and is credited to her plan account. She does not pay tax on amounts contributed to the plan. As Hassan pays for uninsured medical expenses, she submits receipts to the university and will be reimbursed her from her account. If she spends more than $4,000 of unreimbursed medical expenses, they can only reimburse her $4,000. The plan must reimburse the full amount of medical expenses submitted, up to $4,000 in Hassan's case, even if she has not contributed that much into the plan. For example, if she submits a $2,000 receipt for dental expenses in the first month of the plan, IIT will reimburse the full $2,000 although she has only contributed $333 to the plan thus far.

If Hassan does not spend at least $4,000 on medical expenses during the year, she will forfeit the balance remaining in the plan. The Code does not permit the employer to refund excess funds. Employees must specify the amount of the contribution before the plan year begins, so they must accurately estimate the amount they will spend on medical expenses during the plan year. Employers can permit employees to use expenses incurred up to 2½ months after the end of the plan year to qualify for reimbursement from the plan. This will reduce the risk of forfeiture.

Dependent Care Assistance Plans § 129

An employer may provide a similar flexible spending plan for qualified dependent care expenses; the statutory maximum for this benefit is $5,000 per year. IIT offers this plan so if Hassan designates $5,000 for child care expenses and $4,000 for medical expenses, $9,000 will be excluded from her income, saving her $2,520 in the 28% bracket.

Tax Effect of Plans

The effect of participating in these plans is to convert nondeductible medical and child care expenses into exclusions that lower the AGI and taxable income. The reduced AGI lowers the itemized deduction, personal exemption, and other phaseouts for taxpayers measured by AGI.

These plans provide significant tax benefits to employees at little cost to the employers. The employer incurs administrative costs and risks losing money when employees submit large expenses for reimbursement early in the year and quit shortly after that. For example, if Hassan quit IIT the month after receiving the $2,000 reimbursement, IIT would lose $1,334 ($2,000 distributed from her plan minus $666 received from Hassan in the two months she was employed.)

TAX PLANNING FOR DIVORCING COUPLES

Alimony is deductible by the payer as an adjustment and is taxable income to the recipient. Child support is neither income to the recipient nor deductible by the paying spouse. The paying spouse negotiates to pay alimony for the deduction while the recipient spouse negotiates for tax-free child support. The paying spouse is usually in a higher tax bracket than the recipient so the couple will save tax if they can agree to characterize some payments as alimony instead of child support. This enables them to shift income from the paying spouse's higher tax bracket to the recipient's lower tax bracket. They can share the tax saved by having the paying spouse pay more to the recipient.

Plan 1: All Child Support

After ten years of marriage, Frank and Lilly divorced; they have two children, both under seventeen. Lilly is a trial attorney and Frank is a homemaker who will have custody of the children. Lilly agrees to pay $80,000 per year in child support, but is unwilling to pay alimony to Frank. Her taxable income is $250,000 and her tax is $69,092 at the single rates. After paying $80,000 for child support and $69,092 of income tax, she will have **$100,908** of her $250,000 taxable income left. Frank has no taxable income so he keeps the entire $80,000 Lilly paid him.

Plan 2: Part Alimony

Frank will increase the payments from $80,000 to $89,500; $49,500 will be designated as alimony and the $40,000 balance will be child support. Lilly deducts of $49,500 alimony, reducing her taxable income to $200,500 and her tax to $52,757. After paying $89,500 to Frank and $53,164 tax, she retains **$107,743** of her $250,000 income.

Frank is unmarried with dependent children living with him so he is a "head of household" for tax purposes. He reports $49,500 of alimony income and subtracts $7,550 for the head of household standard deduction and $9,900 for three exemptions to get taxable income of $32,050. The tax at head of household rates is $4,270 from which he subtracts the $2,000 child tax credit, reducing his tax to $2,270. Frank retains $87,230 of the $89,500 payment after paying the $2,270 tax.

To summarize the tax consequences of the two arrangements:

	Lilly retains	Frank retains
Plan 2 (alimony)	$ 107,743	$ 87,230
Plan 1 (all child support)	- 100,908	- 80,000
tax savings	$6,835	$7,230

The revised plan saved them $14,065 of tax, which their families can use more than Uncle.

This is an example of "assigning income" to a taxpayer in a lower tax bracket to save taxes. Lilly would have paid tax at the rate of 33% on the $49,500 she paid to Frank. By assigning it to Frank as alimony, he was taxed on only $32,050 after subtracting the standard deduction and the exemptions. The first $10,750 was taxed at 10% and the balance was taxed at 15%. Furthermore, he received the benefit of $2,000 of child tax credit that Lilly could not have used because it was phased out at her income level. The $2,000 tax credit would have been wasted if Frank had not received some taxable alimony to subtract the credit.

Shifting income from a higher to a lower-bracket taxpayer is an important aspect of tax planning. We will study other examples of shifting income during the course. We have already studied how gifts transfer appreciation from the donor to the donee for tax purposes.

CHAPTER 3 PROBLEMS

Problem 1

Jonathan purchased a painting for $2,000 in 1996. The painting was stolen when the appraised value was $10,000; his AGI is $50,000.

(a) How much may he deduct as a casualty loss if the painting was uninsured?

(b) Same as (a), but the painting cost $7,000.

(c) What result in (a) if he received $7,000 of insurance?

Problem 2

Linda and Tom are divorced; Tom has custody of their two children. Tom's only sources of income are alimony and child support received from Linda. He is in the 15% tax bracket and Linda is in the 25% bracket.

(a) Who is entitled to the exemption deductions for the children?

(b) Should the taxpayer entitled to the exemptions consider waiving them to the other taxpayer?

Problem 3

The Johnsons paid $2,000,000 for their condominium, paying $500,000 cash and obtaining a $1,500,000 mortgage loan. They live there five years during which time they pay $100,000 of the mortgage debt, then sell the condo for $2,750,000. Determine how much gain must they report on their tax return and the amount of their cash profit.

EXEMPTIONS

1. In General

A taxpayer is entitled to a $3,400 exemption deduction for himself, his spouse, and qualified dependents in 2007. The amount is adjusted for inflation each year. There are two categories of qualifying dependents: qualifying children and qualifying relatives and sets forth the following dependency tests.

Qualifying Child

(a) relationship test: the taxpayer's child (or descendant of a child) or the taxpayer's sibling (or descendant of a sibling);

(b) abode test: the child must live in the taxpayer's residence for more than one-half of the year;

(c) age test: under 19 or under 24 if the qualifying child is a full-time student;

(d) support test: the qualifying child must not have provided over one-half of his or her own support during the year. Note: the test does not require the taxpayer to have provided over one-half of the qualifying child's support.

A child who is not a qualifying child, perhaps because she does not meet the age test, may still be a qualifying relative if she meets the following requirements.

Qualifying Relative

(a) relationship test: one of several relationships specified in Code § 152(d)(2), which includes most relatives and unrelated individuals who lives in the taxpayer's home for the taxable year. Note: other qualifying relatives do not have to live in the taxpayer's residence.

(b) gross income test: the qualifying relative's gross income must be less than the exemption amount ($3,400 in 2007);

(c) support test: the taxpayer must provide over one-half of the relative's support in the year;

(d) the relative must not be a qualifying child.

2. Phaseout

The deduction is phased out by 1.33% (⅔ of 2%) for each $2,500 that AGI exceeds $156,400 on a single return or $234,600 on a joint return; see h/o 50. These amounts are adjusted for inflation each year. The phaseout will be reduced to ⅓ of 2% in 2008 and will be eliminated in 2010.

3. No Personal Exemption for a Qualifying Dependent

A taxpayer cannot take a personal exemption if he or she *qualifies* as a dependent on another taxpayer's return. For example, a child who qualifies as a dependent on his parents' return cannot take a deduction for a personal exemption. This is true even if the other taxpayer waives the exemption.

4. Waiving a Child's Exemption for § 25A Education Credits

We will study the educational credits (Hope and Lifetime Learning) later in the course. If parents claim a student as a dependent on their return, only the parents, not the student may claim the credit. The credits are fully phased out if the parents' AGI exceeds $114,000, so many middle-income parents may not take advantage of them. If the student has income, the parents may waive the exemption that will permit the student to use the educational credit. Waiving the credit may save tax for the family as illustrated in the following example. Note, however, that the student may not claim an exemption on his or her return even if the parents waive the exemption because the student qualifies as a dependent on the parents' return.

Example

The Kellys have AGI of $150,000 and pay $30,000 of college tuition for Amy, their 20-year-old daughter who is a junior at State. They are in the 28% tax bracket. Amy works part-time and received interest and dividends from securities her parents gave her. Her taxable income is $16,000 and her tax is $2,023.

The Lifetime Learning credit is fully phased out for the Kellys because their AGI exceeds $114,000. If they waive the exemption deduction, it will cost them $952 in additional tax ($3,400 x 28%). Amy may now claim the $2,000 Lifetime learning credit, which will reduce her tax to $23. The family saved $1,048 ($2,000 savings for Amy less $952 cost for her parents).

The family would save even more if the Kellys were higher-income taxpayers. If their AGI had been $313,000, the exemption deduction for Amy would be only $1,992. Waiving the exemption would now cost them only $657 ($1,992 x 33% bracket) and the family's savings would be $1,343 ($2,000 savings for Amy less $657 tax cost for her parents).

EXEMPTION PROBLEMS

1. The Engerts have two qualifying children and AGI of $239,600. Refer to h/o 50 and determine the amount of their exemption deduction. Note that their AGI does not *exceed* $239,600.

2 (a) Roger is 22, a full-time college student, and earned $4,000. Can his parents claim an exemption deduction for Roger? If not, can Roger claim an exemption on his return?

(b) Same facts as (a), but Roger is 25.

3. Barbara and Ron are single and have lived together for two years. Ron is a law student who earned $3,000 in 2007. Barbara provides more than one-half of his support. Can Barbara take an exemption deduction for Ron?

DEPENDENT CARE CREDIT § 21

Code § 21 provides taxpayers a credit for expenses paid for the care of children under 13-years-old to enable parents to work. Up to $3,000 of qualified dependent care expense are eligible for one child and $6,000 for two or more children. The eligible expenses cannot exceed the earned income of the spouse earning the lower income. The credit is computed by multiplying the eligible expenses by the following percentages.

AGI over	but not over	%
0	15,000	.35
15,000	17,000	.34
17,000	19,000	.33
19,000	21,000	.32
21,000	23,000	.31
23,000	25,000	.30
25,000	27,000	.29
27,000	29,000	.28
29,000	31,000	.27
31,000	33,000	.26
33,000	35,000	.25
35,000	37,000	.24
37,000	39,000	.23
39,000	41,000	.22
41,000	43,000	.21
43,000	no limit	.20

Example 1

Horwitz, a single taxpayer, has AGI of $28,200 and paid $4,000 to a child care center to care for his 3-year-old daughter. Only $3,000 of the expenses are eligible because he has one child under 13. The credit is $840 ($3,000 eligible expenses x 28%).

Comparison of the §21 dependent credit and the § 129 dependent care exclusion

The § 129 dependent care exclusion is discussed on casebook page 174, 175 and h/o 45. If the employer has a dependent care plan, the taxpayer must designate the amount they want excluded before the tax year begins. Therefore they should estimate whether the § 21 credit or the § 129 exclusion will give them a better tax result. If the taxpayer has two children under 13 and spends at least $6,000 on child care, he can (1) use $6,000 of expenses for the §21 credit or (2) use $5,000 of expenses for the § 129 exclusion and $1,000 for the § 21 credit. The following examples illustrate the computation.

Example 2

The Garrisons have a 9-year-old daughter and a 4-year-old son. They paid $7,000 of eligible child care expenses, their AGI is $100,000, and they are in the 25% tax bracket. One of their employers offers a § 129 plan with a $5,000 maximum.

Option 1: Use $6,000 for the dependent credit, saving **$1,200** ($6,000 x 20%).

Option 2: Exclude $5,000 under the § 129 dependent exclusion, saving $1,250 of tax ($5,000 x 25%). Use $1,000 of expenses for the § 21 care credit, saving $200 of tax ($1,000 x 20%). Total tax savings is **$1,450**.

Example 3: Same facts as example 1, but their AGI is $35,000 and they are in the 15% bracket.

Option 1: The § 21 credit saves **$1,500** ($6,000 expenses x 25%, based on AGI of $35,000).

Option 2: The $5,000 exclusion saves them $750 in tax in the 15% bracket and reduces their AGI to $30,000. $1,000 of remaining eligible expenses is used for the dependent credit saving $270 of tax ($1,000 x 27%, based on $30,000 of AGI). Total savings: **$1,020.**

As examples 2 and 3 illustrate, high-income taxpayers typically find it beneficial to use the § 129 exclusion first and use the § 21 credit only for the amount that exceeds the $5,000 limit of § 129.

DEPRECIATION

Introduction

Depreciation is the method by which a taxpayer deducts the cost of a capital asset over a period of time. Only assets used in a trade or business or for the production of income are depreciable; assets used for personal purposes are not depreciable. Generally, only assets that "wear out" are depreciable; therefore land or treasured art works cannot be depreciated. When a taxpayer buys a building and the underlying land, she must allocate the purchase price between the two assets according to their relative fair market value. The adjusted basis of the asset is reduced each year by the amount of depreciation deducted.

The Code provides for a depreciation method known as MACRS (modified accelerated cost recovery system) that permits taxpayers to deduct the full cost of depreciable property over a specified "recovery period." The recovery period is unrelated to the actual useful life of the property. Salvage value, if any, is ignored. All property is classified into one of several categories; the most common types of property and their recovery periods are:

(a) 3-year: computer software
(b) 5-year: cars, light-duty trucks, and office machines (copiers, and computers)
(c) 7-year: most other tangible personal property, including office furniture and fixtures
(d) 27½-year: residential real property (apartment buildings)
(e) 39-year: nonresidential real property (office buildings and factories)

Depreciation of Personal Property

The following table is used to calculate the annual depreciation deduction for personal property. To compute the deduction for the current year, multiply the original basis of the property by the applicable percentage rate, using the appropriate column.

Personal Property Cost Recovery Rate

Recovery year	Applicable percentage	
	5-year property	7-year property
1	20.0%	14.3%
2	32.0	24.5
3	19.2	17.5
4	11.5	12.5
5	11.5	8.9
6	5.8	8.9
7		8.9
8		4.5
	100.0%	100.0%

An example appears on the next page.

Example 1

Doran purchased $14,000 of furniture for use in her business. Office furniture is 7-year property so her MACRS depreciation deductions are as follows, assuming she keeps the property at least eight years:

year 1	$2,002	(14,000 x 14.3)
year 2	3,430	(14,000 x 24.5%)
year 3	2,450	(14,000 x 17.5%)
year 4	1,750	(14,000 x 12.5%)
year 5	1,246	(14,000 x 8.9%)
year 6	1,246	(14,000 x 8.9%)
year 7	1,246	(14,000 x 8.9%)
year 8	630	(14,000 x 4.5%)
total	$ 14,000	

Depreciation of Real Property

The Code classifies real property as residential (apartment buildings), or nonresidential (factories, warehouses, etc.). Residential real property is depreciated over 27½ years; nonresidential property is depreciated over 39 years. Only real property used for business or investment purposes can be depreciated. Depreciation deductions are not permitted for real property used for personal purposes, such as a personal residence.

Table 1 Residential Real Property

	month property is placed in service											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	.03485	.03182	.02879	.02576	.02273	.01970	.01667	.01364	.01061	.00758	.00455	.00152
2-28	.03636	.03636	.03636	.03636	.03636	.03636	.03636	.03636	.03636	.03636	.03636	.0363

Table 2 Nonresidential Real Property

	month property is placed in service											
Year	1	2	3	4	5	6	7	8	9	10	11	12
1	.02461	.02247	.02033	.01819	.01605	.01391	.01177	.00963	.00749	**.00535**	.00321	.00107
2-28	.02564	.02564	.02564	.02564	.02564	.02564	.02564	.02564	.02564	**.02564**	.02564	.02564

To calculate the depreciation deduction, multiply the original basis of the property by the amount shown in the column under the month the taxpayer started using the building.

Example 2

Capelli purchased a factory for $1 million on October 1, 2006; $100,000 was allocated to the land. The 2006 depreciation deduction is $4,815 ($900,000 basis of the building x .00535, the percentage in the 10 (October) column for the first year in Table 2 for nonresidential property). The deduction for 2007 and each successive year is $23,076 ($900,000 x .02564, the percentage in the 10 column for years 2-39).

DEPRECIATION EXAMPLE

Sterling purchased a townhouse for investment purposes in March 2005 for $300,000, of which $275,000 was allocated to the townhouse and $25,000 to the land. In 2007, she received $12,000 of rental income and incurred the following out-of-pocket expenses: $3,000 for condominium assessments, $3,200 for real estate taxes and $4,000 of mortgage interest. Her "cash flow" is $1,800 for the year ($12,000 income minus $10,200 of expenses).

For tax purposes she may also deduct deprecation. Referring to Table 1 on the previous page, her 2007 depreciation deduction is $10,000 ($275,000 cost of building x .03636). Sterling reports the following income and expenses on her 2007 tax return:

Rent income		$12,000
Expenses		
assessments	$3,000	
real estate taxes	3,200	
mortgage interest	4,000	
depreciation	10,000	
total expenses	$20,200	- 20,200
Loss for tax purposes		($8,200)

The $8,200 loss will save her $2,050 of tax if she is in the 25% tax bracket. Sterling's 2006 cash gain from the condo investment is $3,850 ($1,800 cash flow plus $2,050 of tax savings).

Note: Real estate is a "passive" investment and the loss may be phased out or eliminated, depending on Sterling's AGI.

Gift Basis Rules and Solutions to Problem 2 on 226

Basis Rules for Property Acquired by Gift

When property is acquired by gift, the donee takes the donor's basis. However, when the donor's basis exceeds the FMV of the property on the date of the gift, the following rules apply:

(a) the basis for purposes of a loss is the FMV on the date of the gift;
(b) the basis for purposes of a gain is the donor's basis;
(c) if the donee sells the property for more than the FMV but less than the donor's basis, the donee has no gain or loss.

Solutions to Problem 2 on 226

(1) Mark sells for $5,000

$1,000 loss Syllabus rule (a)

Mark's basis for purposes of a loss is the $6,000 FMV on the date of the gift. He sold it for $5,000 so he has a $1,000 loss. Note that the amount he was entitled to deduct is the loss that occurred while he held the stock. Mark cannot deduct the $4,000 decline in the value of the stock that occurred while Paola held it. The donor cannot transfer loss to a donee.

(2) Mark sells for $8,000

No gain or loss Syllabus rule (c)

If the property is sold for $8,000, there is no loss using the $5,000 basis for purposes of a loss. There is no gain using the $10,000 gain basis. The result is no gain or loss.

Between Paola and her son Mark, there was a $2,000 loss on the stock. The entire loss occurred while Paola held it and this loss cannot be transferred to Mark, so Mark has no loss. On the other hand, there was no overall gain on the transaction so Mark has no gain.

(3) Mark sells for $13,000

$3,000 gain. Syllabus rule (b)

The basis for purposes of a gain is $10,000.

HOLDING PERIOD RULES

A. Stock must be held *More Than* One Year

A taxpayer must hold a capital asset *more than* one year for it to be considered long-term. A capital asset held exactly one year or less is a short-term asset. The holding period is determined by calendar months, not the number of days the stock has been held. For publicly traded stocks, the holding period begins the day after the stock is purchased and ends on the date of sale. An asset becomes long-term on the first counted day in the 12th month following the day of purchase.

Example 1

Moscov bought 100 shares of GM on 8/7/06. The holding period begins on 8/8/06 and becomes long-term on 8/8/07. If he sells the stock on 8/7/07, he will have held it *exactly* one year (8/8/06 through 8/7/07) and the gain or loss will be short-term.

B. Identification of Shares

If a taxpayer purchased several blocks of the same stock at different times and sells less than all of the shares, the FIFO (first-in-first-out) method is used to determine which shares they are selling. However, the investor can identify the shares he is selling by telling the broker at the time of the sale. Without instructions, the FIFO or average cost method will be used. The average cost method is used for mutual fund shares purchased at different prices.

Example 2

Bellinger bought 100 shares of APL stock on 3/4/06 for $1,400 and another 100 shares on 5/1/06 for $1,700. On 3/8/07 she sold 100 shares for $1,500.

3/4/06	purchased 100 shares for $1,400
5/1/06	purchased 100 shares for $1,700
3/8/07	sold 100 shares for $1,500.

If she tells her broker at the time of the sale that she is selling the May shares, she will have a $200 short-term capital loss. If she does not identify the shares, the FIFO method is used and the March shares will be sold, resulting in a $100 long-term capital gain.

C. Holding Period of Property Acquired by Gift

The general rule is that the donee takes the donor's basis and holding period for purposes of gains and losses. A different rule (not discussed here) applies if the donor's basis exceeds the fair market value of the property on the date of the gift.

D. Holding Period of Inherited Property

The gain or loss on property acquired from a decedent is always long-term, no matter how long the decedent or the beneficiary held the property. If Grandpa bought stock on 2/1/07, died on 2/2/07 and grandson inherits and sells it on 2/4/07, the grandson's gain or loss is long-term.

E. Holding Period of Property Acquired from a Spouse or Incident to a Divorce

The recipient spouse takes the holding period of the transferor spouse.

SALE OF A SOLE PROPRIETORSHIP

A. Negotiating the Sale of an Unincorporated Business

The seller and buyer of an unincorporated business must allocate the sale price of the business to the assets according to their relative fair market values. FMV is subjective so the parties must negotiate and agree on the allocation.

B. Goodwill and Covenants Not to Compete

Hypothetical Jones sells her beauty salon and spa to Wallace for $425,000. The sales agreement requires Jones not to compete with Wallace within a 5-mile radius for two years. The FMV of the tangible assets of the business are:

property and equipment	$20,000
furniture and fixtures	5,000
total FMV	$25,000

The parties must allocate the extra $400,000 Wallace paid over the FMV of the tangible assets between goodwill (going concern value) and the covenant not to complete.

Tax Consequences to Seller Jones

Goodwill and going concern value are capital assets; the gain on the sale is capital gain. The amount allocated to the covenant not to compete is taxed as ordinary income. Jones wants as much of the $400,000 excess allocated to the goodwill as possible to get the 15% preferential rate.

Tax Consequences to Buyer Wallace

Goodwill and covenants not to compete are both amortized (deducted) over a 15-year period so Wallace is indifferent to how they allocate the $400,000 excess. However, he may negotiate for more favorable allocations among the other assets, as explain below.

C. Depreciable Assets

Depreciation Recapture (¶ 3,720, p. 240)

When depreciable personal property is sold at a gain, the gain is "recaptured" as ordinary income to the extent of depreciation deductions taken. Gain that exceeds depreciation deductions is § 1231 gain, explained below. When depreciable real property is sold at a gain, the gain attributable to depreciation is taxed at a maximum of 25%. The balance of the gain is § 1231 gain.

§ 1231 Assets (¶3,710, p. 240)

Section 1231 assets include depreciable personal property and all real property used in a trade or business. The gains and losses from the sale of all § 1231 assets are netted. If the total is a gain, it is taxed as a capital gain; if the total is a loss, the loss is deductible as an ordinary loss. Heads taxpayer wins; tails taxpayer wins. She gets capital gain treatment if the total is a gain and ordinary loss treatment, not limited by the capital loss rules, if the total is a loss. When the taxpayer sells a business, the total of the § 1231 gains and losses is typically a gain, so § 1231 assets typically receive capital gain treatment.

SOLUTION TO PROBLEM 3, CASEBOOK PAGE 241

(1) Inventory: basis $35,000; sold for $50,000
$15,000 ordinary income.

Seller: minimum to reduce ordinary income
Buyer: maximum to reduce future profit on the sale

(2) Equipment: cost: $50,000; basis: $30,000 (cost - $20,000 depreciation) ; sold for $60,000.
$30,000 gain; **$20,000 ordinary income, $10,000 is § 1231 gain**

Seller: minimum to minimize ordinary income
Buyer: maximum to increase basis for depreciation deductions.

(3) Leasehold (8 years remaining): sold for $200,000; no basis.
$200,000 § 1231 gain

Seller: maximum; taxed as long-term capital gain (LTCG)
Buyer: must amortize over eight years

(4) Goodwill: sold for $100,000; no basis.
$100,000 (LTCG)

Seller: maximum; taxed as LTCG
Buyer: must amortize over 15 years

(5) Regional Franchise: sold for $200,000, no basis.
$200,000 LTCG

Seller: maximum; taxed as LTCG
Buyer: must amortize over lesser of remaining period or 15 years

(6) Covenant Not to Compete: sold for $250,000; no basis.
$250,000 ordinary income

Seller: minimum; taxed as ordinary income
Buyer: must amortize over 15 years.

Assume the sale included the business building and land

Land
Seller: maximum; § 1231 asset
Buyer: minimum; not depreciable

Building:

Seller: more allocated to land; recaptured depreciation taxed at maximum 25%; balance is §1231
Buyer: more allocated to building for depreciation deductions

MARRIAGE PENALTY AND MARRIAGE BONUS

Marriage Penalty

The marriage penalty exists when spouses earn approximately equal amounts. They will pay more tax as a married couple than they would as single individuals. For example, the Baileys each earn $150,000 and do not itemize their deductions.

Their tax is computed as follows:

gross income & AGI	$300,000	
minus standard deduction	- 10,700	
minus exemptions	- 4,532	(partially phased out because AGI > $234,600)
taxable income	$284,786	
tax	$73,179	

If they were single, they would each compute their tax as follows:

	Single	
gross income & AGI	$150,000	
minus standard deduction	- 5,350	
minus exemption	3,400	(no phaseout because AGI < $156,400)
taxable income	$141,250	
tax	$33,661	x 2 = $67,332

Computation of the marriage penalty

tax on joint return	$73,179
total tax on two single returns	- 67,332
marriage penalty (extra tax)	$5,857

Marriage Bonus

Many married taxpayers receive a "marriage bonus" and do not complain about it. This occurs when there is a significant disparity between the spouses' incomes and is the largest if one spouse does not have any income. For example, Alice has taxable income of $250,000 and her husband has no income. If she were single, her 2007 tax would be **$68,568**. Their tax is **$58,453** on a joint return, giving them a marriage bonus of $10,115.

THE ALTERNATIVE MINIMUM TAX § 55

Computation

1. The computation begins with taxable income computed the regular way.
2. Add deductions not deductible for AMT purposes, including, but not limited to:
    a. personal exemptions
    b. 2% miscellaneous itemized deductions
    c. state and local taxes
    d. standard deduction
    e. some medical expenses (deductible only to the extent they exceed 10% of AGI)
    f. home equity interest
    g. interest on certain tax-exempt bonds
3. The result is **Alternative Minimum Taxable Income (AMTI)**
4. Subtract the **AMT exemption** ($45,000 for married and $33,750 for single taxpayers). (See note below.)

    The exemption is phased out by 25% of the amount that AMTI exceeds $150,000 on a joint return or $112,500 on a single return. For example, a single taxpayer has AMTI of $160,000, which exceeds $112,500 by $47,500. The $33,750 exemption is reduced by $11,875 ($47,500 x 25%) to $21,875.
5. The result is the **Taxable Excess**
6. The tax is 26% on the first $175,000 of taxable excess and 28% on the balance.
7. Subtract credits; most credits may be subtracted from the AMT.
8. The AMT is the excess of the tax computed for AMT purposes over the tax computed the regular way. The AMT is added to the regular tax to determine the total tax.

Note on the AMT Exemption

The AMT and the exemption have been the subject of intense criticism and hot political debate. In 2002, Congress increased the exemption for 3 years as shown in the table below. The exemption was scheduled to return to the 2001 rate in 2006. There was a public outcry all during 2006 and many called for the repeal of the AMT. However, the government can't afford to lose the significant revenue the AMT generates. In late 2006, Congress enacted an increase for 2006 only and decided to reconsider the exemption this year. The exemption is now scheduled to be reduced to the amount shown in the table, but Congress will probably increase the exemption during the year.

	Single	Joint
2002	$35,750	$40,250
2003-2005	40,250	58,000
2006	42,500	62,550
2007	33,750	45,000

EXAMPLE OF THE AMT COMPUTATION

The Smiths have three children under 17, AGI of $150,000. They have $48,000 of itemized deductions, including $40,000 of state and local taxes and interest on a home equity loan, which are not deductible for AMT purposes.

Regular Tax Computation

AGI	$150,000
minus itemized deductions	- 48,000
minus 5 exemptions	- 17,000
taxable income	$85,000

tax: $14,098 (before the child tax credit)

AMT Computation

taxable income from above	$85,000
add state and local income taxes and home equity interest	40,000
add personal exemptions (not deductible for AMT purposes)	17,000
equals alternative minimum taxable income (AMTI)	142,000
subtract the AMT exemption (assuming the 2006 exemption is retained)	- 62,550
Taxable Excess (TE)	$79,450

tax using the AMT method: $79,450 x 26% = $20,657

tax using the AMT method	$20,657	(before the child tax credit)
tax using the regular method	- 14,098	(before the child tax credit)
alternative minimum tax	$6,559	

If the exemption is reduced to $45,000, as scheduled, the AMT would be $10,230.

AMT Planning

If the taxpayer does some planning before the end of the current year, she may find that the AMT will apply in the current year, but not in the next year. In this case, she should attempt to accelerate income into the AMT tax year, where it will be taxed at 26% or 28%, rather than at a higher regular rate in the next year. (However, she must consider what effect the extra income will have on the AMT exemption phaseout). She should also delay deductions to the next year to get the benefit of the higher regular rate.

Example

In early December 2007, Kelly, a physician, determined that she will be subject to the AMT in 2006, but not in 2008, when her marginal tax rate will be 33%. She immediately sent $10,000 of statements to her patients to attempt to receive the income in 2007. She will pay tax at the 28% AMT on income she receives in 2007, but 33%, her regular tax rate, on income she receives in 2008.

In addition, she postpones mailing her $10,000 contribution to Chicago-Kent until 2008. The $10,000 deduction will save her $3,333 of tax in the 33% bracket in 2008 but only $2,800 of tax at the 28% AMT rate in 2007.