2006 and 2007 TAX RATES, EXEMPTION & STANDARD DEDUCTION

PERSONAL EXEMPTIONS

$4,300 each for taxpayer, spouse and qualified dependents.
See reverse side if AGI exceeds $234,600 on a joint or $156,400 on a single return.

A dependent on another's return gets no exemption.

STANDARD DEDUCTION

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint and surviving spouse</td>
<td>$10,700</td>
<td>$10,300</td>
</tr>
<tr>
<td>Single</td>
<td>5,350</td>
<td>5,150</td>
</tr>
<tr>
<td>Head of household</td>
<td>7,850</td>
<td>7,550</td>
</tr>
<tr>
<td>Married filing separately</td>
<td>5,350</td>
<td>5,150</td>
</tr>
</tbody>
</table>

Dependent on another's return: standard deduction limited to the greater of: (a) $850, or (b) earned income plus $300, but cannot exceed the $5,350 maximum for a single person.

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

ITEMIZED DEDUCTION PHASEOUT: 2% of the amount that AGI exceeds $156,400 (for all taxpayers).

Maximum phaseout: 80% of total itemized deductions.

2007 TAX RATE SCHEDULES

<table>
<thead>
<tr>
<th>Taxable Income but not Tax Plus of excess over</th>
<th>2007</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Over</td>
<td>Over</td>
</tr>
<tr>
<td></td>
<td>is</td>
<td>%</td>
</tr>
<tr>
<td>JOINT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>15,650</td>
<td>10% 0</td>
</tr>
<tr>
<td>15,650</td>
<td>63,700</td>
<td>15% 15,650</td>
</tr>
<tr>
<td>63,700</td>
<td>128,500</td>
<td>25% 63,700</td>
</tr>
<tr>
<td>128,500</td>
<td>195,850</td>
<td>28% 128,500</td>
</tr>
<tr>
<td>195,850</td>
<td>349,700</td>
<td>33% 195,800</td>
</tr>
<tr>
<td>349,700</td>
<td></td>
<td>35% 349,700</td>
</tr>
</tbody>
</table>

SINGLE

|                                              | 7,825        | 10% 0        |
|                                              |              |              |
| 0                                            | 7,825        | 15% 7,825    |
| 7,825                                       | 31,850       | 25% 31,850   |
| 31,850                                      | 77,100       | 28% 77,100   |
| 77,100                                      | 160,850      | 33% 160,850  |
| 160,850                                     | 349,700      | 35% 349,700  |
| 349,700                                     |              |              |

HEAD OF HOUSEHOLD

|                                              | 11,200       | 10% 0        |
|                                              |              |              |
| 0                                            | 11,200       | 15% 11,200   |
| 11,200                                      | 42,650       | 25% 42,650   |
| 42,650                                      | 110,100      | 28% 110,100  |
| 110,100                                     | 178,300      | 33% 178,300  |
| 178,300                                     | 349,700      | 35% 349,700  |
| 349,700                                     |              |              |

MARRIED FILING SEPARATELY

|                                              | 7,550        | 10% 0        |
|                                              |              |              |
| 0                                            | 7,550        | 15% 7,550    |
| 7,550                                       | 30,650       | 25% 30,650   |
| 30,650                                      | 61,850       | 28% 61,850   |
| 61,850                                      | 94,225       | 33% 94,225   |
| 94,225                                      | 168,275      | 35% 168,275  |
| 168,275                                     |              |              |

2006 TAX RATE SCHEDULES

<table>
<thead>
<tr>
<th>Taxable Income but not Tax Plus of excess over</th>
<th>2006</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Over</td>
<td>Over</td>
</tr>
<tr>
<td></td>
<td>is</td>
<td>%</td>
</tr>
<tr>
<td>JOINT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>0</td>
<td>15,100</td>
<td>10% 0</td>
</tr>
<tr>
<td>15,100</td>
<td>61,300</td>
<td>15% 15,100</td>
</tr>
<tr>
<td>61,300</td>
<td>123,700</td>
<td>25% 61,300</td>
</tr>
<tr>
<td>123,700</td>
<td>188,450</td>
<td>28% 123,700</td>
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<tr>
<td>188,450</td>
<td>336,550</td>
<td>33% 188,450</td>
</tr>
<tr>
<td>336,550</td>
<td></td>
<td>35% 336,550</td>
</tr>
</tbody>
</table>

SINGLE

|                                              | 7,550        | 10% 0        |
|                                              |              |              |
| 0                                            | 7,550        | 15% 7,550    |
| 7,550                                       | 30,650       | 25% 30,650   |
| 30,650                                      | 74,200       | 28% 74,200   |
| 74,200                                      | 154,800      | 33% 154,800  |
| 154,800                                     | 336,550      | 35% 336,550  |
| 336,550                                     |              |              |

HEAD OF HOUSEHOLD

|                                              | 10,750       | 10% 0        |
|                                              |              |              |
| 0                                            | 10,750       | 15% 10,750   |
| 10,750                                      | 41,050       | 25% 41,050   |
| 41,050                                      | 106,000      | 28% 106,000  |
| 106,000                                     | 171,650      | 33% 171,650  |
| 171,650                                     | 336,550      | 35% 336,550  |
| 336,550                                     |              |              |

MARRIED FILING SEPARATELY

|                                              | 7,550        | 10% 0        |
|                                              |              |              |
| 0                                            | 7,550        | 15% 7,550    |
| 7,550                                       | 30,650       | 25% 30,650   |
| 30,650                                      | 61,850       | 28% 61,850   |
| 61,850                                      | 94,225       | 33% 94,225   |
| 94,225                                      | 168,275      | 35% 168,275  |
| 168,275                                     |              |              |
### INTERNAL REVENUE CODE SECTIONS (for the course)

<table>
<thead>
<tr>
<th>§</th>
<th>RATES &amp; CREDITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>tax rate schedules</td>
</tr>
<tr>
<td>2</td>
<td>filing status</td>
</tr>
<tr>
<td>21</td>
<td>dependent care credit</td>
</tr>
<tr>
<td>23</td>
<td>adoption credit</td>
</tr>
<tr>
<td>24</td>
<td>child tax credit</td>
</tr>
<tr>
<td>25A</td>
<td>Hope and Lifetime Learning credits</td>
</tr>
<tr>
<td>32</td>
<td>earned income tax credit (EITC)</td>
</tr>
<tr>
<td>63</td>
<td>taxable income and standard deduction</td>
</tr>
<tr>
<td>67</td>
<td>2% floor on miscellaneous itemized deductions</td>
</tr>
<tr>
<td>68</td>
<td>overall limit on itemized deductions</td>
</tr>
<tr>
<td>143</td>
<td>marital status</td>
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### GROSS INCOME

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>61</td>
<td>gross income</td>
</tr>
<tr>
<td>62</td>
<td>adjustments</td>
</tr>
<tr>
<td>71</td>
<td>alimony</td>
</tr>
<tr>
<td>72</td>
<td>annuities</td>
</tr>
<tr>
<td>74</td>
<td>prizes and awards</td>
</tr>
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</table>

### EXCLUSIONS

<table>
<thead>
<tr>
<th>§</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>101</td>
<td>life insurance</td>
</tr>
<tr>
<td>102</td>
<td>gifts and inheritances</td>
</tr>
<tr>
<td>103</td>
<td>tax-exempt interest</td>
</tr>
<tr>
<td>104</td>
<td>recoveries for injuries and sickness</td>
</tr>
<tr>
<td>105</td>
<td>health insurance benefits</td>
</tr>
<tr>
<td>106</td>
<td>employer contributions to health plans</td>
</tr>
<tr>
<td>108</td>
<td>discharge of debt</td>
</tr>
<tr>
<td>117</td>
<td>scholarships and fellowships</td>
</tr>
<tr>
<td>119</td>
<td>meals and lodging</td>
</tr>
<tr>
<td>121</td>
<td>gain from sale of principal residence</td>
</tr>
<tr>
<td>127</td>
<td>educational assistance plans</td>
</tr>
<tr>
<td>129</td>
<td>dependent care assistance programs</td>
</tr>
<tr>
<td>132</td>
<td>fringe benefits</td>
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</tbody>
</table>

### EXEMPTIONS

<table>
<thead>
<tr>
<th>§</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>151</td>
<td>personal exemptions</td>
</tr>
<tr>
<td>152</td>
<td>definition of dependent</td>
</tr>
</tbody>
</table>

### DEDUCTIONS

<table>
<thead>
<tr>
<th>§</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>67</td>
<td>2% floor on miscellaneous deductions</td>
</tr>
<tr>
<td>162</td>
<td>trade or business expenses</td>
</tr>
<tr>
<td>163</td>
<td>interest</td>
</tr>
<tr>
<td>164</td>
<td>taxes</td>
</tr>
<tr>
<td>165</td>
<td>losses</td>
</tr>
<tr>
<td>166</td>
<td>bad debts</td>
</tr>
<tr>
<td>167</td>
<td>depreciation</td>
</tr>
<tr>
<td>168</td>
<td>MACRS (and bonus depreciation)</td>
</tr>
<tr>
<td>170</td>
<td>charitable contributions</td>
</tr>
<tr>
<td>179</td>
<td>first-year expensing</td>
</tr>
</tbody>
</table>
INTERNAL REVENUE CODE SECTIONS  Continued

DEDUCTIONS continued

183 activities not engaged in for profit (“hobby losses”)
195 start-up expenses
212 expenses for production of income
213 medical expenses
215 alimony
217 moving expenses
221 interest on educational loans
222 qualified tuition and related expenses

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262 personal expenses
263 capital expenditures
265 expenses related to tax exempt income
267 losses between related parties
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275 disallowance of deduction for federal income tax
280A deduction of residence (home office)
465 at-risk rules
469 passive loss rules

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1001 definition of gain or loss
1011 adjusted basis
1012 cost basis
1014 property acquired from decedent
1015 property acquired by gift
1016 adjustments to basis

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1031 tax-free exchanges
1033 deferral of gain on involuntary conversions
1041 transfer of property between spouses
1091 wash sales

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1(h) maximum capital gains rate
1091 wash sales
1211 capital loss limitations
1212 capital loss carryover
1221 definition of capital asset
1222 capital transactions
1223 holding period rules
1244 loss on small business stock
2006 PHASEOUT AMOUNTS

All computations in the course will use the 2006 tax rates and phaseouts. For your information, the 2007 phaseout amounts are in parentheses. (If no number appears in parentheses, the phaseouts remain the same for 2007.)

DEDUCTIONS

itemized deductions
phased out by 2% of the amount that AGI exceeds $150,500 ($156,400)

personal exemptions
phased out as AGI exceeds $150,500 on a single return; $225,750 on a joint return ($156,400; $234,600) if AGI exceeds those amounts; use h/o 1A

§ 221 student loan interest deduction
$2,500 maximum deduction is phased out over:
  § 221 MAGI $50,000-$65,000 on a single return ($55,000-$70,000)
  § 221 MAGI $105,000-$135,000 on a joint return ($110,000-$140,000)

§ 222 tuition deduction (expired in 2005, but may be extended retroactively)
$4,000 deduction if § 222 MAGI does not exceed $65,000 on a single return; $130,000 on a joint return;
$2,000 deduction if § 222 MAGI exceeds those amounts but does not exceed $80,000 on a single return;
$160,000 on a joint return.

real estate passive loss
$25,000 real estate passive loss deduction is phased out over MAGI $100,000 - $150,000

CREDITS

Hope and Lifetime Learning (LLC) credits
phased out over AGI range of $45,000-$55,000 on a single return; $90,000-$110,000 on a joint return.
  ($47,000-$57,000 on a single return; $94,000-$114,000)

child tax credit
phased out by $50 for each $1,000 (or fraction of $1,000) that AGI exceeds $75,000 on a single return;
$110,000 on a joint return
TAX TERMINOLOGY

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

Exclusions: 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. There are several types of deductions:

  adjustments: Expenditures such as business expenses and alimony subtracted from gross income to arrive at adjusted gross income (AGI). These deductions are referred to as “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.

  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.

  standard deduction: A statutory amount a taxpayer deducts from AGI, if itemized deductions are less than the standard deduction. The 2006 standard deduction on a joint return is $10,300 and $5,150 on a single return.

  exemptions: A statutory amount ($3,300 in 2006) 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

Credits: amounts subtracted from the tax, such as the Lifetime Learning credit.
A BRIEF TAX HISTORY

1981 Reagan took office and encouraged Congress to pass the **Economic Recovery Tax Act of 1981** that lowered all tax rates and reduced the highest rate from 70% to 50%. This Act is credited for helping the economy begin almost 20 years of growth.

1986 The **Tax Reform Act of 1986** made fundamental changes to Internal Revenue Code. It reduced all rates to 15% or 28% and eliminated many deductions to make up for the steep decline in rates. Many provisions of this Act are still important and I will refer to them frequently during the course.

1990-3 The highest rate was increased to 31% in 1990 and as budget deficits continued to expand, so Congress added 36% and to 39.6% brackets in 1993.

2001 **Economic Growth and Tax Relief Act of 2001**
In the late ‘90’s, the economy was booming and there were large budget surpluses. Early in his administration, President Bush encouraged Congress to pass this major tax reduction bill, which reduced all tax rates over a 5-year period and provided many new tax benefits. The maximum tax rate was reduced from 50% to 35%. To help offset rate reductions, the Act contained a complicated array of phase-in rules and effective dates. **The entire Act expires on December 31, 2010.**

2003 **Jobs and Growth Tax Relief Reconciliation Act of 2003** accelerated many 2001 Act reductions that were not scheduled to take effect until 2006 and included several new provisions, such as reducing the maximum tax on long-term capital gains from 20% to 15%. Some provisions were temporary, expiring in 2004 or 2005. The result was a revolving door of tax rates and other changes between 2003 and 2010 that makes tax planning difficult.


2005 **The Energy Policy Act** provides tax credits to consumers for buying hybrid cars and making energy-conservation improvements with better windows, furnaces, etc. in their existing homes.

2006 **Tax Increase Prevention and Reconciliation Act of 2005** For budgetary reasons, some provisions of the 2001 and 2003 Acts expired in 2005 and others are scheduled to expire over the next few years. This act extended some of the tax cuts for a few more years, including reduced rates on capital gains.

2006 **Tax Relief and Health Care Act of 2006** This bill, passed on December 8, 2006, extended the rest of the provisions scheduled to expire in 2005. The extensions were retroactive to January 1, 2006; some provisions were extended for one year, others for two years.

2007 Congress passed a bill that included several tax breaks for business to pay for an increase in the minimum wage. However, the package was included in the war-spending bill that the President vetoed on May 8, 2007. Several of these provisions will likely be enacted over the next several months.
CHAPTER 4 BASIS EXAMPLE

1. Taxpayer purchased a condo for $150,000:
   - cash $30,000
   - mortgage loan 120,000
   - adjusted basis $150,000

2. Remodels the kitchen for $5,000 cash
   - adjusted basis $155,000

3. She pays $10,000 of loan principal, reducing the loan balance to $110,000. This has no effect on the basis.

4. Sells condo for $200,000; $110,000 of the proceeds is used to pay the loan balance and she receives the $90,000 balance. The amount realized is $200,000, the amount she received plus the amount used to pay the debt.

**Tax Gain on Sale**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>amount realized</td>
<td>$200,000</td>
</tr>
<tr>
<td>- adjusted basis</td>
<td>- 155,000</td>
</tr>
<tr>
<td>equals tax gain</td>
<td>$ 45,000</td>
</tr>
</tbody>
</table>

**Economic Gain on the Transaction**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>cash received at closing</td>
<td>$90,000</td>
</tr>
<tr>
<td>minus cash invested:</td>
<td></td>
</tr>
<tr>
<td>down payment</td>
<td>$30,000</td>
</tr>
<tr>
<td>plus remodeling expense</td>
<td>5,000</td>
</tr>
<tr>
<td>loan principal paid</td>
<td>10,000</td>
</tr>
<tr>
<td>total cash invested</td>
<td>$45,000</td>
</tr>
<tr>
<td>equals economic gain on transaction</td>
<td>$45,000</td>
</tr>
</tbody>
</table>

In transactions between unrelated parties, the tax gain should equal the economic gain.
TAX CONSEQUENCES OF TAXABLE EXCHANGES

The Philadelphia Park Amusement Rule

Tax transactions often involve an exchange of property between two taxpayers, as in the example at the bottom of casebook page 81. In an exchange transaction, each taxpayer must determine (1) the gain or loss realized on the property being disposed of, and (2) the basis of the property received. It helps to diagram the facts of an exchange as shown in the following example so you can visualize it.

Example at the bottom of Casebook 81

Joe agrees to exchange his 100 shares of XYZ Co. for George’s 100 shares of ABC Co. Joe’s basis in the XYZ stock was $5,000 and the stock was worth $10,000 at the time of the exchange. George’s basis in the ABC stock was $12,500 and the stock was worth $10,000 at the time of the exchange.

<table>
<thead>
<tr>
<th></th>
<th>Joe</th>
<th>George</th>
</tr>
</thead>
<tbody>
<tr>
<td>XYZ stock</td>
<td>$ 10,000</td>
<td>ABC stock</td>
</tr>
<tr>
<td>basis</td>
<td>5,000</td>
<td>basis</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$ 10,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>12,500</td>
</tr>
</tbody>
</table>

Analyze each taxpayer’s situation separately, beginning with Joe. He disposed of his XYZ stock and received George’s ABC stock. Joe realized a $5,000 gain on the exchange, measured by the difference between the $10,000 FMV of the ABC stock he received (the “amount realized”) and the $5,000 basis of the XYZ stock he exchanged. What is Joe’s basis in the ABC stock he received? $10,000. The Philadelphia Park Amusement rule states that the basis of property received in a taxable exchange is its fair market value on the date of the exchange. Joe’s basis in the ABC stock is $10,000, its FMV on the date of the exchange.

George realized a $2,500 loss on the disposition of his ABC stock, the difference between the $10,000 FMV of the XYZ shares he received and the $12,500 basis of the ABC stock he exchanged. George’s basis in the XYZ stock is $10,000, its FMV on the date of the exchange.

The basis rule of Philadelphia Park gives you the same result as the “tax cost basis” rule discussed on casebook page 79 and is easier to apply. When the employer gave the employee a $5,000 car, it is considered a taxable exchange. The employee received the car because of the employment relationship. The employee “exchanged” $5,000 of services for the car. The tax result should be the same whether an employer pays an employee $5,000 in cash or a $5,000 car: the employee has $5,000 of compensation income. The employee’s basis in the car is $5,000, the FMV on the date of the exchange, using the Philadelphia Park Amusement rule.

Keeping Score: The Tax Gain Should Equal the Economic Gain

The role of basis in tax law is to make sure the taxpayer’s gain (or loss) for tax purposes equals the actual economic gain (or loss) on the transaction. Look back at Joe. If he sells his ABC stock two years later for $13,000, he will realize a $3,000 gain ($13,000 amount realized minus $10,000 basis). Joe began the whole scenario by buying XYZ stock for $5,000. He ended with $13,000 after he sold the ABC stock. His economic gain is $8,000 ($13,000 proceeds from the sale of ABC minus the $5,000 cost of XYZ stock). His tax gain is also $8,000. He realized a $5,000 gain when he exchanged XYZ for ABC stock and another $3,000 gain when he sold ABC for $13,000.
PHILADELPHIA PARK AMUSEMENT PROBLEMS

The purpose of the following problems is to illustrate that the Philadelphia Park rule works to get the correct tax result. In problem 1, one property declined in value by the date of the exchange, but the parties are obligated to complete the transaction. Diagram the facts so you can visualize the transaction and use the Philadelphia Park rule to answer the questions. You will see that the economic gain will equal the tax gain if you use the Philadelphia Park rule. The solution to problem 1 is on the next page.

Problem 1

In 2001, Belcor bought a diamond necklace for $1,000 and Filler bought a gold chain for $500. On January 12, 2006, when each item was worth $2,000, they contracted to exchange their necklace and chain with each other. By the time they exchanged the jewelry on November 1, 2006, Belcor’s necklace was worth only $1,800. Answer the following questions and try to prove the result.

(a) What is Belcor’s gain on the disposition of the necklace?
(b) What is Belcor’s basis for the chain?
(c) What is Filler’s gain on the disposition of the chain?
(d) What is Filler's basis for the necklace?
(e) If Belcor sells the chain for $5,000, how much is the gain?
(f) If Filler sells the necklace for $6,000, how much is the gain?

Problem 2

Bauer is a sales associate in an antique store. He purchased a $10,000 desk from the store in 2006, but paid only $9,000 because he is entitled to a 10% employee discount. (You will learn in Chapter 11 that § 132(a)(2) excludes certain employee discounts from income as a tax-free fringe benefit.) He sold the desk in 2006 for $14,000.

(a) What is the tax consequence in 2006 when Bauer bought the desk?
(b) How much gain does he realize in 2006 when he sells the desk?
(c) How much was his economic gain?
(d) How much gain was he taxed on?
(e) If the answers to (c) and (d) are different, what accounts for the difference?
SOLUTION TO HANDOUT PROBLEM 1

In 2001, Belcor bought a diamond necklace for $1,000 and Filler bought a gold chain for $500. On January 12, 2006, when each item was worth $2,000, they contracted to exchange their necklace and chain with each other. By the time they exchanged the jewelry on November 1, 2006, Belcor’s necklace was worth only $1,800. Answer the following questions and try to prove the result.

<table>
<thead>
<tr>
<th>Belcor</th>
<th>Filler</th>
</tr>
</thead>
<tbody>
<tr>
<td>FMV of necklace</td>
<td>$1,800</td>
</tr>
<tr>
<td>basis</td>
<td>1,000</td>
</tr>
<tr>
<td>FMV of gold chain</td>
<td>$2,000</td>
</tr>
<tr>
<td>basis</td>
<td>500</td>
</tr>
</tbody>
</table>

Answer the following questions and try to prove the result.

(a) What is Belcor’s gain on the disposition of the necklace? $1,000 (2,000 - 1,000)
(b) What is Belcor’s basis for the chain? $2,000 (its FMV)
(c) What is Filler’s gain on the disposition of the chain? $1,300 (1,800 - 500)
(d) What is Filler’s basis for the necklace? $1,800 (its FMV)
(e) If Belcor sells the chain for $5,000, how much is the gain? $3,000 (5,000 - 2,000)
(f) If Filler sells the necklace for $6,000, how much is the gain? $4,200 (6,000 - 1,800)

Proof of the Result

Belcor began with $1,000 when she purchased the necklace and ended with $5,000 when she sold the chain resulting in an economic gain of $4,000. She was taxed on $1,000 of gain in (a) when she exchanged the necklace and another $3,000 of gain in (e) when she sold the chain, resulting in $4,000 of gain for tax purposes.

If Belcor’s basis in the chain in transaction (b) above had been $1,800, the value she “paid,” her gain in part (e) would have been $3,200. She would have been taxed on $4,200 of gain ($3,200 in part (e) and $1,000 in part (a)) although she had only $4,000 of economic gain.

Filler began with $500 when she purchased the chain and ended with $6,000 when she sold the necklace, resulting in an economic gain of $5,500. $1,300 of gain was taxed when she exchanged the chain in (c) and $4,200 of gain was taxed when she sold the necklace in (f), resulting in $5,500 of gain for tax purposes.

The tax gain equaled the economic gain using the Philadelphia Park rule although the value of the two properties was not equal at the time of the exchange.
### Solution to Problem 2, Casebook Page 71

<table>
<thead>
<tr>
<th>Transaction</th>
<th>cumulative investment</th>
<th>adjusted basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>a bought a $200,000 home; paid $50,000 cash and borrowed $150,000</td>
<td>(50,000)</td>
<td>200,000</td>
</tr>
<tr>
<td>she invested $50,000 of her own funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>b paid $25,000 of loan principal</td>
<td>(75,000)</td>
<td>200,000</td>
</tr>
<tr>
<td>she invested an additional $25,000 of her own funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>c refinanced the $125,000 balance of the loan with a $175,000 loan</td>
<td></td>
<td>240,000</td>
</tr>
<tr>
<td>(1) $40,000 of extra proceeds was used to remodel the home</td>
<td></td>
<td></td>
</tr>
<tr>
<td>basis increased by amount used to improve the home</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$40,000 came from bank, so she did not invest any more funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(2) $10,000 of extra proceeds was used to purchase a piano</td>
<td></td>
<td>(65,000)</td>
</tr>
<tr>
<td>(she withdrew $10,000 of the bank loan to use for personal purposes,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>reducing her funds invested by $10,000)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>d the balance of the $175,000 loan at the time of sale was $160,000</td>
<td>(80,000)</td>
<td>240,000</td>
</tr>
<tr>
<td>(she reduced the loan principal by paying $15,000 from her funds)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>sold the home for $300,000</td>
<td>300,000</td>
<td></td>
</tr>
<tr>
<td>(after repaying the $160,000 loan, she received $140,000</td>
<td>140,000</td>
<td></td>
</tr>
<tr>
<td>cash profit and tax gain</td>
<td>60,000</td>
<td>60,000</td>
</tr>
</tbody>
</table>

**Tax Gain**

- amount realized $300,000
- minus adjusted basis - 240,000
- equals gain on sale $60,000

**Cash Profit**

- cash received at sale $140,000
- minus down payment - 50,000
- minus principal payments - 40,000
- plus withdrawal to buy piano + 10,000
- equals cash gain $60,000
**GIFT & ESTATE TAX OVERVIEW**

Distinguish gifts for income tax purposes and gifts for gift tax purposes.

**GIFT TAX** (taxed to donor)

**Annual Exclusion**

$12,000 per donee per year. If donor is married, the exclusion is $24,000 per donee per year, if donor’s spouse consents.

**Educational and Medical Exclusion**

In addition to the annual exclusion, an unlimited gift tax exclusion is allowed for amounts paid on behalf of a donee directly to an educational organization for tuition (not books, room or board) and amounts paid directly to health care providers for medical services on behalf of a donee.

**Lifetime Exclusion:** $1 million.

**Tax Rate:** 45% in 2007-2009; 35% in 2010 and thereafter.

**Marital Deduction:** all gifts to a spouse are excluded from the gift tax.

---

**ESTATE TAX** (taxed to estate)

**Lifetime exclusion:**

- 2007-2008: $2 million (reduced by exclusion used for gift tax)
- 2009: $3.5 million (reduced by exclusion used for gift tax)
- 2010: unlimited
- 2011: $600,000

**Tax Rate:** 45% in 2007-2009; zero 2010.

**Status of Estate Tax Repeal**

The 2001 Tax Act repealed the estate tax (but not the gift tax) in year 2010, but the Act expires in 2010. If Congress doesn’t act, the estate tax is reinstated in 2011 as it was prior to the 2001 Act. The top tax rate will be 50% on estates over $2.5 million and the lifetime exclusion will be only $600,000. The House passed a bill in 2005 permanently repealing the estate tax, but the Senate rejected it.

In August 2006, Senate Republicans tried to link a permanent reduction in estate tax rates and a higher estate tax exemption with a $2.10 increase in the minimum wage. The bill needed 60 votes to pass and was defeated by a 56-42 vote.

**INCOME TAX RATES on Estates and Trusts**

- up to $2,150 15%
- $2,150 to $5,000 25%
- $5,000 - $7,650 28%
- $7,650 - $10,450 33%
- over $10,450 35%
A tip calculator figures that $3.90 is an acceptable tip for a $26 meal - a 15 percent nod to a waiter or bartender for a job well done. Generous tippers might leave $5.20, or 20 percent of the bill, as a bigger token of appreciation for caring for a customer's needs. But it's difficult to find a word that adequately describes the customer who signs off on a $26 dinner bill and puts down $10,000 for the tip. Never happen? It did - a 38,461 percent tip - right here in Hutchinson. Cindy Kienow, a bartender at Applebee's Bar and Grill, received a $10,000 tip last Sunday after a customer signed the bill for his $26 meal. "He usually signs his ticket and flips it upside down," Kienow said. "But this time, he had it right side up and said 'I want you to know this is not a joke.'"

Kienow, who has worked at Applebee's for eight years, said the man is a regular customer who comes in a couple of times each month and sits at the end of the bar to eat his meal. He usually orders two beers, cheese quesadillas for an appetizer and an entrée for dinner, and he always tips very well, Kienow said - generally leaving a $15 tip on a $30 ticket.

Two weeks ago, the same customer left her a $100 tip, but the size of Sunday's tip left her in shock."I couldn't move," Kienow said. "I didn't know what to say. He said, 'This will buy you something kind of nice, huh,' and I said, 'Yeah, it will.'"

Rhodri McNee, vice president of operations for JS Enterprises, the owner of the Hutchinson Applebee's, said the company is in the final stages of verifying the tip. "This is a great deal for us and a great deal for Cindy," McNee said. "We did have a guest leave this tip on a credit card, and we're doing everything to make sure it's a valid charge."

McNee said the company is exercising caution to protect the customer's privacy and ensure that the tip goes through the appropriate channels to end up in Kienow's hands. "Nothing would make us happier than to present her with that check," McNee said. "She's been with us for eight years, and she's a great employee who does a great job."

Kienow isn't sure what she did to deserve the tip, but she said she feels honored and privileged that the man thought her efforts were worth that much money. "It's a great compliment," Kienow said. "I'm still kind of in shock." She talked with the customer, described as a man in his mid-40s, every time he came into the restaurant. He lives in the area, Kienow said, but she didn't learn many details about the man's personal life.

Mostly, they talked about the weather, current events or recent happenings - the sort of talk that's common between a bartender and a patron. But there's not a specific incident she can think of that prompted the extra large tip. "I've been waiting on him for about three years," Kienow said. "We'd just talk across the bar - he's a really nice guy. ... I hope he comes back in so I can tell him thank you, because the other day I was kind of dumb-founded."

The 35-year-old Kienow said she's not entirely sure what she'd like to do with the money. Her dad is scheduled for double-knee surgery and will have to take some time off work. "I'd like to take care of my parents, since they always took care of me," Kienow said. "But I feel like he wanted me to buy something for myself, and there's a Jeep that I've had my eye on for a while."
CHAPTER 5 PROBLEMS

1. Read h/o 13 and advise Cindy how she should treat the tip for income tax purposes.

2. Weiss gave Brandenburg CBS stock that cost $20,000 and was worth $30,000 at the time of the gift. What is Brandenburg’s gain or loss if he sells the stock for the following amounts?
   (a) $35,000
   (b) $15,000
   (c) $25,000

3. Wretzky gave Bauer GE stock that cost $52,000 and was worth $30,000 at the time of the gift. What is Bauer’s gain or loss if he sells the stock for the following amounts?
   (a) $60,000
   (b) $18,000
   (c) $47,000

4. Blackney purchased GM stock for $32,000 and gave it to Springfield when it was worth $22,000. What is Springfield’s gain or loss if he sells the stock for the following amounts?
   (a) $21,000
   (b) $30,000
   (c) $40,000

5. Deconinck paid $40,000 for Abbott Labs stock and gave it to Rice when it was worth $50,000. What is Rice’s gain or loss if she sells the stock for the following amounts?
   (a) $45,000
   (b) $55,000
   (c) $35,000
5. Jim purchased AOL stock in 2001 for $30,000 and gave it to his elderly father on June 12, 2006 when it was worth $100,000. His father died on September 19, 2006 when the stock was worth $110,000. Jim inherited the stock and sold it on September 22, 2006 for $115,000.

(a) What is Jim’s gain or loss on the sale? Read the last paragraph on casebook 96 and § 1014(e)(1).

(b) What is Jim’s gain or loss on the sale if his dad died August 12, 2007 when the stock was worth $110,000 and Jim sold the stock on September 21, 2007 for $115,000?

6. Joyce purchased property for $10,000 and sold it to her daughter Bonnie for $21,000 when the FMV was $50,000.

(a) What are the tax consequences to Joyce and Bonnie at the time of the transaction? See Reg. §1.1001-1(e).

(b) What is Bonnie’s gain or loss if she sells the property for $5,000? See Reg. § 1.1015-4(a)(1).

(c) How much total economic gain did mom and daughter realize?

(d) How much total income did they have to pay tax on?
SALE OF RESIDENCE PROBLEMS

Determine how much gain the taxpayers may exclude under § 121 in the following problems. Married couples will file a joint return and the entire profit is reported on their return. Single taxpayers report their respective share of the profit their separate tax returns.

Problem 1
1/5/02  Wanda bought a home for $200,000
1/1/05  Barry moved in
8/1/05  they married
7/1/06  they moved and sold the home for $800,000

Problem 2
1/5/02  Brenda bought a home for $200,000
1/1/05  Larry moved in
8/1/05  they married
7/1/06  they moved because of Larry’s change of employment and sold the home for $800,000
7/1/06  they purchased a new home for $950,000

Problem 3
1/5/02  Linda bought a home for $200,000
1/1/05  Gary moved in
8/1/05  they married
7/1/06  they moved because of Linda’s change of employment and sold the home for $800,000
7/1/06  they purchased a new home for $950,000

Problem 4
1/5/02  Deborah bought a home for $200,000
1/1/05  Jerry moved in
7/1/05  Deborah transferred a one-half interest in joint tenancy to Jerry
7/1/06  They sold the home for $800,000.

Problem 5
Same facts as problem 4, but they sold the home for $500,000.

Problem 6
Same facts as problem 5, but they were married at the time of the sale.

Problem 7
1/5/02  Sally bought a home for $200,000
1/1/05  Harry moved in
7/1/05  Sally transferred to Harry a one-half interest in joint tenancy
7/1/06  they moved because of Harry’s change of employment and sold the home for $800,000
EXCLUSIONS of EMPLOYER-PROVIDED EDUCATIONAL BENEFITS

Qualified Tuition Reduction § 117(d)

Most universities have tuition reduction plans that enable employees, their spouses and dependents to attend classes tuition-free. Section 117(d) excludes the value of tuition for undergraduate courses.

Educational Assistance Programs § 127

When an employer reimburses an employee for tuition, the reimbursement is additional compensation to the employee unless a Code section excludes it. Section 127 excludes up to $5,250 of tuition reimbursements received from an employer for both undergraduate and graduate courses. The exclusion applies whether or not the education is related to the employee’s work.

Example 1

Prof. Brill’s son attends Chicago-Kent tuition-free and Brill must include the value of the tuition in his income. Section 117(d) does not apply because the courses are graduate courses. Section 127 does not apply because that section excludes $5,250 of tuition for an employee, not the spouse or dependents of the employee.

Working Condition Fringe Benefits § 132(d)

Code § 132(d) excludes some tuition reimbursements as “working condition” fringe benefits. (We will study fringe benefit exclusions in Chapter 11.) Working condition fringe benefits are amounts the employer reimburses the employee for that the employee could have deducted as a business expense under § 162 if she had paid them herself. A taxpayer may deduct the cost of tuition as a business expense if the education maintains or improves skills in her employment. However, if the education prepares the taxpayer for a new trade or profession, the expense is not deductible.

Example 2

First Bank reimbursed Rosen, a manager in the finance department, for $9,000 of tuition he paid for a graduate course in finance, which improves her skills. If her employer had not reimbursed her, she could have deducted the tuition as a business expense under § 162. Therefore she may exclude the reimbursement under § 132(d).

If the reimbursement had been for law school tuition, she could not have deducted the expense because it prepares her for a new profession. Therefore she cannot exclude the $9,000 reimbursement as a § 132(d) working condition fringe benefit, but she may exclude $5,250 of the reimbursement under § 127.

Example 3

Prof. Rudstein took a graduate course in the law school’s LL.M. tax program that would normally cost $10,000. He did not pay tuition because of the university’s tuition reduction plan. Rudstein may not exclude the $10,000 under § 117(d) because it was a graduate course. You will learn that a lawyer may deduct the cost of graduate law courses because they maintain or improve her skills and a graduate law degree does not prepare a lawyer for a new profession. Rudstein could have deducted the tuition as a business expense if he had paid it himself, so he may exclude the full $10,000 under § 132(d) as a working condition fringe benefit.
EXCLUSION PROBLEMS

(1) Microsoft reimbursed employee Grosch $10,000 for law school tuition. She is a computer programmer and Microsoft is paying her law school tuition so she can program legal software. How much of the $10,000 reimbursement may she exclude under §§ 117(d), 127 or 132(d)?

(2) What if the company paid $10,000 of tuition for her to obtain a master’s degree in archeology that has nothing to do with her work at Microsoft?

(3) How much income should Professor Spak report in the following situations? He and his sons take the courses at IIT and Spak does not pay tuition pursuant to the university’s tuition reduction plan.

(a) His younger son is an undergraduate majoring in chemical engineering.

(b) His older son attends Chicago-Kent.

(c) Spak takes courses in the graduate tax program.

(d) Spak takes undergraduate psychology courses.

(e) Spak takes graduate psychology courses.

(4) Sue, an Evening division student at Kent, works full-time as a faculty secretary. As an employee, she receives nine hours of law school credit without charge. How should she report this on her income tax return?

(5) A Chicago-Kent student receives two free hours of tuition for serving as a TA. Is this taxable income? (Assume the value of the tuition was subtracted from the tuition bill instead of being paid in cash.) See § 117(d)(5), but read § 117(c)(1) carefully.
LIFE INSURANCE PRORATED AMOUNT

Section 101(d), discussed at the bottom of casebook 144 and the top of 145, prescribes the tax treatment of insurance proceeds received over a period of time, instead of a lump sum. To compute the § 101(d)(1) “prorated” amount excluded from the beneficiary’s income, divide the face amount of the policy by the number of periods the payments will be made. The face amount is the death benefit. The number of periods is either a fixed number of years or the life expectancy of the beneficiary, depending on the insurance contract. The result is the amount of each annual payment excluded; the balance of each payment is included as interest income.

Example

Able purchased a $100,000 term policy on his life and paid the first $100 premium. He died in a car accident the next week and his widow Barbara elected to receive the $100,000 over her life expectancy of 25 years. The insurance company contracted to pay her $6,000 per year for her life. The amount excluded is computed as follows:

$$\frac{100,000 \text{ face amount}}{25 \text{ year life expectancy}} = 4,000 \text{ excluded each year}$$

The $4,000 exclusion continues as long as the beneficiary lives, even if the beneficiary lives beyond her life expectancy. If Barbara lives more than 25 years and receives $6,000 in the 26th year, she will still exclude $4,000 although she has recovered the entire $100,000 face value of the policy tax free. (She excluded $4,000 per year for 25 years.)

If the beneficiary dies before recovering the face amount of the policy, there is no deduction for the unrecovered portion of the face amount. If Barbara died two years after her husband, she will have received $12,000 and excluded only $8,000. The $88,000 balance of the insurance is lost, but her estate does not get any tax deduction for amount that ended at her death.

PROBLEMS

Bill was the beneficiary of his wife’s $75,000 life insurance policy; she paid $12,000 of premiums before her death. What are the tax consequences to Bill if elects the following settlement options?

(1) He takes the $75,000 in a lump sum payment.

(2) The insurance company will retain the $75,000 and pay him 6% interest per year, § 101(c).

(3) He elected to receive $7,500 per year for his 12-year life expectancy. What are the tax consequences:

   (a) when he receives the first $7,500 payment?

   (b) when he receives the $7,500 payment 14 years after his wife’s death?

   (c) if he dies two years after the payments began and the balance of the insurance proceeds are lost?
CANCELLATION OF DEBT

Code § 61(a)(12) provides that when a creditor forgives or cancels part of a debt, the amount forgiven is income from the discharge of indebtedness. This is referred to as cancellation of debt (“COD”) income. For example, Wetzel lent Solberg $10,000 three years ago and Wetzel now agrees to accept $7,000 in full payment of the debt. Solberg paid the $7,000 and Wetzel cancelled the $3,000 balance. Solberg must report $3,000 of COD income, unless excluded by a Code provision or common law.

Balance Sheets

Assets are the cash and property an entity owns and liabilities are what an entity owes to creditors. Assets minus liabilities equals net worth (A - L = NW). Net worth is the amount of assets remaining for the owner after liabilities are subtracted.

Example 1

Adam has $5,000 of cash and owes Visa $2,000. His net worth is $3,000 ($5,000 assets - $2,000 liabilities). Adam’s balance sheet would look like this:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $5,000</td>
<td>Visa payable $2,000</td>
</tr>
<tr>
<td>Total Assets $5,000</td>
<td>Liabilities &amp; Net Worth $3,000</td>
</tr>
</tbody>
</table>

Assets are listed on the left side of the balance sheet. The claims on the assets are listed on the right side. The creditors have a $2,000 claim on the assets and the $3,000 balance of the assets belong to Adam. He is solvent by $3,000.

Example 2

Betty has $10,000 of cash and owes $16,000 in student loans. Her balance sheet looks like this:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash $10,000</td>
<td>Student loans $16,000</td>
</tr>
<tr>
<td>Total Assets $10,000</td>
<td>Liabilities &amp; Net Worth (6,000)</td>
</tr>
</tbody>
</table>

Her liabilities exceed her assets by $6,000 so Betty has a negative net worth of $6,000. She is insolvent by $6,000 (see § 108(d)(3)).
Cancellation of Debt When Debtor is Insolvent

There are several statutory and common law exclusions of gross income, one of which is the insolvency exception. Code § 108(a)(1)(B) provides that COD income is excluded if the debtor is insolvent after the debt is cancelled.

Example 3

Charlene has $14,000 of cash and owes VISA $5,000 and American Express $15,000. Her $20,000 of liabilities exceed the $14,000 of assets, giving her a negative net worth of $6,000. She is insolvent by $6,000. Her balance sheet looks like this:

<table>
<thead>
<tr>
<th>Charlene’s Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Cash $14,000</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Total Assets $14,000</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

VISA agrees to accept $4,000 in full payment of the $5,000 debt. Visa cancelled $1,000 of her debt, which is COD income unless excluded by the Code. After she pays Visa, her balance looks like this:

<table>
<thead>
<tr>
<th>Charlene’s Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Cash $10,000</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Total Assets $10,000</td>
</tr>
</tbody>
</table>

After the transaction she is still insolvent. Code § 108(a)(1)(B) excludes the $1,000 cancellation. American Express now agrees to accept $9,000 in full payment of their $15,000 debt and forgive $6,000. Charlene’s balance sheet after the American Express transaction looks like this:

<table>
<thead>
<tr>
<th>Charlene’s Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
</tr>
<tr>
<td>Cash $1,000</td>
</tr>
<tr>
<td>Net Worth $1,000</td>
</tr>
<tr>
<td>Total Assets $1,000</td>
</tr>
</tbody>
</table>

After the transaction she is solvent by $1,000. Code § 108(a)(3) provides that the exclusion cannot exceed the amount by which the taxpayer is insolvent. Before the American Express payment she was insolvent by $5,000. American Express forgave $6,000 of the debt, but only $5,000 is excluded. The $1,000 balance, the amount by which she is solvent after the transaction, is included in gross income.
COD PROBLEMS

1. Holland borrowed $5,000 from Last National Bank. The loan is due but he does not have the money to repay it. What are the tax consequences if the bank agrees to accept $2,000 and cancels the $3,000 balance? See § 61(a)(12).

2. Eyber owes Marshall Fields $7,000. What are the tax consequences if the entire debt is cancelled in a title 11 bankruptcy case? See §108(a)(1)(A).

3. (a) Wallen has $20,000 of assets and $30,000 of liabilities, including $9,000 he owes to Smythe. What are the tax consequences if Smythe agrees to accept $2,000 and cancels the $7,000 balance of the loan? See § 108(a)(1)(B).

(b) Same facts as (a) but Wallen’s liabilities are $25,000 before Smythe cancelled $7,000 of the loan. See §§ 108(a)(1)(B) and 108(a)(3).

4. Liebl borrowed $20,000 from his parents to pay tuition. What is the result if his parents cancel the loan on graduation day? See § 102(a).

5. Grandma lent Neff $10,000 to buy a new car. Grandma forgave the $10,000 debt in her will, noting it was in appreciation of the care that Neff provided to her during the last years of her life. What are the tax consequences of the debt forgiveness?

6. Baker’s bakery faltered and the employees agreed to accept $3,000 in full settlement of the $5,000 of wages owed them. How should she treat this for tax purposes? See § 108(e)(2).

7. Rippe had his car’s transmission repaired at the Double A Transmission Shop and was outraged when he received the $2,500 bill. What are the tax consequences to him if the owner agrees to accept $1,500 in full payment of the bill?

(a) Does § 108(e)(5) permit him to exclude the $1,000? Read § 108(e)(5)(A) carefully.

(b) Read Disputed or Contested Debts on casebook p. 165 and see if that helps Rippe’s case.

8. Montgomery contracted to purchase a condominium from Henderson for $80,000, with payments to be made over a ten-year period. A few years later, when the loan balance was $65,000, the FMV of the condo had declined to $50,000 because of a downturn in the real estate market. Montgomery was insolvent. To prevent Montgomery from defaulting on the contract, Henderson agreed to reduce the balance owing on the loan to $50,000. What are the tax consequences, if any, to Montgomery? What will be the basis in the condo after the debt reduction? See § 108(e)(5).

9. McCarthy owes Jackson $12,000. Jackson agrees to accept $9,000 in full payment. What are the tax consequences to McCarthy if she pays the $9,000 with:

(a) $9,000 in cash?

(b) a painting with a basis and a fair market value of $9,000?

(c) a painting with a basis of $5,000 and a fair market value of $9,000?

(d) services worth $9,000 by remodeling Jackson’s garage?
Problem 3
Consider the first 17 lines of the problem, through “What advice would you give?” (Ignore the question regarding the attorney’s lien statute in Martha’s jurisdiction.) For this part of the question, determine what damages are excluded and how she should deduct the attorney’s fee. Study the last two sentences of § 104(a) immediately before § 104(b).

For the next part of the problem involving the unwanted physical contact and bruising, do the additional facts make it an excludible physical injury? See PLR 200041, discussed in the middle of 183, and Amos following this handout page. Assuming there is a physical injury, can Mary establish that the damages were awarded “on account of” and were intended to compensate for that physical injury, as required by Schleier on 190?

For Problem 4, consider the following questions:

1. How Susan should treat the amounts received from her own policy? See § 104(a)(3).

2. How should the treat the amounts she received from her employer’s policy? See §§ 104(a)(3), 105(a) and 105(b).

3. How should Susan treat the health insurance premiums that her employer paid? See § 106.
CHIECHI, Judge:

The only issue remaining for decision is whether the $200,000 settlement amount that petitioner received in 1997 in settlement of a claim is excludable under section 104(a)(2) from petitioner's gross income for that year. We hold that $120,000 is excludable and that $80,000 is not.

FINDINGS OF FACT

Most of the facts have been stipulated and are so found. At the time petitioner filed the petition in this case, he resided in Minneapolis, Minnesota.

During 1997, petitioner was employed as a television cameraman. In that capacity, on January 15, 1997, petitioner was operating a handheld camera during a basketball game between the Minnesota Timberwolves and the Chicago Bulls. At some point during that game, Dennis Keith Rodman (Mr. Rodman), who was playing for the Chicago Bulls, landed on a group of photographers, including petitioner, and twisted his ankle. Mr. Rodman then kicked petitioner. (We shall refer to the foregoing incident involving Mr. Rodman and petitioner as the incident.)

On January 15, 1997, shortly after the incident, petitioner was taken by ambulance for treatment at Hennepin County Medical Center. Petitioner informed the medical personnel at that medical center (Hennepin County medical personnel) that he had experienced shooting pain to his neck immediately after having been kicked in the groin, but that such pain was subsiding. The Hennepin County medical personnel observed that petitioner was able to walk, but that he was limping and complained of experiencing pain. The Hennepin County medical personnel did not observe any other obvious signs of trauma.

While petitioner was seeking treatment at Hennepin County Medical Center, he contacted Gale Pearson (Ms. Pearson) about representing him with respect to the incident. Ms. Pearson was an attorney who had experience in representing plaintiffs in personal injury lawsuits. After subsequent conversations and a meeting with petitioner, Ms. Pearson agreed to represent him with respect to the incident.

On January 15, 1997, after the incident and petitioner's visit to the Hennepin County Medical Center, petitioner filed a report (police report) with the Minneapolis Police Department. In the police report, petitioner claimed that Mr. Rodman had assaulted him.

On January 16, 1997, petitioner sought medical treatment at the Veterans Affairs (VA) Medical Center. The medical personnel at that medical center (VA medical personnel) took X-rays of petitioner's back. Petitioner complained to the VA medical personnel about his groin area, but he did not advise them that he was experiencing any symptoms related to that complaint. The VA medical personnel determined that there was no swelling of, but they were unable to ascertain whether there was bruising around, petitioner's groin area. The VA medical personnel gave petitioner some pain medication and told him to continue taking his other prescribed medications.

Very shortly after the incident on a date not disclosed by the record, Andrew Luger (Mr. Luger), an attorney representing Mr. Rodman with respect to the incident, contacted Ms. Pearson. Several discussions and a few meetings took place between Ms. Pearson and Mr. Luger. Petitioner accompanied Ms. Pearson to one of the meetings between her and Mr. Luger, at which time Mr. Luger noticed that petitioner was limping. Shortly after those discussions and meetings, petitioner and Mr. Rodman reached a settlement.

On January 21, 1997, Mr. Rodman and petitioner executed a document entitled "CONFIDENTIAL SETTLEMENT AGREEMENT AND RELEASE" (settlement agreement).

[The settlement agreement provided that Rodman would pay Amos $200,000, without allocation, that the settlement covered not only any physical injuries to Amos, but also Amos' agreement not to defame Rodman; not to disclose the existence or terms of the agreement; not to publicize the incident; and not to assist in any criminal prosecution against Rodman with respect to the matter (Amos had filed a police report, claiming Rodman had assaulted him, on the day of the incident). The agreement also provided that]
Rodman did not admit any liability for the incident.

Petitioner filed a tax return (return) for his taxable year 1997. In that return, petitioner excluded from his gross income the $200,000 that he received from Mr. Rodman under the settlement agreement. In the notice that respondent issued to petitioner with respect to 1997, respondent determined that petitioner is not entitled to exclude the settlement amount from his gross income.

**OPINION**

We must determine whether the settlement amount at issue may be excluded from petitioner's gross income for 1997.

Section 61(a) provides the following sweeping definition of the term "gross income": "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived".

Section 104(a)(2) on which petitioner relies provides that gross income does not include:

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness; ***

Where damages are received pursuant to a settlement agreement, such as is the case here, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under section 104(a)(2). United States v. Burke, supra at 237. The determination of the nature of the claim is factual. Where there is a settlement agreement, that determination is usually made by reference to it. If the settlement agreement lacks express language stating what the amount paid pursuant to that agreement was to settle, the intent of the payor is critical to that determination. Although the belief of the payee is relevant to that inquiry, the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment. Whether the settlement payment is excludable from gross income under section 104(a)(2) depends on the nature and character of the claim asserted, and not upon the validity of that claim.

The dispute between the parties in the instant case relates to how much of the settlement amount at issue Mr. Rodman paid to petitioner on account of physical injuries. It is petitioner's position that the entire $200,000 settlement amount at issue is excludable from his gross income under section 104(a)(2). In support of that position, petitioner contends that Mr. Rodman paid him the entire amount on account of the physical injuries that he claimed he sustained as a result of the incident.

Respondent counters that, except for a nominal amount (i.e., $1), the settlement amount at issue is includable in petitioner's gross income. In support of that position, respondent contends that petitioner has failed to introduce any evidence regarding, and that Mr. Rodman was skeptical about, the extent of petitioner's physical injuries as a result of the incident. Consequently, according to respondent, the Court should infer that petitioner's physical injuries were minimal. **

On the instant record, we reject respondent's position. With respect to respondent's contentions that petitioner has failed to introduce evidence regarding, and that Mr. Rodman was skeptical about, the extent of petitioner's physical injuries as a result of the incident, those contentions appear to ignore the well-established principle under section 104(a)(2) that it is the nature and character of the claim settled, and not its validity, that determines whether the settlement payment is excludable from gross income under section 104(a)(2). In any event, we find below that the record establishes that Mr. Rodman's dominant reason in paying the settlement amount at issue was petitioner's claimed physical injuries as a result of the incident. **

Our finding is supported by the settlement agreement, a declaration by Mr. Rodman (Mr. Rodman's declaration), n6 and Ms. Pearson's testimony.

n6 The parties introduced into evidence a declaration by Mr. Rodman, who did not appear as a witness at trial. The parties stipulated the accuracy and truthfulness of Mr. Rodman's statements in that declaration.

The settlement agreement expressly provided that Mr. Rodman's payment of the settlement amount at issue releases and forever discharges ** * [Mr.] Rodman ** * from any and all claims and causes of action of any type, known and unknown, upon and by reason of any damage, loss or injury * ** sustained by Amos [petitioner] arising, or which could have arisen, out of or in connection with * * [the incident].
Mr. Rodman stated in his declaration that he entered into the settlement agreement "to resolve any potential claims" and that the settlement agreement was intended to resolve petitioner's "claim without having to expend additional defense costs." The only potential claims of petitioner that are disclosed by the record are the potential claims that petitioner had for the physical injuries that he claimed he sustained as a result of the incident. Furthermore, Ms. Pearson testified that Mr. Rodman paid the entire settlement amount at issue to petitioner on account of his physical injuries. As discussed below, Ms. Pearson's testimony that Mr. Rodman paid that entire amount on account of petitioner's physical injuries is belied by the terms of the settlement agreement. Nonetheless, her testimony supports our finding that Mr. Rodman's dominant reason in paying petitioner the settlement amount at issue was to compensate him for claimed physical injuries relating to the incident.

We have found that Mr. Rodman's dominant reason in paying petitioner the settlement amount at issue was to compensate him for his claimed physical injuries relating to the incident. However, the settlement agreement expressly provided that Mr. Rodman paid petitioner a portion of the settlement amount at issue in return for petitioner's agreement not to: (1) Defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident (collectively, the nonphysical injury provisions).

The settlement agreement does not specify the portion of the settlement amount at issue that Mr. Rodman paid petitioner on account of his claimed physical injuries and the portion of such amount that Mr. Rodman paid petitioner on account of the nonphysical injury provisions in the settlement agreement. Nonetheless, based upon our review of the entire record before us, and bearing in mind that petitioner has the burden of proving the amount of the settlement amount at issue that Mr. Rodman paid him on account of physical injuries, we find that Mr. Rodman paid petitioner $120,000 of the settlement amount at issue on account of petitioner's claimed physical injuries and $80,000 of that amount on account of the nonphysical injury provisions in the settlement agreement. On that record, we further find that for the year at issue petitioner is entitled under section 104(a)(2) to exclude from his gross income $120,000 of the settlement amount at issue and is required under section 61(a) to include in his gross income $80,000 of that amount.

We have considered all of the contentions and arguments of respondent and of petitioner that are not discussed herein, and we find them to be without merit, irrelevant, and/or moot.

To reflect the foregoing and the concessions of the parties, Decision will be entered under Rule 155.
DEDUCTION OF ATTORNEY’S FEES IN PERSONAL INJURY CASES

Code § 212(1) permits the deduction of attorneys’ fees paid for personal injury awards only if the award is included in gross income. If the plaintiff receives $300,000 of damages for employment discrimination and pays a $100,000 attorney’s fee, the entire $300,000 is included in gross income and the entire fee is deductible. If 75% of the award had been for a personal physical injury and 25% for punitive damages, $75,000 (25%) of the award is included in gross income and $25,000 (25%) of the fee is deductible. Expenses deducted under § 212, such as attorneys’ fees, are classified as 2% miscellaneous itemized deductions (2% MIDs), which we will study later.

The Alternative Minimum Tax (AMT)

As you will study later in the course, taxpayers must compute their tax the “regular” way, then compute it using the AMT rules and pay whichever tax is higher. Certain itemized deductions are not deductible for AMT purposes, including 2% MIDs. If the taxpayer is subject to the AMT, the attorney’s fee paid for taxable personal injury settlements is not deductible. A plaintiff must include the full award for nonphysical personal injuries in gross income and may deduct the attorney’s fees only for regular tax purposes as a 2% MID.

Discrimination Cases

Code § 62 specifies which deductions are deductible as adjustments, rather than itemized deductions. As mentioned above, attorneys’ fees in personal injury cases are classified as 2% miscellaneous itemized deductions and are not deductible for AMT purposes. Code § 62(a)(20) classifies attorneys’ fees in unlawful discrimination cases as adjustments. Section 62(e) defines unlawful discrimination. Note that the discrimination award is included in gross income, but the attorney’s fee is deductible as an adjustment for regular tax purposes and for the AMT, not as a 2% MID.
FLEXIBLE SPENDING ARRANGEMENTS (FSAs)

Medical Care Reimbursement Plans §125

Medical expenses are deductible only to the extent they exceed 7½% of AGI. A taxpayer with AGI of $50,000 cannot deduct the first $3,750 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 plan and Code § 125 excludes the designated amount from the employee’s income. The employer determines the maximum an employee can contribute to the plan; there is no statutory maximum. (IIT limits the contribution to $4,000 per year.)

Prof. Jones, an IIT employee, designates $4,000 for the medical FSA plan. IIT withholds $333 from her pay each month ($4,000 ÷ 12 months) and credits it to her plan account. $4,000 is excluded from her income, saving her $1,000 of tax if she is in the 25% bracket. Jones submits receipts for medical expenses and IIT reimburses her up to $4,000.

The employer must reimburse the full amount submitted for reimbursement (up to the amount the employee designated), regardless of the amount the employee has contributed. For example, if Jones seeks reimbursement for a $2,000 uninsured dental expense in the first month of the plan, IIT will reimburse the $2,000 although she has only contributed $333 to the plan thus far. If Jones leaves IIT the next month, the university loses $1,667 and cannot seek reimbursement from Jones. This is the employer’s risk.

On the other hand, if Jones does not spend the full $4,000 during the year, she will forfeit the balance remaining in the plan. The employer retains the amounts forfeited, which help offset losses described in the previous paragraph. Employees must designate the amount of the contribution before the plan year begins, so they must accurately estimate their medical expenses for the plan year to avoid forfeiting unspent contributions. 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, which reduces 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. If Jones designates $5,000 for child care expenses and $4,000 for medical expenses, $9,000 is excluded from her income, saving her $2,250 of tax if she is in the 25% bracket. (Note: we will later study the dependent care credit, which is an alternate way child care expenses can save tax.)

Tax Effect of Plans

The effect of participating in these plans is to convert nondeductible medical and child care expenses to exclusions that lower the AGI and taxable income. The reduced AGI lowers the itemized deduction phaseout, the exemption phaseout, and other phaseouts measured by AGI. These plans provide significant tax benefits to an employee at little cost to the employer. The employer incurs some administrative costs and risks losing money when they reimburse an employee for large expenses early in the plan year and the employee quits shortly after that.
HEALTH SAVINGS ACCOUNTS (HSAs) § 223

A health savings account is a savings account similar to an IRA, but earmarked for medical expenses. HSAs are only available for employees with a “high-deductible Health Plan (HDHP).” For 2006, the minimum deductible amount for the health insurance plan is $1,050 for single coverage and $2,100 for family coverage. In other words, if a single taxpayer is covered by her employer’s health insurance and the annual deductible is at least $1,050, the employee is eligible to contribute to an HSA.

Contributions by an employee are deductible as adjustments under § 62(a)(19). If the employer contributes to the plan, the contributions are excluded from the employee’s income. Income earned by assets in the fund is not currently taxed. Unlike amounts in FSAs that are forfeited if not used by the end of the year, unused HSA funds remain available for use in later years.

Amounts withdrawn from HSAs are excluded from income if used for qualified medical expenses. Withdrawals before age 65 that are not used for medical expenses are included in income and subject to a 10% penalty. After age 64, amounts can be withdrawn for non-medical purposes without the penalty, but are included in gross income. Unused HSA funds can supplement retirement savings.

The maximum annual contribution is adjusted for inflation each year. In 2006, a taxpayer with an individual medical plan can contribute the lesser of the insurance plan deductible amount or $2,700 ($2,850 in 2007). Taxpayers with a family medical plan can contribute up to $5,450 ($5,650 in 2007).
TAX PLANNING FOR DIVORCING COUPLES

The payor of alimony deducts it as an adjustment and the recipient reports it as income. Child support is neither income to the recipient nor deductible by the paying spouse. The paying spouse negotiates to pay alimony so the payments will be deductible and the recipient spouse negotiates to receive 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

Frank and Bonnie divorced in 2006; they have two young children. Bonnie is a trial lawyer and Frank is a stay-at-home dad who has custody of the children. Bonnie 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 single rates. After paying $80,000 for child support and $69,092 of tax, she has $100,908 of her $250,000 taxable income left. Frank has no taxable income so he keeps the entire $80,000 Bonnie paid him.

Plan 2: Part Alimony

Bonnie will increase the payments from $80,000 to $89,500, with $49,500 designated as alimony and the $40,000 balance designated as child support. Bonnie deducts the $49,500 alimony, reducing her taxable income to $200,500 and her tax to $52,757. After paying $89,500 to Frank and $52,757 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 has $49,500 of gross income from which he subtracts $7,550 for the head of household standard deduction and $9,900 for three exemptions. His taxable income is $32,050. The tax at head of household rates is $4,270. He is entitled to a $2,000 child tax credit, which reduces 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:

<table>
<thead>
<tr>
<th></th>
<th>Bonnie retains</th>
<th>Frank retains</th>
</tr>
</thead>
<tbody>
<tr>
<td>Plan 2 (alimony)</td>
<td>$ 107,743</td>
<td>$ 87,230</td>
</tr>
<tr>
<td>Plan 1 (all child support)</td>
<td>- 100,908</td>
<td>- 80,000</td>
</tr>
<tr>
<td>tax savings</td>
<td>$ 6,835</td>
<td>$ 7,230</td>
</tr>
</tbody>
</table>

The revised plan saves 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. Bonnie 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 Bonnie 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.
ALIMONY RECAPTURE (EXCESS FRONT-LOADING) § 71(f)

Casebook page 837 explains the reasons for Code § 71(f). This handout explains the computation of the amount to be “recaptured.” Only the payments made in the first three “post-separation” years are subject to recapture. After the third post-separation year, the payments can fluctuate up or down any amount without any recapture consequences. See § 71(f)(6) for the definition of a post-separation year. The following example will explain the recapture computation.

Facts: Steve and Jackie divorced in 2004. Their settlement agreement requires Steve to pay Jackie $153,000 in 2004, $123,000 in 2005, $104,000 in 2006 and $7,000 from 2007 to 2011. If Jackie dies before 2010, he will pay $3,000 to her estate through 2011.

$3,000 of each payment that continues beyond her death is a property settlement (PS), not alimony (§ 71(b)(1)(D)). Subtract $3,000 from each payment to determine the deductible alimony.

2004: $153,000 payment - $3,000 PS = $150,000 deductible alimony
2005: $123,000 payment - $3,000 PS = $120,000 deductible alimony ($116,000 after adjustment)
2006: $104,000 payment - $3,000 PS = $101,000 deductible alimony
2007 to 2011: $7,000 payment - $3,000 PS = $4,000 deductible alimony

In each year, Steve deducts alimony as an adjustment and Jackie reports alimony as income. Steve deducts $120,000 in 2005 and Jackie reports $120,000.

In 2006, the third post-separation year, they calculate the amount to be recaptured as follows:

Step 1: Calculate the amount to be recaptured for the second post-separation year (2005). Subtract 2006 alimony from 2005 alimony and subtract another $15,000 (a statutory amount). The result is alimony recaptured for 2005. $120,000 - $101,000 - $15,000 equals $4,000 recaptured for 2005. [Important note: If the third year alimony is larger than the second year alimony, no alimony is recaptured for the second year. Skip Step 2 and go to Step 3. You will see this situation in problem 2 on the next page.]

Step 2: Next calculate the amount to be recaptured for the first post-separation year (2004). Subtract the $4,000 alimony recaptured in Step 1 from 2005 alimony to arrive at adjusted 2005 alimony. $120,000 - $4,000 = $116,000 adjusted 2005 alimony.

Step 3: Add adjusted 2005 alimony and 2006 alimony, then divide the sum by two to arrive at the average alimony for 2005 and 2006. $116,000 + $101,000 = $217,000 ÷ 2 = $108,500 average for 2005 and 2006.

Step 4: Subtract the average determined in step 3 from 2004 alimony and subtract another $15,000. The result is alimony recaptured for the 2004. $150,000 2004 alimony - $108,500 average - $15,000 = $26,500 recaptured for 2004.

The total amount recaptured is $30,500 ($4,000 plus $26,500).

In 2006, Steve deducts $101,000 of alimony as an adjustment and reports $30,500 of recaptured alimony as income. Jackie reports $101,000 of alimony income and deducts $30,500 of recaptured alimony as an adjustment.
RECAPTURE PROBLEMS

Lana pays Alan the following amounts pursuant to their divorce decree. In problems 1-6, determine Alan’s tax consequences in 2006. Unless otherwise stated, all payments end at Alan’s death.

1. 2004: $85,000
   2005: $105,000
   2006: $15,000
   2007 to 2010: $7,000
   She must pay $5,000 to Alan’s estate each year if he dies before 2010.

2. 2004: $135,000
   2005: $40,000
   2006: $60,000
   2007 to 2010: $20,000
   She must pay $10,000 to Alan’s estate each year if he dies before 2010.

3. 2004: $160,000
   2005: $137,000
   2006: $90,000
   2007 to 2010: $50,000

4. 2004: $150,000
   2005: $170,000
   2006: $60,000
   2007 to 2010: $50,000

5. 2004: $50,000
   2005: $100,000
   2006: $200,000
   2007 and later: zero

6. 2004: $100,000
   2005: $85,000
   2006: $70,000
   2007 to 2010: $10,000

For problems 7-9, determine how much alimony, if any, is recaptured and the year in which they report the recaptured amount. Read § 71(f)(6) before you do problems 8 and 9.

7. 2004: $1
   2005: $1
   2006: $1 million

8. 2004: $0
   2005: $120,000
   2006: $110,000
   2007 - 2010: $80,000

9. 2004: zero
   2005: zero
   2006: $1 million
   2007 and later: zero
SOLUTIONS TO RECAPTURE PROBLEMS

Problem 1
$5,000 payable each year beyond Alan’s death is a property settlement; subtract it from each payment to determine the alimony amount.

2004: $85,000 - $5,000 PS = $80,000 deductible alimony
2005: $105,000 - $5,000 PS = $100,000 deductible alimony ($25,000 adjusted after recapture)
2006: $15,000 - $5,000 PS = $10,000 deductible alimony
2007: $7,000 - $5,000 PS = $2,000 deductible alimony

Recapture computation:
Step 1: $100,000 2005 alimony - $10,000 2006 alimony - $15,000 = $75,000 recaptured for 2005.
Step 2: $100,000 2005 alimony - $75,000 recaptured = $25,000 adjusted 2005 alimony
Step 3: $25,000 + $10,000 = $35,000 ÷ 2 = $17,500 average for 2005 and 2006
Step 4: $80,000 2004 alimony - $17,500 average - $15,000 = $47,500 recaptured for 2004.

A total of $122,500 of alimony is recaptured. In 2006, Alan reports $10,000 of alimony income and deducts $122,500 as alimony recapture. Lana deducts $10,000 of alimony and reports $122,500 of recapture income in 2006.

(Note that Alan is entitled to deduct $122,500 but reports only $10,000 of alimony income. Unless he has substantial additional income from other sources, most of the deduction will be wasted.)

Problems 2-9

<table>
<thead>
<tr>
<th></th>
<th>2005 Recap</th>
<th>2004 Recap</th>
<th>Total</th>
<th>Alan’s Tax Consequences in 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>0</td>
<td>70,000</td>
<td>70,000</td>
<td>$50,000 alimony income; $70,000 recapture deduction</td>
</tr>
<tr>
<td>3.</td>
<td>32,000</td>
<td>47,500</td>
<td>79,500</td>
<td>*see solution below</td>
</tr>
<tr>
<td>4.</td>
<td>95,000</td>
<td>67,500</td>
<td>162,500</td>
<td>$60,000 alimony income; $162,500 recapture deduction</td>
</tr>
<tr>
<td>5.</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>$200,000 alimony income; no recapture</td>
</tr>
<tr>
<td>6.</td>
<td>0</td>
<td>7,500</td>
<td>7,500</td>
<td>$70,000 alimony income; $7,500 recapture deduction</td>
</tr>
<tr>
<td>7.</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>no recapture in any year</td>
</tr>
<tr>
<td>8.</td>
<td></td>
<td></td>
<td></td>
<td>2005 is the first post-separation year. $15,000 is recaptured for 2006 and $17,500 is recaptured for 2005; total recapture in 2007 is $32,500.</td>
</tr>
<tr>
<td>9.</td>
<td></td>
<td></td>
<td></td>
<td>2006 is the first post-separation year so the payments are $1 million in 2006 and zero in 2007 and 2008. $985,000 is recaptured in 2008.</td>
</tr>
</tbody>
</table>

*Problem 3 solution:

$137,000 - $90,000 - $15,000 = $32,000 recaptured for 2005
$137,000 second year - $32,000 recaptured = $105,000 adjusted 2005 alimony
$105,000 + $90,000 = $195,000 ÷ 2 = $97,500 average 2005 and 2006 alimony
$160,000 2004 alimony - $97,500 average - $15,000 = $47,500 recaptured for 2004
Total recapture is $79,500. In 2006: $90,000 alimony income and $79,500 recapture deduction.
CHILD SUPPORT

When the payor is in a higher tax bracket than the recipient, a couple can save tax by characterizing
some payments as alimony instead of child support. For many years, taxpayers attempted to
“disguise” payments that were essentially nondeductible child support as deductible alimony.

This strategy won support from the Supreme court in Commissioner v. Lester, discussed on
casebook page 836. In Lester, the husband agreed to pay his ex-wife $10,000 of alimony each year
for ten years, but no child support. If their child died or married, the payments were reduced to
$6,000 per year; all payments ended at the time of the wife’s death. $4,000 of the payments that
ended on the child’s death or marriage seemed intended for the benefit of the child and therefore
might be child support. The Supreme Court held that the agreement did not “fix” an amount for the
benefit of the child under § 71(c)(1) so the entire $10,000 payment was deductible alimony.
Taxpayers used “Lester” agreements to save tax. The amount that the payment was reduced when
the child turned 18 or married was essentially child support, but was deductible as alimony.

Congress added § 71(c)(2) in 1984 to reverse Lester. Section 71(c)(2)(A) applies when the
agreement provides that the payments are reduced upon a contingency relating to the child. If the
agreement does not mention the child, but payments are reduced on specified dates, § 71(c)(2)(B)
classifies some payments as child support (depending on the ages of the children on the reduction
dates). Regs. § 1.71-1T(c), A-18, explains this provision and sets forth two situations when
reductions in payments are presumed to be child support.

We will only consider the first situation: When the payments are reduced within six months before or
after any child becomes 18-years-old, the amount of the reduction is presumed to be child support.

Example

Nate pays Rachael the following amounts pursuant to their settlement agreement. If Rachael dies
before 2014, all payments end except $5,000 per year that he will pay to Rachael’s estate. Rachael
has custody of their child Evan, who was born on March 14, 1993.

2004 - 2007: $40,000
2008 - 2010: $32,000
2011 - 2014: $14,000

Step 1: Determine how much of each payment is a property settlement (PS).
$5,000 continues after Rachael’s death so $5,000 is considered a property settlement each year.

Step 2: Determine how much of each payment is child support (CS).
Determine when each child becomes 18 and see if the payments are reduced within six months
before or after a child’s 18th birthday. Evan becomes 18 on March 14, 2011, which is within six
months before or after the payments are reduced by $18,000 on January 1, 2011. $18,000 is
presumed to be child support until 2011, the year Evan becomes 18. The tax status of these
payments is as follows:

2004 - 2007: $40,000 payment - $5,000 PS - $18,000 CS = $17,000 of alimony
2008 - 2010: $32,000 payment - $5,000 PS - $18,000 CS = $9,000 of alimony
2011 - 2014: $14,000 payment - $5,000 PS = $9,000 of alimony

Step 3: Determine how much alimony must be recaptured.
The alimony payments were $17,000 in each of the first three post-separation years, so there is no
recapture.
ADDITIONAL PROBLEMS

Problem 1

Tony and Nancy were married in 1988 and had one daughter born on December 18, 1997. They were divorced in 2005 and Tony was awarded custody of their daughter. The court ordered Nancy to make the following cash payments to Tony. All payments terminate on his death, except $5,000 that will continue to be paid to his estate. What are the tax consequences in 2007?

2005: $205,000
2006: $215,000
2007: $55,000
2008 through 2015: $25,000 per year
2016 through 2021: $15,000 per year

Problem 2

Jamie purchased Ha-Lo stock for $7,000.

(a) She gave the stock to her husband Oscar when it was worth $3,000. What is Oscar’s gain or loss when he later sells it for $1,000?

(b) Instead of giving it to Oscar, she gave it to her son Arthur who later sold it for $1,000; what is Arthur’s gain or loss?

(c) Instead of giving it to Oscar, she sold it to him for its $3,000 fair market value. What is Oscar’s gain or loss when he later sells it for $1,000?
SOLUTION TO CHILD SUPPORT PROBLEM 1

**Step 1:** Subtract payments that continue after death, are not in cash, or are specifically designated as child support. The $5,000 that continues after her death is a property settlement (PS) and is subtracted from each payment. The remaining amounts are $200,000, $210,000 and $50,000.

**Step 2:** Their daughter becomes 18 on 12/18/2015 and the payments are reduced by $10,000 within six months after that date. $10,000 of each payment is child support (CS) until 2016, when the payments are reduced to $15,000. Beginning in 2016, $5,000 of each payment is a property settlement and $10,000 is alimony.

<table>
<thead>
<tr>
<th>Year</th>
<th>Payment</th>
<th>PS</th>
<th>CS</th>
<th>Alimony</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>205,000</td>
<td>-5,000 PS</td>
<td>-10,000 CS</td>
<td>190,000 alimony</td>
</tr>
<tr>
<td>2006</td>
<td>215,000</td>
<td>-5,000 PS</td>
<td>-10,000 CS</td>
<td>200,000 alimony</td>
</tr>
<tr>
<td>2007</td>
<td>55,000</td>
<td>-5,000 PS</td>
<td>-10,000 CS</td>
<td>40,000 alimony</td>
</tr>
<tr>
<td>2008-2015</td>
<td>25,000</td>
<td>-5,000 PS</td>
<td>-10,000 CS</td>
<td>10,000 alimony</td>
</tr>
<tr>
<td>2016-2021</td>
<td>15,000</td>
<td>-5,000 PS</td>
<td>-10,000 CS</td>
<td>10,000 alimony</td>
</tr>
</tbody>
</table>

**Step 3:** Determine how much alimony must be recaptured.

**Recapture for the second year**

200,000 - 40,000 - 15,000 = 145,000 recaptured for the second year

200,000 - 145,000 = 55,000 adjusted second year payment

55,000 adjusted second year payment + 40,000 third year payment = 95,000 ÷ 2 = 47,500 average

**Recapture for first year:** 190,000 - 47,500 average - 15,000 = 127,500

Total recapture: 145,000 + 127,500 = $272,500

In 2007, Nancy deducts $40,000 of alimony and reports $272,500 of recapture income. Tony reports $40,000 of alimony income and deducts $272,500 of recapture as an adjustment.
INTRODUCTION TO THE TAX COMPUTATION AND DEDUCTIONS

A. The Income Tax Formula
The basic income tax formula follows; we will slightly modify it later in the course.

\[
\text{total receipts} - \text{exclusions} = \text{gross income} - \text{adjustments} = \text{adjusted gross income (AGI)} - \text{taxable income}.
\]

\[\text{AGI} = \begin{cases} 
(a) \text{itemized deductions} & \text{"below the line deductions" } \\
(b) \text{the standard deduction} \\
- \text{exemptions} \\
= \text{taxable income}
\end{cases}\]

determine the tax on the taxable income using the tax rate schedules
subtract credits from the tax to arrive at the tax due or refund

B. Exclusions
We have studied the following exclusions:
- receipts with a corresponding obligation to repay (loans and related items)
- gifts and bequests (§ 102)
- the basis of property sold or exchanged (§ 1001)
- gains from the sale of a personal residence (§ 121)
- scholarships (§ 117)
- life insurance proceeds (§ 101)
- the excludible amount of annuity payments (§ 72)
- compensation for personal physical injuries (§ 104)
- meals and lodging on the business premises (§ 119)
- fringe benefits (§ 132)
- tax-exempt interest from state and local government bonds (§ 103)
- flexible spending arrangements for medical expenses (§ 125) and child care (§ 129)

C. Gross Income
Income that is excluded is not reported on the tax return so gross income is the starting point for the tax computation. (Tax-exempt interest is reported on the 1040 as an information item.)

D. Deductions
Deductions are subtracted from gross income to arrive at taxable income. Generally, there are four types of deductions: adjustments, itemized deductions, the standard deduction and exemptions. Adjustments are subtracted from gross income to arrive at AGI. Exemptions, itemized deductions and the standard deduction are subtracted from AGI to arrive at taxable income.
E. AGI and Adjustments

AGI is used to measure the deductibility of several deductions. As AGI increases above specified amounts, various deductions and credits are reduced or phased out. For example, medical expenses are deductible only to the extent the total exceeds 7½% of AGI. Personal exemptions begin to phase out at $150,500 of AGI on single returns and at $225,750 of AGI on joint returns.

Deductions are either adjustments or itemized deductions. Adjustments are “above the line” deductions because they are subtracted from gross income to arrive at AGI, which is “the line.” The substantive Code section does not usually specify whether the deduction is an adjustment or an itemized deduction. Section 62 lists most of the deductions that are adjustments.\(^1\) For example, § 215 does not specify whether alimony is deductible as an adjustment or an itemized deduction. Section 215 is listed in § 62(a)(10), so alimony is deductible as an adjustment. Note that § 62 does not authorize any deductions; it just specifies which deductions are deductible as adjustments.

F. Itemized Deductions and the Standard Deduction

If a deduction is not an adjustment, § 63(d) classifies it as an itemized deduction. Charitable contributions are deductible under § 170, which is not listed in § 62, so contributions are itemized deductions. Itemized deductions are “below the line” deductions and are subtracted from AGI to arrive at taxable income. Itemized deductions begin to phase out as AGI exceeds $150,500.

Taxpayers may deduct the greater of their itemized deductions or the standard deduction, which is a specified amount. The amounts are on h/o 1 and are adjusted for inflation each year. The 2006 standard deduction for a single taxpayer is $5,150 and $10,300 for married taxpayers. The standard deduction is subtracted from AGI to arrive at taxable income.

G. Exemptions

Exemptions are amounts a taxpayer may deduct from AGI for himself, his spouse and each eligible dependent. The exemption is adjusted for inflation each year; the deduction is $3,300 for each exemption in 2006. A married couple with two dependent children deducts $13,200 for exemptions ($3,300 x 4), provided it is not phased out.

The exemption deduction is phased out by 1.33% for each $2,500 that AGI exceeds a “threshold amount” indexed for inflation each year, § 151(d)(3). The threshold amounts for 2006 are $150,500 on a single return and $225,750 on a joint return. If AGI exceeds the threshold amounts, use the tables on h/o 1A (on the back of h/o 1) to determine the amount of the deduction. Prior to 2006, exemptions were phased out by 2% for each $2,500 that AGI exceeded the threshold amount. However the phaseout was reduced by one-third in 2006 and will be reduced by two-thirds in 2008. The phaseout is eliminated in 2010.

Note that itemized deductions begin phasing out at $150,500 of AGI for all taxpayers, single and married. Exemptions, on the other hand, begin phasing out at AGI of $150,500 for single taxpayers and $225,750 on joint returns. These amounts are listed on h/o 1.

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\(^1\)In a few cases, the substantive section authorizing a deduction specifies that the deduction is an adjustment. For example, § 71(f)(1)(B) provides that recaptured alimony is deductible by the payee spouse “in computing adjusted gross income.” This means it is subtracted from gross income to compute AGI, which makes it an adjustment.
H. Itemized Deductions and 2% MIDs

All itemized deductions are either “regular” itemized or 2% miscellaneous itemized deductions (“2% MIDs”). Regular itemized deductions are fully deductible if they exceed the standard deduction, subject to being phased out if AGI exceeds $150,500. On the other hand, 2% MIDs are deductible only to the extent their total exceeds 2% of AGI. If Smith’s AGI is $100,000 and he has $3,200 of 2% MIDs, only $1,200 are deductible; the first $2,000 of 2% MIDs ($100,000 AGI x 2%) are not deductible.

Section 67 specifies which itemized deductions are not 2% MIDs; if a Code section is listed in § 67, the deduction is a regular itemized. As previously mentioned, charitable contributions are deductible under § 170. Section 170 is not listed in § 62, so charitable contributions are itemized deductions, not adjustments. Section 170 is listed in § 67(b)(4), so charitable contributions are regular itemized deductions, not 2% MIDs. Investment expenses are deductible under § 212, which is also an itemized deduction because it is not listed in § 62. It is not listed in § 67(b), so investment expenses are 2% MIDs.

I. Unreimbursed Employee Business Expenses are 2% MIDs

Section 162 authorizes a deduction for expenses incurred in carrying on a trade or business. An employee is in a trade or business – the business of being an employee, so an employee’s union dues are deductible under § 162. As explained above, after you determine an expenditure is deductible, you look at § 62 to see if it is deductible as an adjustment or an itemized deduction.

The first clause of § 62(a)(1) states that trade and business expenses are deductible as adjustments. The second clause states that a trade or business expense is deductible as an adjustment [only] “if such trade or business does not consist of the performance of services by the taxpayer as an employee.” In other words, § 62(a)(1) characterizes the business expenses of an employer or a self-employed taxpayer as adjustments. Employees’ unreimbursed business expenses are not adjustments, which makes them itemized deductions. As with all itemized deductions, you now see if the deduction is listed in § 67(b) to determine if the deduction is a 2% MID. Section 162 is not listed in § 67(b), so employee business expenses are 2% MIDs. This characterization prevents most employees from deducting their routine unreimbursed business expenses.

Example

Harrison, an associate, and Moore, a partner in the law firm of Bleiman & Moore each paid $300 for bar association dues. A partner is considered a self-employed taxpayer for tax purposes. The firm did not reimburse either of them. The expense is deductible as a business expense under § 162. Harrison, the employee, deducts the expense as a 2% MID. Moore, the partner, deducts the expense as an adjustment, which reduces his AGI and increases the deductibility of his other expenses. Furthermore, Harrison can only deduct the expense if her 2% MIDs exceed 2% of her AGI and then only if her itemized deductions exceed the standard deduction.

Tax Computation Worksheet

The tax computation worksheet on the next page will help you classify a taxpayer’s income and deductions. Make several copies of the worksheet and bring a few to each class.
TAX COMPUTATION WORKSHEET  

**Problem:** 

* Make sure to put parentheses around loss amounts; e.g., (1,000).*

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<tr>
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<th>2</th>
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<td><strong>§ 221 &amp; § 222 Adjustments</strong></td>
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</tbody>
</table>
**TAX COMPUTATION EXAMPLE**

**Example**

Engert, a single taxpayer, earned $135,000 as an associate in a law firm. He paid $25,000 of alimony to his former wife (an adjustment), $3,000 for state income tax and $1,200 to his church. State income tax and charitable contributions are regular itemized deductions. He computes his tax as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross income</td>
<td>$135,000</td>
</tr>
<tr>
<td>Minus adjustments (alimony)</td>
<td>-25,000</td>
</tr>
<tr>
<td>Equals AGI</td>
<td>110,000</td>
</tr>
<tr>
<td>Minus standard deduction*</td>
<td>-5,150</td>
</tr>
<tr>
<td>Minus exemption</td>
<td>-3,300</td>
</tr>
<tr>
<td>Equals taxable income</td>
<td>101,550</td>
</tr>
</tbody>
</table>

His tax is $22,766**

*The $5,150 standard deduction exceeds the $4,200 total of his itemized deductions ($3,000 state income tax and $1,200 of charitable donations).

** To compute the tax, refer to the single rate schedule in the right column of h/o 1 and locate the bracket for Engert’s taxable income. His taxable income is over $74,200 but not over $154,800. Referring to the column headings on the tax rate schedule, his tax is **$15,108** (always round) plus 28% of taxable income over $74,200.

$101,550 taxable income - $74,200 = $27,350; $27,350 x 28% = **$7,658**

Total tax = $15,108 + $7,658 = **$22,766**

An easier way to calculate the tax is explained on the next page. However you have to know how to calculate the tax using the tax rate schedules on h/o 1 because you will not have access to the tax calculator during the exam. We will study the tax computation in more detail later in the course.
TAX CALCULATOR

You will calculate the tax in many problems during the rest of the course. It is time-consuming and easy to make mistakes when you use the tax rate schedules on h/o 1 to compute the tax. The tax calculator makes it easy to compute the tax without using h/o 1.

Download the Word or WordPerfect file from the website and follow the instructions below.

Instructions for the Tax Calculator

Word Calculator

Enter the taxable income (without commas) in the column to the right of the appropriate tax bracket on the joint or single rate table. Tab right to the third column and press F9 and the tax appears in the tax column to the right of the taxable income you entered.

WordPerfect Calculator

Enter the taxable income (without commas) in the column to the right of the appropriate tax bracket on the joint or single rate table. Move the cursor up or down to any other cell and the tax appears in the tax column to the right of the taxable income you entered.

The $101,550 taxable income from the example on the previous page was entered in the taxable income column of the calculator and the $22,766 tax appeared in the tax column.

2006 TAX CALCULATOR

<table>
<thead>
<tr>
<th>JOINT RATES</th>
<th>Taxable Income</th>
<th>Tax</th>
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<tbody>
<tr>
<td>Tax Bracket</td>
<td>not over 15,100</td>
<td>7,600</td>
</tr>
<tr>
<td></td>
<td>over 15,100 - 61,300</td>
<td>38,977</td>
</tr>
<tr>
<td></td>
<td>over 61,300 - 123,700</td>
<td>90,200</td>
</tr>
<tr>
<td></td>
<td>over 123,700 - 188,450</td>
<td>163,122</td>
</tr>
<tr>
<td></td>
<td>over 188,450 - 336,550</td>
<td>259,422</td>
</tr>
<tr>
<td></td>
<td>over 336,550</td>
<td>437,622</td>
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</table>

<table>
<thead>
<tr>
<th>SINGLE RATES</th>
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</tr>
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<tbody>
<tr>
<td>Tax Bracket</td>
<td>not over 7,550</td>
<td>1,350</td>
</tr>
<tr>
<td></td>
<td>over 7,550 - 30,650</td>
<td>7,600</td>
</tr>
<tr>
<td></td>
<td>over 30,650 - 74,200</td>
<td>33,000</td>
</tr>
<tr>
<td></td>
<td>over 74,200 - 154,800</td>
<td>101,550</td>
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<tr>
<td></td>
<td>over 154,800 - 336,550</td>
<td>200,500</td>
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<tr>
<td></td>
<td>over 336,550</td>
<td>695,000</td>
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</table>
PRIVATE RULING 9639001 (1996)

ISSUE:
Was the Worker an employee of the Firm for federal employment tax purposes?

FACTS:
The Firm was a sole practitioner in the practice of law. The Firm hired the Worker, a law school student, as a part-time law clerk to perform legal research and assist with litigation support. There was no written agreement between the Firm and Worker. The Worker performed research on various areas of the law and on cases assigned to him. He also performed other tasks, such as preparing complaints, motions, pleadings and memorandums.

According to the Worker, the Firm provided the Worker with instructions and some training. However, it was assumed that as a law school student, the Worker knew generally how to perform the tasks assigned without detailed supervision. The Worker states that he had no prior litigation experience before working for the Firm. The work was reviewed by the Firm and it was necessary for an attorney to sign all legal documents to be filed with a court. The Worker submitted time reports providing a description of the work done and showing the number of hours charged to a particular case and was paid an hourly rate for his services. The Worker did not engage others to assist him in the performance of his services.

The Worker was generally free to set his own hours of work and decide where he worked. Usually, he worked in the Firm's office, at a nearby law school library or in his own home. The Worker was permitted to use the Firm's computer, office equipment, secretarial services and law books. The Firm furnished the supplies the Worker used to perform his services. The Firm reimbursed the Worker for parking expenses.

The Worker performed his services on a part-time, temporary basis. He worked approximately 15 hours per week. Either party could terminate the relationship without incurring a liability. The Worker states that his services were performed under the Firm's business name. He did not maintain an office, advertise, or represent himself as being in the business of providing the same or similar services. Nor did he have a financial investment in a business related to the services performed and could not incur a profit or suffer a loss in the performance of his services. The Worker was not allowed a drawing account or advances against future pay. He was not eligible for a pension, bonuses, paid vacations, or sick pay. The Firm treated the Worker as an independent contractor for federal employment tax purposes and reported his wages to the Internal Revenue Service using Form 1099.

LAW AND RATIONALE:

Section 3121(d)(2) of the Internal Revenue Code provides that the term "employee" means any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of employee. The question of whether an individual is an independent contractor or an employee is one of fact to be determined upon consideration of the facts and the application of the law and regulations in a particular case. Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1. **

Section 31.3121(d)-1(c)(2) of the regulations provides that generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the results to be accomplished by the work, but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done, but also as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if she or he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is the employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished and not as to the means and methods for accomplishing the result, she or he is an independent contractor.

In determining whether an individual is an employee under the common law rules, several factors have been identified as indicating whether sufficient control is present to establish an employer-employee
relationship. These factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. See, Rev. Rul. 87-41, 1987-1 C.B. 296.

Consideration must also be given to such factors as the continuity of the relationship and whether or not the individual's services are an integral part of the business of the employer as distinguished from an independent trade or business of the individual herself or himself in which she or he assumes the risk of realizing a profit or suffering a loss. See, United States v. Silk, 331 U.S. 704 (1947), 1947-2 C.B. 167 .

Section 31.3121(d)-1(a)(3) of the regulations provides that if the relationship of an employer and employee exists, the designation or description of the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

Rev. Rul. 68-324, 1968-2 C.B. 433, examined an attorney who was engaged by a law firm. The attorney was furnished a place to work, performed services for the firm under its direction and was required to work certain hours each day. Under these circumstances it was ruled that the attorney was an employee.

Rev. Rul. 59-49, 1959-1 C.B. 255, considered an individual engaged by a title company to perform services as a title searcher or examiner. The individual examined titles solely for the company and was paid a stated percentage of the fee that was charged to the customer by the company. The fee was the same for each title examined regardless of the difficulty of the examination or the amount of time spent in making the search. The individual devoted approximately forty hours per week to these activities at times of his own choosing during hours when the courthouse was open, since his findings were based primarily on public records kept at the courthouse. The titles were assigned to the individual by an official of the company who was also responsible for reviewing the title work. When an error was discovered, the individual was expected to correct it in the manner directed. The title company provided the individual with a desk and telephone for use in its office together with all necessary forms and business papers. The individual performed the services personally without helpers.

Rev. Rul. 59-49 concluded that the individual was an employee of the company based primarily upon the following factors: an officer of the company assigned the titles to be searched; the work was subject to review by the company's officer; the company determined the price to be charged the customers; and the company provided the individual with office facilities and equipment necessary for the performance of his services. As noted in Rev. Rul. 59-49, "while the company may not exercise control to the fullest degree possible over the services performed for it by the individual in question," it nevertheless retained the right to exercise sufficient control to establish the relationship of employer and employee.

Rev. Rul. 59-49 is substantially similar to the instant case in their most important aspects. In this case, as in the rulings, the Worker performed personal services pursuant to an agreement that was terminable at any time. The Worker was not engaged in an independent enterprise involving any substantial capital investment or the assumption of any risk of loss.

Instead, the Worker performed services which were an integral and necessary part of the Firm's business. The Firm supplied the Worker with a computer, office equipment, secretarial services, and law books. In addition, the Firm stated that it reimbursed the Worker's parking expenses. Although the Worker did not require detailed supervision, the Firm had the right to control and direct the Worker's activities to the extent necessary to assure satisfactory services to its clients.

CONCLUSION:

Accordingly, based on the above information and applicable law, we conclude that the Worker was an employee of the Firm for federal employment tax purposes.
START-UP EXPENSES § 195

The § 195 amortization rules for start-up expenses discussed on 251 have been changed. The Selected Statutes have the amended version. Taxpayers may now deduct up to $5,000 of start-up expenses in the year the business begins. The remaining start-up expenses are amortized (deducted) over a 15-year period, beginning in the year the business begins. The $5,000 amount deductible in the first year is reduced dollar for dollar for start-up expenses that exceed $50,000.

Example

Philco Corporation spends $51,000 for start-up expenses in 2006 and the business opens its doors on January 1, 2007. The start-up expenses exceed $50,000 by $1,000 so the immediate deduction is $4,000 in 2007 ($5,000 - $1,000 in excess of $51,000). The remaining $47,000 of start-up expenses ($51,000 - $4,000 deducted) are amortized over 15 years. $47,000 ÷ 15 equals $3,133 deductible each year for 15 years. In 2007, Philco deducts $7,133 of start-up expenses ($4,000 plus $3,133 of amortized expenses) and will deduct $3,133 in each subsequent year.

If the business fails during the 15-year amortization period, the unamortized start-up expenses are deductible in the year the company goes out of business.

Problem

Read problem 4 on 236. All of the expenditures are start-up expenses except the $100,000 cost of the franchise. (The cost of the franchise is a capital asset that must be amortized over 15 years.) Using the facts of the problem and revised § 195(b), answer the following questions:

(a) How much of the start-up expenses may Phil deduct in the year he opens the business?

(b) Same as (a), except Phil spent $52,000 for start-up expenses.

(c) Same as (a), except Phil spent $60,000 for start-up expenses.

(d) Using the facts in part (c), if the business fails in the third year of operation, how should Phil treat the start-up expenses in that year? See § 195(b)(2).