FED TAX
FALL 2007
HOYT

How to Read Statutes

- 101(a)(2)(A)(i)
  - 101 is section
  - (a) is subsection
  - (2) is a paragraph
  - (A) sub paragraph
  - (i) sub sub paragraph

History of Taxation

- **Type of taxes:**
  - Local/county
    - **Schools (#1)**, sanitation, police and fire
    - Largest source of revenue is property tax; another source is small sales tax
      - High sales taxes will cause people to shop elsewhere and discourages improvement
  - State
    - Education, highways, prisons, roads
    - Source - 50/50 between income tax and sales tax
      - income tax lower in cities b/c easy to avoid; retailers collect sales tax for govt
    - Sales tax is regressive: poor ppl pay proportionately more than rich people
    - Exception: NH has no income or property tax, but has high property tax
    - 9 states do not have income tax (FL, TX, WY, TN, SD, NV, WA, & NH)
  - Federal
    - Social security, military pensions, social service pensions, national defense, etc.
    - Source: Income tax (44%); Corp income tax (9%); Social security tax (40%); Excise taxes (3%); estate taxes (1%); Other (3%)
    - power given by clause in constitution
      - if taxes are levied on US population, must be proportionate to the population
        - have to have a head tax—meaning if VA and NY had same number of people must collect the same from each person
          - income taxes were't allowed so govt got revenue from port taxes
          - until 1900's there was no income tax, only tariffs
          - during Civil War there was an income tax, this was probably illegal
          - Constn said head tax had to be the exact same for every person, in proportion to population
          - Constn amended to remove head tax language **(16th A** in **1913**)—only the rich were taxed
            - 1916 revenue act—estate taxes enacted (hit rich people)
            - 1921: 1st gift tax
            - Pre-WWII only 6% paid income taxes
            - Post-WWII—75% of people were paying taxes
      - 1921: tax statutes somewhat organized but were located throughout Code
      - 1939: dedicated the 19th title of code to taxes; Title 26 = The Tax Code
        - Consolidated existing taxes into one code (instead of being scattered)
      - 1954: during Cold/Korean War—finally got a comprehensive code, however everything thereafter was the 1954 code amended for 1960
      - 1985: Reagan said code was too complicated, so enacted code of 1986 and is amended every year
        - **Tax Reform act of 1986 – amended every year and this is what we now use today**

How is tax law enacted

- It is different from any other law
- Constitution gives special rules for tax law
  - Constn requires that every tax law start in **House of Representatives** (cannot start in Senate)
    - Theory: since Reps are replaced every 2 years, you can vote out people you didn't like to change the tax law

- US legislature is based on 2 part model of VA House and Senate (Madison drafted this)
  - CT (small state) objected, proposed 2 amendments that passed
    - **Every state had 2 senators and**
    - **Must start in house**
- ***BEGINS in Ways and Means Committee:*** House Committee that controls things; drafts tax bill
- **House** approves it then it goes to **Senate Finance Committee**
- **Senate Finance Committee:** Takes bill once it has been approved by House and change/modify/edit the bill, then it goes to Joint Committee
- **Joint Conferences committee of Ways & Means and Senate Finance** – 5 House and 3 Senate and they hash it out (go over it line by line), compromise to one package
- **Goes to House, then Senate for approval**
  - If passes both House and Senate, then goes to Pres for veto/approval (he's never vetoed)
- Executive Branch (Sec'y of Treasury) administers the law through the IRS (biggest of their departments)

Who is involved in the tax-making process?

a) **LEG** – Make the laws and statutes
b) **EXE** – Enact regulations
   (1) Interpretive – EX agency "interprets" what the LEG meant; JUD usually accepts.
   (2) Legislative
c) **JUD** – Interprets the above in courts
   (1) Tax Courts
   (2) Bankruptcy Courts
   (3) Must file a tax case in one of these courts
      (a) Rare to actually go to court
      (b) Most settle beforehand.

<u>TAX RESEARCH</u>

- Two main books—CCH/RIA are about the same
  - CCH (Congress Clearing House)—Standard Fed Tax Reporter
    - Updated weekly, has most recent cases
    - Alphabetical index
    - Organized by Code section
  - RIA (Research Institute of America)
    - US Tax Reporter—updated weekly, has most recent cases
    - Fed Tax Coordinator—For people who have hard time reading legalese (not updated weekly, simplifies law)
      - A sort of treatise on the law, so it doesn't have every case
      - Best for use by non-tax specialists
  - LexisNexis/Westlaw
    - Document retrieval
    - No essays/explanations
    - Lexis is better for tax stuff
  - BNA—Tax Management Portfolio
    - Little books on single subject—good to use for a new topic you aren't familiar with
  - Tax Court Documents
    - Regular decisions
    - IRS Cumulative Bulletin
      - Updated twice/year; a compilation of IRS rulings
- <u>Hierarchy</u>
  - **<u>Tax Code</u>** (passed by Congress)
    - the language of the statute as expressed by Congress
  - **<u>US SC decisions</u>**—very few decisions, aren't very relevant to tax law practitioners b/c about constitutional issues
  - **<u>Regulations</u>** – issued by Dept. of Treasury (executive branch)—not IRS, secret service are agencies under it
    - **<u>types of regulations</u>**:
      - *legislative regulations*—IRS will generally defend to the SC, SC generally agrees w/ IRS
      - *Interpretive regulations*—IRS will always defend to SC, SC generally agrees w/ IRS
        - Ex § 451

        - *Proposed Regulations*—Congress passes a new statute and then Dept. of Treasury will interpret it
            - There is a Notice and comment period w/ proposed regulations and then issue final regulations (allows general public to write in and comment)—dept of treasury will collect these comments but doesn't have to listen (but usually does
            - While waiting for final regulations, can follow these proposed regulations
            - Really aren't law, it just tells what IRS is thinking
        - *Temporary Regulations*—says there is a new law and you need to know right away
- **Court of Appeals Decision**
    - The IRS will feel bound only in jurisdiction where they lose a case (ex – HUNTSMAN CASE)
- **Trial Court Decision** (3 courts have jurisdiction to hear federal tax cases)—can't do in state court (these are in hierarchical order!)
    - US Tax Court is the most popular—can wait to pay taxes until you get the decision—no appeals
        - NOTE – US Dist. Ct. and Court of Claims can ONLY hear cases for refunds – YOU MUST PAY FIRST AND THEN SUE FOR A REFUND.
            - The Tax Court is the only court where they can stay the payment of taxes – can sue BEFORE you pay the taxes
        - Special court in Wash. DC has 19 judges—only hear tax cases—tour country 2X a year to hear cases
        - Don't like litigations—strongly encourage no dispute in facts between IRS and tax payer
        - Two Types of decisions issued
            - *Regular*—important issues—published in US Tax Court Cases
            - *Memo*—routine cases, things that come up all the time—published in separate vol. of CCH or RIA
        - 80% of these cases are tried pro se (w/o lawyer)
        - S cases—small claims court of tax courts < $50,000
            - 50% of all tax court cases are S cases
                - no written opinion
                - CANNOT APPEAL – THE JUDGE'S DECISION IS FINAL!!!!
                - not supposed to be used as precedent
    - US Federal District Court Case—can only handle refund litigation only—really needs to be worth it
        - appeals go to circuit in which you live if you live in KS, appeal in 10th circuit and MO appeal in 8th
    - US Court of Claims—(in DC) can only handle Refund litigation only
        - Is a commercial court for commercial dispute—patent issues, customs issues
        - Really has to be worth it
        - Appeal to federal circuit court of appeals in DC
- **Legislative History**—
    - look at committee reports because they will tell where the current law is and what the proposed law is and why they are changing it
- **IRS** (agency in dept of Treasury that administers tax laws)
    - Public
        - Revenue Ruling—IRS must follow—come out every week in I.R.B. (Internal Revenue Bulletin)
        - Revenue Procedure
            - Get the IRS to do something you want
        - IRS notice
    - private
        - Private letter rulings (PLR)—not supposed to be cited as precedent but often is anyway
            - Tax payer is going to do a transaction in the future and you write to IRS to get their opinion
            - Costs $10,000 to do this
            - The Freedom of Information Act made private IRS tax documents public, but there is a 3 month lag time for PLRs
        - Technical Advice Memorandum (TAM) – Complicated memo
            - Same people that write the PLR write the TAM and will say whether transaction is taxable or tax free
            - Agent contacts D.C. with facts, D.C. will analyze the issue and provides an answer
        - General Counsel Memorandum (GCM)
- Tax Evasion v. Tax Avoidance (Page 2-33)

- Tax Evasion—Illegal
  - ex: receiving payments for services and not reporting it
- Tax Avoidance—legal tax planning
- Reducing tax bill

Objectives of Tax Law:

- **Economic efficiency**
  - Tax law should interfere as little as possible w/ the optimal allocation of resources
    - Taxes screw up economic behavior as people try to avoid them
  - High tax rates effect peoples behavior
- **Equity/Fairness**
  - Horizontal Equity: Provides that 2 people in same economic circumstances should pay the same amount of income tax
    - Important b/c paying same amount will perceive the tax system as fair
    - Violated b/c you pay less taxes if you are married
  - Vertical Equity: Concept that the rich people should pay proportionally more than the poor
    - Best example is progressive tax rates/brackets; see inside cover of book
- **Simplicity**
  - Is imp that tax law can be understood by people—is view of sales tax (income tax not as simple)
  - If not simple, it leads to people feeling that it's unfair, which can cause people to cheat
  - If the IRS is giving refunds and charging people during an audit on a provision—shows that people are not understanding
- **To Promote Specific Economic and Social Objectives**
  - Ie – encourage daycare through tax breaks, discourage smoking via high taxes, etc.
  - Two means
    - **Tax Credits**
    - Collecting tax for a program
    - Providing deductions for a particular service (day care tax break; homeowners exception)
      - In Canada, no deduction for homeownership—means more people rent
      - In US, deduction for homeownership—means more people own
- Equity and Simplicity often conflict w/ one another

BASIC TAX CONCEPTS

d) **Income** – All the taxpayers income, both taxable and nontaxable. Does not include a return of capital or receipt of borrowed funds.
   i) **Example** – wages (taxable)
e) **Exclusions –** Certain types of income excluded from the income tax base
   i) Accident insurance proceeds; child support payments; SS benefits; life insurance, gifts
b) **Gross Income –** IRS definition: "Except as otherwise provided (i.e. exclusions)… All income from whatever source derived."
   i) Alimony; Awards; back pay / bonuses / commissions; Interest; Rents; Salary; Severance; Essentially, EVERYTHING.
c) **Adjusted Gross Income (AGI)** – Subtotal, that serves as the basis for computing limitations on itemized deductions.
d) **Itemized Deductions** – Specific personal expenses Congress has allowed as deductions, reduces your income
   i) Medical expenses, certain taxes and interest, and charitable contributions.
e) **Standard Deduction –** Specific amount, depending upon the status of the taxpayer, that can be deducted from tax liability.
f) **Personal and Dependency Exemptions** – Exemptions allowed for the taxpayer, spouse, and each dependent.
   i) **Personal Exemptions** – Idea that someone with little income shouldn't be taxed; allows a specified amount of income to be exempt from tax.
   ii) **Dependent Exemptions** – Exemption for each eligible individual (see below to determine who qualifies as a dependent).

INCOME – WHEN DO YOU FILE A RETURN?

- <u>**Taxable Income Formula**</u>
  - **AGI - standard deduction <u>or</u> itemized deduction – personal exemption (dependent) = taxable income**
    - If Itemized deductions are less than standard deduction then use standard deduction
    - If over age 65 or blind add more to deduction
      - <u>Blind = $1,100</u>
      - <u>Over 65 = $1,400</u>
  - Tax return required when:
    - Must file if *gross income is **greater** than standard deductions + exemptions*
    - Table 3.6 Filing Levels (includes blindness & over 65)
    - Self-employed with net earnings of $400+ must file regardless of gross income
- Standard Deduction 2009 - $5,700
- Personal Exemption 2009 - $3,650 (this can be for you or your dependent)
  - 2009 gross income: $9,350 (must file)
- After these 2 deductions (that you get right off the bat) you now have your TAXABLE INCOME
- if your income is under this gross income amt ($9,350), then you don't have to file a return
- The second column is for inflation
- <u>For Dependents</u> (exceptions for filing p 3-26)
  - **Earned Income** – labor, employed (social security taxes)
    - Must file if only have earned income and gross income > total std deduction
  - **Unearned Income**- investments, savings account (no taxes w/held)
    - If *only* have unearned income and gross income is > $950 + additional std deduction allowed for the yr, then you have to file; if < don't have to file tax return
      - Child must file if earn more than $950
  - If child has both earned and unearned?
    - **Pg. 3-26** go through test above, if they are more or less
    - If gross income > larger of: $950 *or* earned income + $300 (lmtn to basic std deduction), + additional std deduction allowed for the yr
    - Capped at 5,700
      - This means if the amount is over the $950 or EI+$300, and over $5,700, then the $5,700 is the deduction you can allow. If less than $5700, then deduct that amount.

1040 – B-6, 7
FILING STATUS (determined on the last day of the year)

Single	• highest tax rate • Get to 35% faster if single then do if you are married • *basic Standard Deduction for 2009: $5,700* • *Each Additional Standard Deduction for 2009: $1,400*

Married Filing *Jointly*	• Lowest tax rates • Means both spouses sign form and both are responsible legally (liable for spouse) • *basic Standard Deduction for 2009: $11,400* • *Each Additional Standard Deduction for 2009: $1,100*

Married Filing *Separately*	• highest tax rates
	• Means file own separate return, are only liable for own return
	• You might do this even if can file jointly if you do not trust the other spouse (cheat on taxes)
	• Usually don't file this way
	▪ *Basic Standard Deduction for 2009: $5,700*
	▪ *Each Additional Standard Deduction for 2009: $1,100*
	▪ Each reports own income, exemptions, deductions & credits
	▪ Marriage Penalty – when it is more advantageous to file separate returns & be single, usually when both spouses have large incomes (Congress has taken steps to reduce the effect of this)
	▪ Limitations:
	  • If either itemizes, both must itemize
	  • Cannot claim earned income credit & credit for child and dependent care expenses
	  • No deduction for interest paid on qualified education loans
	  • Only $1500 of excess capital losses can be claimed

Head of Household	• Generally single parent – this is the best way to think of it
	• Pay middle range of tax
	• *Basic standard deduction for 2009:$ 8,350*
	• *Each additional standard deduction for 2009: $1,400*
	• TEST:
	• 1. Unmarried individual at the end of the year
	  o Exception to the UNMARRIED requirement
	    ▪ **Abandoned Spouse**—you are married w/ a QC and your spouse had not been a member of the household for the last 6 mos of the yr (July-December)
	      • Spouse walks out in May and can't find to sign joint return—can file HoH
	      • Spouse walks out in Oct and Can't find to sign joint return—can't file
	      • Must have a QC (not QR)
	• 2. Pays more than ½ the cost of maintaining a household for the dependent living with you
	• 3. Live w/ a dependent (QC or QR)
	  o Exceptions to the DEPENDENT requirement
	    ▪ Child does not have to be your dependent (deals with divorce situations where non-custodial parent claims child as dependent)
	      • Dad pays child support so he claims child as dependent, mom would claim head of household
	      • If mom is unmarried, and daughter (age doesn't matter) who is broken up w/ her husband and moves back in w/ mom, mom can claim head of household
	      • If child is married then CANNOT be a dependent
	    ▪ Dependent **parent** does **not** have to live w/ you
	      • Often kids take care of elderly parents, could take mom as a dependent even though she doesn't live w/ you as long pay ½ of moms living expenses—qualifies if mom is living in nursing home

Qualifying Widower (Surviving spouse)	• *Basic Standard Deduction for 2009: $11,400* • *Each Additional Standard Deduction for 2009: $1,100* • qualify for the married filing jointly (lowest rates) • If spouse in married couple dies: Can file jointly in the yr of death; if have dependent child (next yr file as single); can file jointly for 2 yrs following yr of spouse's death. After that, must file as per your current status (married/single/HofH)
Test for Filing Status	• TEST: what were you on the last day of the year • If you get married on Dec. 31st, you were married all year • If you get divorced on Dec. 31st, you were single all yr
Defense of Marriage Act	• Fed law defines marriage as b/t 1 man and 1 woman—even if state has exception for homosexuals,

	doesn't apply for federal purposes

- **Deductions**
  - Can do standard deductions or itemized deductions
    - Standard deductions
      - Single: $5,700
      - Married Joint $11,400
      - Over 65 get an extra $1,400
      - Blind get an extra $1,100
    - Itemize (1/3 of people do this)
  - Personal deductions and dependents
    - For yourself get $3,650
    - Get **$3,650** for each dependent
  - **AGI—Standard deductions—personal exemptions—dependent exemptions = taxable income**
  - Dependents: Is either a qualifying child or a qualifying relative

Test For Dependency Exemption		
	Qualifying <u>Child</u> **(used for tax statutes too)**	**Qualifying <u>Relative</u>** **(don't have to apply to child under 18, but once turn *19* have to apply)**
Relationship 1. Child (incl step, foster, adopted), brother/sister (step), or descendent of any of these 2. Other blood relationship (*cousins* don't count though) 3. Unrelated "member of household"	1. Yes 2. No 3. No	1. Yes 2. Yes (parents, grandparents, uncles, aunts, in laws) 3. Yes
Age 1. Child under age 19? (under age 24 if FT student—FT student exception)	1. Yes	1. N/A (child over age 18 can be QR if pass support and gross income tests)
Abode (>1/2 year- Abode- must live w/ taxpayer for over ½ the year, exempt for school, illness, military service; FT student exception)	1. Yes	1. N/A (except for household member)
Support 1. Pay > 1/2 of dependents support? • only applies to QR unless - rich child pay > 1/2 of own support can't be dependent	• N/A *(rich child)	1) Yes: Food, clothing, shelter, and med care • **<u>Multiple Support Agrmt</u>**: for when children are providing care for elderly parents but no one provides 50% of the care so they can agree to allow one of them to take the exception
Gross Taxable Income Less Than $4,000? 1. Dependent has less than personal exemption of taxable income or $4,000+ (only applies to QR)	1. N/A-- NO income test	Yes, This is what knocks most people out of qualifying relatives
No Joint Return by Married Dependents - **exception – if you have no liability filing separately, you are OK filing a joint**	1. Yes (if under 18)	1. Yes

return		
Citizen/Resident of US, Mexico, or Canada	1. Yes	1. Yes
Qualifying Child Tie Breaker 1. Parent trumps claim of non-parent 2. 2 parents want to claim?—Whoever has custody more during the year wins 3. Can't tell who has more custody?—Richer parent claims* *watch out—if too rich, deduction phases out—want to give deduction to person who can use it		
Divorced Parent 1. Custodial Parent Gets Dependent Deduction		

        - If you meet the criteria for the rich, then you don't get the exemption for yourself or kids
            - Really rich people (over $250,200) don't get any tax reduction (p 3-18)
        - **Rich Child**
            - Parents shift wealth to child which made some income tax free or taxed at a lower rate
            - Congress changed the law by making the std deduction = the greater of either the earned income + $300 OR $950
                - The cap on this is $5700—meaning the most the exemption can ever be is $5700
            - If the parents are claiming the child as a dependent they can't take the personal exemption, so the child's taxable income is lowered b/c they can't take the standard deduction
        - **Kiddie Tax** (tax rate pd by dependents)
            - **Effective in 2006**: up to age 17 but not 18 subject to kiddie tax
            - Once you have taxable income, if you have *unearned* income of > $1,900, the extra income is taxed at the parents' rate
            - If it is under $1,900 it will be taxed at 10% but anything over will be taxed at parents rate
            - Subtract same std deductions, no personal exemption
        - **Multiple Support Agreement**
            - Permits one of a group of taxpayers who support to claim a dependent even if they each don't contribute more than 50% but they must at least contribute 10%
            - Might not want to agree to take this on if you make too much or not enough money – WILL YOU OBTAIN A TAX BENEFIT FROM THIS?
        - **UTMA (Uniform Transfer to Minors Act)**—says a child can own anything an adult can
            - Idea is that parents own stocks and transfer the stocks and the bank account to the child
            - If the parents want to save for college and parents are 35% tax bracket and child in 10%--look at chart to see the difference in income
            - just have to make sure income stays under $1,900 or will be subject to the Kiddie tax
    - **Dependents tax return**
        - If dependent is claimed on parents' return, dependent can't take personal exemption for themselves—each person can only have 1 exception (has to file own return, can't file on parents')
            - std deduction is the greater of $950 OR their earned income + $300
- **Phase Out of Exemptions**
    - If you file joint return and income is > $250,200, can't take deductions, (amt lower for other filing statuses)
    - This is important in divorce—b/c only 1 person can get deduction, the temptation is to give the exemption to the richest parent *but* if they are making too much they lose the exemption—want to give it to someone who can actually use it
    - In divorce a different law trumps everything, the custodial parent gets the deduction

- **Everyone files own tax return, EXCEPT when file jointly**
    - The SOL for the IRS collecting taxes is **3 years**
    - You are liable for your spouse even if they, themselves, are not cheating
        - Innocent Spouse Defense – not liable if did not know they were cheating on taxes
            - Objective standards – should have known/reasonable person
        - Threats of physical violence is always a defense – Form 8857

WHO IS TAXPAYER: WHO HAS INCOME

- <u>**Sources of Income**</u> **What is taxed/ Who is taxed?**
    - **Personal Services (labor) – earned income**
        - Income must be included in gross income of person who earned it (*Lucas v Earl*)
            - <u>**Lucas v. Earl**</u> – wife contracted with husband to receive ½ of his income. Justice Holmes used the "fruit and tree" metaphor to explain that the fruit (income) must be attributed to the tree from which it came. (Mr. Earl's Services)
                - A mere assignment of income does not shift the liability for the tax.
        - <u>Services of an EE:</u> Services performed by an EE for the ER's customers are considered to be performed by the employer. (ER taxed on income from services)
        - <u>Services of a Child:</u> Child's income must be included on the child's AGI
    - **Income from Property – unearned income (taxed to the owner of the property)**
        - Interests, dividends, rent; Interest Income (stocks, CD's, or property)
        - Income is taxed to the owner of the property
        - <u>Interest</u> – accrues daily - Depends on method of accounting & method of transfer
            - Gift – donor must recognize his share of accrued income at the time it would have been recognized had the donor continued to own the property
            - Sale – at the time of the sale
        - <u>Dividends</u>
            - Corporation taxed on earnings
            - Shareholders taxed on dividends paid from corp's after-tax earnings
                - If sold – before or after the dividend is paid – the purchaser is taxed
                    - Ex – even if I designate interest or dividends to go to another person instead of me, I am still entitled to receive them and am responsible for the taxes to them.
            - Actual or constructive earnings
                - Constructive = s/h's use of corporate assets
            - Post-2002, taxed at same marginal rate as capital gains (but not reduced by capital losses)
    - Income received by an agent
        - Income received by a taxpayer's agent is still considered to be received by the taxpayer.
            - Thus, wages, no matter who gets them (garnishment, etc.) are still taxed to me.
    - Income from partnerships, S-Corps, Trusts, and Estates
        - Partnership itself does not pay taxes, but rather the partners must report their own share of the partnership's income.
        - S-Corps can pay taxes like partnership (i.e. shareholders pay their share of income)
        - Beneficiaries of Estates and Trusts are taxed on the income earned that is actually distributed to them. Income not distributed is taxed to the estate or trust.
            - Ex. If you don't get trust money you don't have to pay taxes, but the trust is taxed on what it earned.
    - Income in Community Property states
        - Property owned by married couple is taxed according to whether it is held as separate property or marital property.
- **Who is the taxpayer—determines who the IRS can go after to collect taxes**
    - 2 times when there is liability for another
        - <u>**Joint tax return**</u> (liable for spouse)
            - If divorce and turns out husband cheated on taxes, the IRS goes after easiest person to collect from, usually wife b/c she gets steady job and good credit and husband can't be located
            - **Innocent Spouse Defense**: didn't know spouse was cheating on taxes (form 8857)→ IRS is required to prove that the wife did know about the fraud
                - Typical problem is that wife knew/should have known b/c husband was making too little money to be living the lifestyle they were living (constructive notice)
            - Abuse to spouse is an *absolute* defense
        - <u>**Trust Fund Withholding Tax**</u>: when ER pays EEs and says they are w/holding the tax but in fact ER hasn't been w/holding the taxes and they can't IRS, IRS will go after anyone in the company—advice should always be to pay the withholding taxes before paying EEs
            - Impossible to win in these cases

            - 100% penalty tax- whoever was supposed to forward the $$ to the govt will personally have to pay what should have been pd
- Cases
    - *Chambers v. Commissioner of IRS*
        - Tax court- special court whose only job is to try cases (federal tax cases only)
        - Facts: Chambers represented himself; argues he should only have to pay taxes on the amount of income he received, and not on the amount that was garnished
        - Court decided Chambers had to pay the taxes on the garnished wages
        - He earned them therefore they are taxed to him (income from personal services must be included in the gross income of the person who renders the services)
    - *Schuster v. Commission of IRS*
        - nun signed vow of poverty; becomes a nurse for clinic- Convent claimed nun was agent on their behalf so it was tax free but clinic wrote checks to nurse
            - Ct determined that it was taxable; nun could claim charitable donation exemption (max is ½ of salary) and the rest is taxed to her
    - Two Requirements for Self-Incorporation:
        - Individual must submit themselves to the control of the corporation (essentially a labor contract with one's self).
        - Employment contract must be with the corporation.
            - Doesn't matter where the money went, matters who the contract is with. (taxed to the person who does the work)
- Tax Planning (Saving Money For/Through the Kids)(Playing Games With Tax Rates)
    - Tax planning can make a lot of sense sometimes
        - Example – Parents want to set aside money for a child. They can put money into account under kid's SS#. This allows the money to be taxed at a much lower rate (15% kid rate) than the parents might have (35%); interest can be earned much faster, allowing the account to grow. End result after a number of years: $400 v. $100 in interest earned.

- Self- incorp: Forming own personal corporation
    - Must be very careful to always use letterhead and stationary w/ incorp name on it
- Accounting methods
    - Cash basis—Revenue – Expenses = Profit

When is Income

- **Defer income and Deduct early** (IRS wants the opposite)
- Tax deferral is good because it allows you to keep money and invest the money.
- W/ deductions- you want to put them in earlier rather than later-- then you get money earlier

- **§ 451 Gen rule for taxable yr of income:** The amt of any item of gross income shall be included in the gross income for the taxable yr in which *rec'd* by the txpyr, UNLESS, under the method of accounting used in computing taxable income, such amt is to be properly accounted for as of a diff period
  - Include in the year you get income (Cash Method)
  - Include when you earn income (Accrual Method)
  - **Regulations**: will have a # and a dot before the code § #
    - *Interpretive Reg*- where agency simply takes a stat and w/o being asked they interpret it b/c law is ambiguous
    - *Legislative Reg*—Statute itself says Sec'y of Treasury shall issue regulations
      - **ct will often give more deference to legislative reg and less to interpretive reg**
  - § 1.451: Regulation Interpretation of § 451; gains, profits, and income are to be incl'd in gross income for the yr in which they are actually/constructively rec'd by txpyr
    - (-1) Actual Receipt – When actually get money
      - Delivery to agent is the same as delivery to principal
      - Mailbox Rule: Income is reported on *receipt* of mail
      - Under accrual method, income is includible in gross income when all even have occurred which fix the right to rec such income and the amt thereof can be determ'd w/ reasonable accuracy
    - (-2) Constructive Receipt- when $ made available
      - If payment is made available to taxpayer and actual receipt is not subject to subst'l restriction
        - Check bouncing, negotiations, 50 mile car drive constitute substantial restriction
        - If avoid receipt then taxed as if there was actual receipt

Congress – make laws
Executive Branch – Executes
Secretary of Treasury – Regulations (Interpretation and Legislation)

- **When you have a choice between cash and accrual you want cash if at all possible**

Cash Basis Method ****_Individuals_ usually use this method**** **Is Accounted For When You RECEIVE the Income**	

Income—have income whether actual or constructive receipt	• Actual Receipt: Have the check and have deposited it your account
	• Constructive Receipt (§ 1.451-2)
	  ○ Gen Rule: income, although not in txpyrs possession, is constructively rec'd when it's made available
	  ○ Defense in this situation would be if there was substantial restriction or substantial lmtn
	    ▪ 60 mile round trip is enough
	  ○ ex] if IBM said if you quit now and meet these criteria we'll give you a $20,000 bonus—not constructively rec'd b/c there is a condition of quitting your job
	  ○ if at NYE party client offers to pay you right then and you say no wait till next year—must pay taxes b/c it was *constructively received* b/c it was made available
	  ○ if check bounces **not** constructively received b/c it was not available
	  ○ when there is still price to be pd not constructively rec'd b/c have to work for it; Ex: negotiations
	• Amounts Received Under an Obligation to Repay – you don't have to include funds that you borrow, for while you "gain" money your liability also increases (not real income).

Agents	• Delivery to the agent is delivery to principle and income is recognized even if handed to agent • Doesn't matter when the principle deposits/cashes the payment just when received it

Deductions	• Only actual payment qualifies (461)
	• When you write and deliver a check—it is a deduction
	• Mailbox Rule: only time tax law favors cash method
	  ○ Your client is a LL and T puts check in mail in Dec. and LL doesn't get the rent till Jan. when does T deduct rent
	    ▪ T can deduct rent in Dec. when they wrote the check, the post office is deemed to the

	agent of the LL o When the check is large make sure send by certified mail b/c IRS could want to make sure it was mailed o LL will not attribute it as income until it is received • If pay by credit card—you deduct when you charge it o Logic is that when you charge something you are essentially taking a loan from the bank
Prepaid Income	• If get income in advance, you own taxes on when it is **received**—pay taxes on prepaid income • If client is LL and wants 1st and last month rent—has to pay taxes on both • Not as complicated as prepaid expenses
Prepaid Expenses	• **General Rule**: you can't deduct in year of actual payment, must allocate over the time period (can't deduct in advance for expenses must allocate). You will be only allowed deductions from year to year, not all at once on one year. o Example – I win a $3 million settlement, and I know I will have to pay taxes on it at the end of the year. I want deductions, so I pay the entire next year's rent for my new office building up front on Dec. 1. That expense cannot be deducted – only one month (Dec.) can be deducted; the rest (Jan-Dec) could be deducted next year. o **Exception** where can deduct expenses in advance ▪ **One year Rule**: **<u>Zaninovich</u>** – common law (only applies to business expenses)—as long as payments don't extend beyond one year you can take the deduction in year of payment (doesn't have to be calendar year) CASH METHOD ONLY (Accrual method, you must apportion) • could be more then 1 actual year, just must not span more then 2 different years o Ex: if you have an expense that you pay in July 2003 that is for 15 months, could take the deduction in 2003, as long as time frame doesn't extend into 2005 o Example of magazine subscription and insurance, you have to pay up front o **Exception** to 1 year rule: **Can't deduct prepaid interest 461(g)** ▪ Reason is b/c Congress passed a law saying can't do that – where statute conflicts with common law, statute wins (461 is legislative reg, so more power than interp reg – can tell because in statute it gives power to secretary to prescribe reg.) o **Exception to Exception**: ▪ You can deduct points on mortgage for your principle place of residence in the year in which you took out the loan ▪ Statute doesn't say whether refinancing is allowed, but IRS has said it is not ▪ If you are buying a vacation home, doesn't count b/c not primary residence—must allocate points over life of loan ▪ Rental property doesn't qualify either b/c not primary residence, and neither does a vacation home • Example: If you buy a house in 2003 can deduct all points in 2003, if you refinance in 2005 then you have to amortize the points for the life of the loan, if you refinance in 2007 you can take the remaining points from the 2005 refinance in 2007 but have to amortize the points from 2007 for the life of that loan o This came from a private letter ruling which is something you get from IRS which is almost bullet proof and they are not supposed to be relied on o When you have a client having a problem that is not explained by the regulations or by the statute then you can search these private letter rulings and when you find several of them going your way you can tell your client they likely can do this and then have them staple the rulings to their return when they mail it in
Huntsman Case	• 25 years ago interest rates were really high and people had hard time getting loans, people would basically sell their homes and allow other to technically rent the home from them for a few years and then get the loan on their own worked like a balloon payment • IRS said wouldn't let the people deduct points on the loan to pay the balloon payment b/c it was technically a refinance • 8th Circuit said that they could deduct the points b/c it was necessary to buy the house under the circumstances • IRS decided not to appeal but stated that they will follow this ruling in the 8th circuit but are waiting for another case w/ similar facts in another circuit and then they will fight the case there o **Golson Doctrine**: says that you can safely tell your client in that circuit that they are safe, but are

	not safe necessarily safe in another circuit ○ This will only work in the 8th but no other circuit, and they want to re-litigate in others to get a different outcome ○ If there is a split in the circuits then the Supreme Court will have to step up and make a decision, they are waiting for this to happen • The IRS wants to sue in another circuit in hopes that the decision will come out differently and then the SC has to take the case to determine which circuit is right b/c it is a national law and must be uniform across the country

If LL demands pymt in advance of last mos rent
- if you pay it, LL will have to recogn the rental income for 2007 in 2006
- tax planning: call it a deposit

What about deductions for business expenses?
- Mailbox rule w/ deductions pd
- LL doesn't have income until next yr, but there is a special tax break that you can get the deduction in 2006 when you put the $$ in the mail
- PO is agent for LL, you get the tax deduction the day you put it in the mail

W/ CC- it goes on day you charged/made the transaction
- CC bills are well organized

What about prepaid expenses?
- LL says you have to pay rent in advance (LL will be taxed on this)
- Can you get income tax deduction for that
  - Gen rule: you have to allocate it to the time period, it's not when you write the check, its when the expenses occurred
  - Tax break
    - Exception: ***1 year rule***- if the expense that you are prepaying is for an expense that will take place in the next calendar yr, then you are allowed to deduct it in the yr pd (*Zannovich)*
    - Exception: ***prepd interest***- statutory law trumps common law
      - Prepd interest has a stat stating that it cannot be taken early
      - Ie] you pay $3000 in interest for mo of Nov, Dec, and Jan in Oct 2006. Only $2000 can be taken on 2006, The other $1000 is takes on your 2007 return
      - If taxable income is pd under cash receipts method, interest is pd by taxpyr which is properly allocable to any period

Private Letter Ruling 8637058
- Year (86), Week of year (37), ruling (58)
- Ask the IRS a question directly with a letter
- 14,000 a year
- They apply only to the person who asked for it, not a blanket for all cases with the same fact pattern. It is not precedent
- The written ruling is like an insurance policy, and unlike the telephone call to the free number, you will be safe with this advice
- Now they are numbered like this, **200437058**, because of Y2K
- It now cost $10,000.00 to do this, in '86 it was free
- You should attach a copy of this letter to your tax return
- Usually the IRS goes with your conclusions unless it is new law that is still un-litigated
- **TAM** – Technical Advice Mirandum, the IRS auditor asks these same people to do essentially a private letter ruling

Note:
1.451-1
→What type of statute is being interpreted is the number before the (.) Number to left of dot
→Number to the right of the dot (.) is the statute being interpreted.

Accrual Method • *****Businesses* usually use this type****	
Income Generally:	• If you use accrual on the books then you have to for taxes • Many businesses are required to use the accrual method • There are three exceptions where the business can use the cash method

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1. Farming business
2. Qualified personal service corporation (law)
3. Entity who is not a tax shelter and whose average annual gross for the most recent 3-year period are $5 mission or less, (this number may now be $10 million)
You have to use this method if you have $1 million in sales and inventory
Report taxable income as it is earned not when it is received
Two Part Legal Test:

Have all events occurred which fix the right to receive the income?
Can you determine the amount w/ reasonable accuracy?

Constructive Receipt: does not apply to the Accrual method
Disputes: only time you don’t have income

If there is a dispute about the entire amount of income—none is recognized
If there is a dispute about a portion of the income—undisputed part is recognized, disputed portion is recognized when dispute resolved (not necessarily when paid)

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<tr><td>Prepaid Income</td><td>

Tax due on prepaid income when you EARN it

TEST – Have all events occurred?
TEST – Can the amount be reasonably determined?
Example – someone pays you 3 months ahead on rent; then you can defer it/count it each month, regardless of getting it early.

Advanced payments from customers are treated as pre-paid income and are taxed in the year of receipt.

Example – on December 31, 2000, you pay your landlord $4350 for next year’s rent; LL must count that payment as income for 2000, not 2001 which is when the money would be applied.

Deferral of Advanced Payments for Services

Taxpayer can defer recognition of income from advance payments for services (as above).

Example – on Jan 1, 2000, ABC Corp. is prepaid for next 24 months of a service contract; it can defer 50% (12/24)(next year’s) payment until the next tax period (2001) since it will not be “earned” until that period.
Must be required payment, not a voluntary payment.

Tax law follows actual receipt

Applies even if there is a dispute

Lawyer cash sends out bill for $300, after payment client says wait it should only have been $200, you owe me $100—must recognized all $300, later can deduct the $100 when you pay it back

Businesses don’t use the actual receipt method, they would allocate prepaid income to when it is actually earned—causes businesses financial statements and tax statements to be very different

Congress decided to make some exceptions to the actual receipt method to make it easier on the business

Says if you sell goods and you say haven’t gotten money yet—okay just use what would for books

Services: 2004-34

Have a snow removal business and ways they will remove snow and payment is demanded up front—if follow actual receipt method would have to pay taxes on everything at time of payment
If meet the following criteria

Service
Not rent or interest (doesn’t apply to LL)
Then can allocate it you allocate on your books, but the maximum is into next year

Example: client A who pays $400 for one season—client B pays $1600 for 4 years

For client B would let you recognize $100 in 2005, but have to recognize $1500 in 2006

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<tr><td>Prepaid Expenses</td><td>

Always allocate, there is one 1 year rule for accrual method b/c no economic performance has occurred b/c paying in advance

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<tr><td>Deductions (461)</td><td>

3 Tests

all events occur which fix the fact of liability 461(h)(4)
the amount is ascertainable 461(h)(4)

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<li style="list-style:none">
economic performance has to have occurred 461(h)
the all events test shall not be treated as met any earlier than when economic performance w/ respect to such item occurs
Subsection (2) time when economic performance occurs
Economic performance occurs as such person provides such services
For use of property economic performance occurs as tax payer uses such property
Want to tax on profit that is made, so deduct when the expenses occur, not when they are paid
Makes cash flow less important and makes it so taxed on profit
Example:
Stenographer comes in and says bill is $600, you said you thought it was only $400—when you dispute a bill, you can only wait on the party that is not in dispute, so must pay the $400 and wait on $200
Client has a loan on 1/1/2004 for $20,000, on 1/1/2005 paid $20,000 back
In what year would the lender have actual income under the cash method?—2005
Borrower would get the deduction in 2005
Lender is accrual method, contract said payment due 1/1/2005
Borrower: what year did accrual method taxpayer have income—2004 b/c in 2005 the loan is paid off therefore all the interest was actually earned in 2004
Borrower: for deductions 2004

</td></tr>
<tr><td>Exception for Tort Cases w/ Deductions</td><td>

Structured settlement: when calculate the damage for tort victim, might say that victim needs 20 years of physical therapy at a cost of $10,000 per year = $1 million now
Client burns all money so now companies put the money in annuities which pay to the victim in disbursements
Company would deduct all $1 million in the year the annuity was created, congress said no, you can't do that must amortize for life of annuity
Applies to tort and workers compensation
For structured settlements we make the accrual taxpayer be on the cash basis method
Example:
Client came into office and there was a dispute—uses accrual method
Had a computer consultant come in 2003 and had a $10,000 dispute b/c thought work was bad, settled for $3000 in 2004, paid in 2005
In 2003 had a P fall on ice dispute for $20,000, settle for $4000 in 2005
Computer
No liability in 2003 b/c all of bill disputed
Would take the deduction in 2004 when settlement was reached, not when payment made
Plaintiff
No liability in 2003 b/c entire bill is disputed
Can't take deduction in 2004 even though all tests are met b/c there is a special rule for torts—therefore deduction would be in 2005, the year of payment

</td></tr>
<tr><td>Who must use the Accrual method?</td><td>

Business' w/ a lot of inventories
Manufactures
Retailers
Merchandizing
Corporations
Exceptions for Corporations
Chapter S Corporations
Corporations who have lobbied to be able to use cash method
Some service providers—Dr.'s, Lawyers, etc.
Option to use Cash method
If total receipts are under 5 million a year
If between $5 million and $10 million as long as inventories are not main business—Ex: Construction Co.'s
Have to use same method as you use on financial statements
Always want to recommend Cash method

</td></tr>
<tr><td>What is Income—Clash</td><td>

Economic Theory (Haig-Simon)—Change in value of your assets between beginning and end of year
FMV of assets at the beginning of the year – FMV of assets at end of year + dollars consumed +

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between Accountant and Economic Theory (1913)	Imputed Income (wealth you have where money didn't change hands—Ex: growing own vegetables or money you would pay for rent if own home) • Accountants Definition: ○ Transaction value = Income (have you realized a gain or loss?) • Supreme Court went w/ accountants definition b/c it would be easier—get taxed when sell property, not when it increases in value w/o sale

- Related-Party Transactions
  - The Code places restrictions on the recognition of gains and losses from Related Party Transactions…otherwise, families would abuse it to produce tax savings of little substance.
    - Example – a family business hires their kid, who works in Dec. 2000; they pay him in Jan. 2001 (thus deferring the expense until 2001 tax year). Is that permitted, since he actually earned it in 2000? NO
      - IRS didn't like this, came up with Code §267(a)(2)(a)-(b) – if related persons, payment must occur on date earned.
        - I.e. – Cash Method, not Accrual Method
        - Applies to any payment made to a relative
        - The same situation, with a non-relative, is permissible.

INCLUSIONS—receipt that you get that is taxable income, interest income, dividends, rents

- Annuities
  - Portion that is profit is an inclusion and is taxable, portion that is a return on investment is excludable
  - Example: If you give an annuity company $100,000 and they say they will give you a check for $15,000 every year for the next 10 years, the amount above the $100,000 is profit and is taxable ($10,000 of the $15,000 every year is a return on investment)
  - **Tax Calculation in an Annuity**
    - Rule: Of money received, (employee's investment amount/ number of anticipated monthly payments), this will equal the amount you should deduct from each monthly payment. –- investment 1/3 is tax-free, 2/3 is taxed as income. ***CONFIRM THIS.***
    - if live beyond life expectancy, all is taxable
    - if you live after capital paid off = no more deductions
    - ***if you die early*** = survivor files 'short form' + can deduct all remaining capital
    - ***if die before life expectancy*** – the year of death, only include amt. received
    - If you receive less than your $50k, you take a deduction for the un-recovered portion of the payments in your last taxable year (i.e. only see $20k, you deduct $30k from that years income.)
  - **Annuity penalty** – if take out $ before 59 ½ years old, receive 10% penalty
- Prizes and Awards
  - You are taxed on the FMV of the prize (if find same thing at cheaper price, you can staple a copy to your return)
  - Exceptions:
    - Prize--where its tax free
      - Contest you never entered (Nobel Prize, Pulitzer Prize)
        - Can't have entered the contest or taken any proactive action, just picked
      - Prize is transferred to a qualified gov't unit or nonprofit org.
      - Is a prize in reorganization of religious, scientific, etc.
      - Have to endorse entire check to charity
    - Scholarships
      - Beauty pageants—law of prizes outweighs exception for scholarships
      - Have made exceptions for academic scholarships
- Group Term Life Insurance
  - Life insurance, when cashed in/received, is taxable income.
  - Policy (§79) is that it is tax free on the first $50,000 of coverage (typically employer provides for twice salary)
    - Employees can exclude the value of the insurance from Gross Income for no more than 50K.
  - For amount over $50K ⇒ ((Amount - $50,000)/1000) x Chart Amount x 12
  - Example: if you make $40,000 and employer gives twice salary ($80,000) you would be taxed on $30,000 ($80,000-$50,000) $30,000 X .10 X 12 = $36 (table in book for #'s) so your W2 from employer would actually read $40,036
  - Partially includable, partially excludable
- Unemployment Compensation:
  - 100% taxable—theory is that you would be taxed if working and you are essentially getting paid not to work
- Social Security Benefits (WILL GIVE MC QUESTION ON TEST)
  - 1983 social security benefits were all tax free, people were getting $5 back for every $1 they put in while working—Congress decided they were making profit and that was bad so changed law
    - single and income is less then $25,000, married income less then $32,000 it is **tax free**
    - single and income is $34,000 or more, married and income is $44,000 or more—**only 15% excludable** (85% is taxable)
      - people in middle of the two incomes have a weird, complex formula they have to go through—TURBO tax
- Life Insurance (code § 101) (portions includable, portions excludable—be careful)
  - Paid by Reason of Death
    - General Rule: is excludable—tax free—looked at like inheritance
    - Exception: (is taxable)
      - If policy is ever sold (transfer for valuable consideration)—taxed when person whose benefit it was bought for dies ($ received from policy – what was paid for policy = taxable amount)—makes tax free life insurance taxable
      - Exception: (isn't taxable) some transfers are okay and are still tax free (only certain people can buy)
        - The insured (employee buys it from company)

            - Partner of the insured (business partnership)
            - To a partnership to which the insured is a partner
            - To a corporation in which the insured is a shareholder or an officer
    - Example: Company owned a policy worth $30,000, husband is member of corporation, wife gives corporation $30k for the policy, husband dies
        - Wife must pay tax on policy
        - Wife could get tax free if done in two steps
            - Have husband buy the policy (is transfer for valuable consideration that falls into an exception)
            - Husband then gives to wife as gift (gifts are tax free)
                - Result: Policy remains tax free
- Not Paid by Reason of Death (is taxable)
    - General Rule: gain is taxable ($ received – the premiums paid)
    - Exception: (isn't taxable) – Accelerated Death Benefits
        - Viatical Termination
            - People who are terminally ill
                - Been diagnosed as dying in less then 2 years tax free—company that bought policy is taxed on the profit when person dies and policy pays
            - People who are chronically ill
                - Lives more then 2 years, but will be ill for rest of life, if spend proceeds on care then can get tax free
- **Case: <u>Comm. v. Duberstein</u>**
    - Facts: Employee retired, got a new sports car at his send-off party.
    - Rule: Court said ***Employers and Employees do not have donative intent***.
        - Thus, a retirement "gift" is not really a gift, but income.
        - Statute reinforces this, but allows "gift" <$400 to be permitted.
        - Some cases say that donative intent exists for "gifts" to a widow.
- **Return on Capital TAX FREE**
    - Capital = ECO resources (money, land, buildings, stocks).
    - Thus, if you loan $1000 and get $1100 back, the ROC is only $100 (not $1100, since you started out already "owning" $1000 of it).
    - Also, if you give a landlord a $1000 rent deposit and he returns it upon your moving out, that is not income – you already owned it.

EXCLUSIONS—receipt you get that makes you richer but that is tax free—municipal bond interest

- General Rule (*chart on pg. 5-3*)
  - Donative Items (gifts)
  - Personal and welfare items
  - Wage and salary supplements
    - Fringe benefits (some)
    - Military benefits
    - Foreign income
  - Investor items
  - Social security—15% is always taxable (more could be depending on income)
  - Others
- Worker's Compensation
  - Deductible
- Gifts and Inheritances (code § 102)
  - General Rule: gifts are tax free
  - Gift = a voluntary transfer of property by one to another without adequate (valuable) consideration or compensation + must be out of respect, affection, admiration, charity or other like impulses.
  - Exception: any income made from gifts are taxable
    - In Respect of Decedent (IRD's)—if what you are inheriting is pure income, it is taxable. Ex: Father dies and hasn't been paid income yet. Son inherits the income ⇒ Must pay taxes
      - Pay checks, IRA, 401K
  - Can Employer make a gift to employee?
    - No—SC held that there is NEVER donative intent between employer and employee—it is a bonus (Comm. V. Duberstein above)
    - Gifts between employees are tax free
    - Employer may have donative intent for family of employee – Courts disagree
  - Inheritances
    - Inherited property is generally NOT taxable
      - Code §102 lists exceptions – income from inherited property IS taxable income if :
        - The property you inherit is by its nature income
          - "Income in Respect to the Decedent (IIRD) – income that would have been taxable to the decedent (102b)
          - Example – if you inherit a building worth $200K and tenant owes $10K in back rent, that $10K is taxable. 401 Accounts given to you are taxed at your own rate.
        - Inherit stock that makes money
- State Bonds
  - Interest on State & Local (municipal) Bonds are tax free. Interest on Federal Bonds are taxable.
- Employee Death Benefits
  - If company sees the widow/widower is in dire straights, SC held that employer can give money to family—IRS still says it is taxable
- Life Insurance (code § 101)
  - Paid by Reason of Death
    - General Rule: is excludable—**tax free**—looked at like inheritance
    - Exception: (is taxable)
      - If policy is ever sold (**transferred for valuable consideration**)—taxed when person whose benefit it was bought for dies ($ received from policy – what was paid for policy = taxable amount)—makes tax free life insurance taxable
      - Exception: (isn't taxable) some transfers are okay and are still tax free (only certain people can buy)
        - The insured (employee buys it from company)
        - Partner of the insured (business partnership)
        - To a partnership to which the insured is a partner
        - To a corporation in which the insured is a shareholder or an officer
    - Example: Company owned a policy worth $30,000, husband is member of corporation, wife gives corporation $30k for the policy, husband dies
      - Wife must pay tax on policy
      - Wife could get tax free if done in two steps

        - Have husband buy the policy (is transfer for valuable consideration that falls into an exception)
        - Husband then gives to wife as gift (gifts are tax free)
          - Result: Policy remains tax free
    - Not Paid by Reason of Death (is taxable)
      - General Rule: gain is taxable ($ received – the premiums paid)
      - Exception: (isn't taxable)
        - Viatical Termination
          - People who are terminally ill
            - Been diagnosed as dying in less then 2 years tax free—company that bought policy is taxed on the profit when person dies and policy pays
          - People who are chronically ill
            - Lives more then 2 years, but will be ill for rest of life, if spend proceeds on care then can get tax free
  - Recovery of Capital Doctrine:
    - When you borrow money, it is not taxable b/c you increase your income but also increase liability and are in no better position
    - When you lend money, the interest is taxable, money equaling amount of the loan is not taxable as return of capital
    - Exception: 1 time security deposits are taxable
      - When can't identify who made the deposit—Ex: returnable soda cans
  - Annuities
    - Portion that is a return on the investment you put in is excludable—any profit is an inclusion and is taxable
    - Example: If age 65, you have a life expectancy of 20 years, and you invest $200,000, and annuity company is giving you a check for $15,000 every year for 20 years
      - $200,000/20years=$10,000 (yearly income that is return on investment)—the additional $5,000 every year will be an inclusion and is taxable as profit
      - If you die before your life expectancy
        - On last return you take a deduction for what you have not been able to recover
        - In the year of death
          - File a 1040 until the day of death, and a 1041 for from the day of death till the end of the year (Called a Short Year Return)
            - On the 1040, they take a deduction for what they were not able to recover—in above example if died in year 18, in year of death would take a deduction for the $20,000 they would have received in years 19 and 20
      - If you die after your life expectancy, you pay taxes on the entire amount of the income
  - Group Term Life Insurance
    - 1st $50,000 is always excludable—see example above
  - Social Security Benefits
    - If make single and makes $25,000 or less, married and make $32,000 or less, benefits 100% excludable
    - If make more then this portion of benefits are taxable—depends on income
  - Education (5 exclusions)
    - Scholarships—if provided by a university, charity or non-profit organization and is used for books, tuition, supplies, etc.
      - Room and board is NOT excludable and is taxable
      - If you are an RA and your tuition is reduced instead of being paid wages, that is NOT excludable and is taxable.
      - If provided by parents employer or your employer is generally a type of compensation (Disguised Fringe Benefit)
      - Disguised Compensation – Can't make scholarships available only to executives or parent-employees as a "non-taxable fringe benefit" (perk) – that is NOT excludable and is treated as income.
    - 529/Qualified tuition plans
      - Qualified Tuition Plans
        - States set up a program where money can be given to the university to lock in the tuition rate, generally state makes it tax free—must attend state school
        - Very few states do this, is not economically efficient
        - When the tuition goes up, in real terms you've realized a profit, and that profit is taxed to the child, not to the parent.

- Child has taxable income = to the amount over what the parent paid
- Parent has no taxable income if child goes to college
- All investment income tax is free provided it's paid out by age 30.
- 529 Plan
  - Tax free when the money is taken out it is used for college expenses—only till 2010, then is taxable at the child's rate
  - If child does not go to college, goes back to parents is taxable as investment income
    - Could transfer to another child
    - Doesn't matter what school child goes to
  - MO program called MOST contracts w/ TIAA Quest—get $3000 deduction when put money in
  - KS program called Learning Quest contracts w/ American Century—get $3000 deduction when put money in
- <u>Employee of educational institution § 117</u>
- <u>Savings Bonds (Series EE)</u>
  - If when cashed money is used to put a child through school, interest is tax free IF
    - Purchased in 1990's or after
    - Purchased by someone over age 24 (might have to have child's social security number on it)
    - This phases out between $50,000 and $80,000.
  - If rich makes no sense to do this b/c of phase outs
- <u>127 Plans</u>
  - Company gives employees $5250 a year tax free to use for education
- Accident and Health Insurance Benefits EXCLUDED
- Foreign Earned Income EXCLUDED
  - Want to encourage people to live abroad and promote trade with the US
  - First $75,000 is tax free
- Dividends – generally taxable if company has a profit
  - Payment to shareholders
  - Can actually receive dividend but not pay taxes on it – treated as a decrease to the "basis" value of the stock
  - Only tax free up to the amount paid

FRINGE BENEFITS

- Where your employer pays you something other than cash
  - Example – stocks, perks, in-store discounts, insurance, company car, etc.
    - Company car is the most common fringe benefit (an image thing)
      - Business miles NOT taxed; personal miles ARE taxed
      - Employer has deduction (use, value of car) and you have income (use of car)
- General Rule: Fringe Benefits are **taxable**—all tax free fringe benefits were made by Congress through statute to encourage employers to offer employees certain things
  - Most common fringe benefit that is taxable is the company car
- Compensation – Employer takes deduction & employee has taxable income
  - Social Security Tax/FICA – 15.3%
    - Applies to taxable compensation AND taxable fringe benefits
    - 6.2% - Old Age Survivor Disability Insurance (first $90K)
    - 1.45% - Health Insurance (Medicare)
    - Payroll tax on employer – Also has to pay 7.65% for hiring
- **Tax Exempt Fringe Benefits** (§ 132 or IRC) (*see pg. 5-25*)
  - Exclusion from gross income--gross income shall not include any fringe benefit which qualifies as a
    - **(1) No additional cost service** (No exclusion if discrimination to higher paid employees)
      - Must be in a service business to get this
      - Must be what you sell to the public, in the same line of business (airlines can give free fare for employee)
      - Not substantial additional cost to giving to the employee (if seat on plane is empty no cost if airline lets employee use it)
      - If you are senior management and your company is involved in several different lines of business you can do all parts tax free
      - If work only for one division, can't do this
      - Example – standby air travel – airline can let you on an empty plane, but can't set you up with hotel/rental (not the same line of business, additional cost, etc.)
    - **(2) Qualified employee discount** (No exclusion if discrimination to higher paid employees)
      - Property, the gross profit percentage of the price at which the property is being offered by the employer to customers
        - Example: store can sell down to cost, but if they sell at a loss, the extra discount is taxable
      - Services, biggest discount you can offer is 20%
        - If you work in estates and trust division, you will be giving all employees of firm a free will but this can generally be done for free if you can argue that it is a no additional cost service
      - No additional cost service fringe and qualified employee discounts can apply to highly compensated employee only if there is no discrimination as to whom this is offered to (highly qualified is more then $95,000 a year)
        - Means that if only the executives fly free and everyone else pays 20%, then this exclusion does not apply must pay full price (general rule applies in full)
        - Example:
          - If executives fly free on a $100 ticket, and employees to fly for 20%, the executives get no break have income of $100
          - The employees can have their discount tax free
    - **(3) Working condition fringe**
      - Anything where the employee could have taken it as a deduction if paid, then if the employer gives it to you for free, then it is an exclusion
      - If you pay for it yourself, you can deduct it
        - Example:
          - Bar association fees, law firm pays this for all employees
      - Can discriminate in favor of executives
    - **(4) De minimums fringe**
      - Benefit that you get where the accounting records to keep track is so cumbersome and burdensome that IRS says just forget about it
        - Example: once in awhile you use the copy machine to make a personal copy, free coffee
      - Can discriminate in favor of executives

- **(5) Qualified transportation**
  - 3 tax breaks
    - Transportation in commuter highway vehicle from employees home to business--employer has a van that picks them up and brings them to work, typically is driven by one of the employees
      - Limit is $105 per month
    - A transit pass: Limit is $105 per month
    - Qualified parking: Is tax free only up to $205 a month
  - Can discriminate in favor of executives

- **Health insurance fringe benefit**
  - §§ 106 & 105
    - 106 says health insurance fringe benefits are tax free
    - 105 says if company pays your actual medical bill, instead of your insurance, that is tax free also
    - Typically the insurance part has a high deductible--companies often self insure in they are small, so the employer puts a certain amount of money in an account at an insurance company, so the check actually comes from the employer money, just a check w/ insurance company name on it, they just handle the paper work
  - Long term care insurance benefits
    - Payments are tax free
    - Exclusion is limited to the greater of below amounts:
      - $250 a day for care
      - Cost of care
        - Example: $9000 in expenses, $7000 in benefits, $3000 in Medicare, must pay taxes on extra $1000
- **Meals and lodging for the benefit of the employer** (§119)
  - 2 requirements for meals (must both be met) (Boyd casino)
    - The meals provided by employer are for the convenience of the employer
    - On the premises of the employer
  - 3 requirements for lodging (all must be met)
    - For the convenience of the employer (meals and lodging)
    - On the premises of the employer (meals and lodging)
    - Must be a condition of employment (if employee has a choice, it is not tax free) (LODGING ONLY)
  - Meal allowances
    - Must be on the premises of the employer, where you report to work
- **Other Fringe benefits**
  - 129 plan (child/dependent care) – Reimbursement of child care expenses
    - You can say I want my W2 to say $35,000 even though my salary is really $40,000, the extra $5,000 is deposited into a special account and you are reimbursed from that account for those child care expenses--this is tax free
      - Allows you to beat the social security tax and employer to beat the payroll tax
  - Gyms: value of use of gymnasium if it is on the company property is tax free (working condition exclusion)
  - Adoption expenses: Doesn't occur much
    - Up to $5000 is allowable for adoption assistance
    - This benefit is phased out at higher income levels
  - Cafeteria Plan
    - Plan that allows employees to choose between cash compensation and a tax free fringe benefit
    - Without this statute there would be constructive receipt
    - Allows people to get rid of duplicate benefits
  - Education Assistance Plan
    - If employer contributes money to employee's education, that is deductible
    - Up to $5000 tax-free
- **Flex plans**
  - Typical for health insurance
  - At beginning of year, you can set up a flex account and can pick some number of your income to go into the flex account (is tax free)
  - As have the payments that you must make are reimbursed from the flex account for those expenses (get money tax free)
  - They are however use it or lose it, if you don't use it, the money is gone

EXCEPTIONS

- Interest on State and Local Bonds (No tax on state/local bonds but there IS tax on federal bonds)
- Tax Benefit Rule: If in a prior year you took a deduction and in current year you recover this deduction, the recovery is taxable to the extent of the tax benefit you got.
    - Example: 3 years ago you lent money and it looked like you wouldn't get it back b/c they filed bankruptcy, and you took a deduction for $2000 then. You get paid back now so you must recognize this income now.
    - Recovery is taxable ONLY to the extent you got a tax benefit (any amount greater than standard deduction)
        - If you took the standard deduction prior year, income is tax free, but if you itemize it would be taxable b/c you got a tax benefit—if you got more money then what your standard deduction would be then you are taxed on the amount above the standard deduction
        - Rebates are tax free
- **Cancellation of Indebtedness**
    - General rule: Cancellation of Indebtedness is normally taxable.
        - If you satisfy a debt w/ you appreciated property, you will be taxed as if you sold the property (if you owe money and debt is forgiven—is generally taxable)
    - Exceptions to General Rule: TAX FREE
        1. Creditor gift—creditor must have donative intent (generally loan from family member)
        2. Discharge under federal bankruptcy
            - MUST be in Federal Bankruptcy Court
        3. Discharge that occurs when the debtor is insolvent (liabilities > assents)—different than bankruptcy b/c haven't filed bankruptcy petition
        4. Discharge of farm debt of a solvent taxpayer
        5. Sellers cancellation of buyer's indebtedness—when seller reduces the debt buyer owes
            - Seller financed – More like a tax deferral
            - Essentially, a buyer is revaluating what was purchased and so will simply realize a larger gain when he sells it later
        6. Discharge of qualified real property business indebtedness
            - Example: buyer buys property for $300, puts $100 down. Seller says they want cash now, so buyer takes out a loan to finance through bank, then the bank lowers the debt to reduce payments—must be real property
            - Not deductible unless related to business
        7. Shareholders cancellation of corporations debt—if you cancel the debt and take stock instead
        8. Forgiveness of certain student loans—plans where you agree to work in certain field or location for certain period of time for you debt to be forgiven (ex: working in impoverished areas)

DAMAGES IN A LAWSUIT

- General Rule: Ask what you are suing for, and ask what would outcome be if lawsuit hadn't happened
  - Example: If suing for breach of contract, would be taxable b/c would have made a profit and that would be taxable
  - Example: If property damage and suing to get payment for damage, tax free b/c end up in same position as if no damage
- Damages that are included/taxable
  - Breach of Contract – suing for recovery of loss in profits; that damage IS taxable, because it is replacing income you would have had if there was no breach
  - Lost Wages (wrongful termination)
- Damages that MAY be included
  - Tort Damages – when damages only restore you to previous condition, they are tax free; beyond that, however, is taxable.
- Lawyer-Client Relationship is not a partnership
- §104 of code deals w/ Personal Injuries
  - **General Rule**: Except in case of amounts attributed to deductions allowed under §213 (relating to medical expenses) for any prior year, gross income DOES NOT include:
    - Amounts received for workers compensation as compensation for personal injury
    - The amount of any damages (other then punitive) received (whether by suit or agreement and whether lump sum or periodic payments) on account of personal physical injuries or sickness
      - Structured settlements are great tax-wise
        - Pay tax on $ over the and above the investment
        - If structured settlement and D buys an annuity, excludable
  - Property damage not covered by this section

Look at origin of claim, is the cause of action physical or non-physical (sexual harassment can go either way, IRS will always try to move it to non-physical side)

Physical Personal Injury	Non-Physical Personal Injury	Physical Sickness
• Examples: Car accident, Battery • Punitive Damages—Taxable • Compensatory—Excludable • Pain and Suffering—Excludable • Emotional Distress—Excludable • Lost Wages—Excludable b/c of revenue ruling 85-97 • All other compensatory damages—Excludable	• Examples: Slander, Discrimination • Punitive Damages—Taxable • Compensatory—medical Excludable • Pain and Suffering—Taxable • Emotional Distress—Taxable • Lost Wages—Taxable • All other compensatory damages—Taxable	• *Cates v. Commissioner* • Issue: Can P exclude the damages she got for racially offensive comments made to her—as a result now has physical symptoms ○ Symptoms physical, cause is not • Argued that damages received for emotional injuries should be tax free • Court determined it was taxable b/c the origin of the claim was taxable—says in statute that emotional distress should be treated as non-physical if origin of claim is non-physical

- **Structured Settlements**
  - Typical lawsuit, client hurt in accident, have a problem that requires physical therapy , so figure out how much it will require to take care of them and their problem for the rest of their life (this amount lump sum is tax free)
    - All investment income in future is tax free
  - Structured Settlement—D writes one check and puts in annuity that pays to P once a year, this amount and all investment income is tax free
    - D must write the check
- **Lost Wages**
  - If they resulted from a physical injury—Rev. Rule 85-97 makes them tax free
    - Revenue ruling is a public statement by the IRS about what they think the laws mean—if have a rev. ruling in your favor, IRS has to follow it
  - Counter intuitive b/c if working would be taxed

DEDUCTIONS

- Revenue
  - Revenue is gross concept
  - Income is a net concept
- §162 tells you what you can deduct for trade or business expenses
  - Requires 2 things to be a trade or business expense:
    - Objective is make a profit
      - Not a charity, doctor owning horses on the side is questionable)
    - Must be a regular activity
    - Must sell goods or services (IRS requirement ONLY)
      - Case: Gretzinger Case – Man wanted to claim gambling as his business or trade, so he could take advantage of losses. IRS said no, but SC said yes, only NEED #1 and #2
      - Case: Harris Case – investing full time (day-trading) is not a trade/business (that way they can't deduct money spent/lost trading). Thus, an investment deduction can be taken (§212), but a business deduction can't (§162)
  - General Rule: There shall be allowed as deductions all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business (must be ordinary and necessary expenses)
    - Ordinary – is it customary in your business?
    - Necessary – is it helpful?
      - Example – full page ad in phone book for attorney is helpful
    - A **reasonable allowance** for salaries or other *compensation* for personal services actually rendered
      - §162m – most you can deduct is $1 million
    - **Traveling expenses** while away from home in pursuit of trade or business (meals and lodging)
      - Can only deduct 1/2 of meals
      - Commuting to work is NOT deductible b/c you can choose where to live.
    - **Rentals or other payment** required to be made as a condition to the continued use or possession, for purpose of the trade or business, or trade or property to which taxpayer has not taken
- **Business Deductions**

	Profit	Loss
§162 – Trade/Business ⇒	Pay tax	Deduct loss
§183 – Hobby ⇒	Pay tax	No deduction *
§280A – Vacation Home ⇒	Pay tax	No deduction *
§280A – Office in Home ⇒	Pay tax	No deduction *
§489 Passive Losses ⇒	Pay tax	No deduction *

(*YOU CAN DEDUCT UNTIL BREAK EVEN)

i. If there is something that you use in personal life, but also in business—it is likely a personal expense
   1. *Moss* – Lawyer ate lunch everyday and discussed business – Deducted it. IRS said no.

ii. Large assets
   1. Where you can mathematically apportion business and personal expenses (ex: Own apartment building and live in one of the 20 rooms. You can apportion 19/20 to business)
   2. Cars—must keep very detailed records

iii. Assets which have mainly business use, but occasional personal use—likely okay as business if you keep it at office

a. Hobby Losses (§183)
   - When you lose money—IRS tries to say it was a hobby instead of trade or business
   - Rule for what is hobby and not a trade or business
     - Whether the activity is conducted in a business like manner
     - The expertise of the taxpayer or their advisers
     - The time and effort expended
     - The expectation that the assets of the activity will appreciate in value
     - The taxpayer's previous success in conducting similar activities
     - The history of income or losses from the activity
     - The relationship of profits earned to losses incurred
     - The financial status of the taxpayer (if little income derived from other sources may indicate it's a trade or business, or vice versa)
     - Elements of personal pleasure or recreation in the activity

b. Corporation v. S-Corp Deductions

i. Corporations
   1. Receive tax deductions for salary, but not dividends
   2. Example – ABC Corp is owned by John (owner and sole shareholder). ABC earns $1 million in income, $600K in profits; if he pays himself $600K in salary, ABC can deduct that, but if he pays himself that $600K as a dividend, it is taxable

ii. S-Corps
   1. receive tax-deductions for dividends, but not salaries
   2. Example – same situation as above, only salary is taxable/ dividend is not

c. Legal Expenses/Fees/ (civil/criminal)
   i. May deduct legal expenses if related to business, and NOT PERSONAL
      1. example – applies when arrested after drinking at business meeting, but not on Friday night
   ii. Case: Comm v. Teller – Apple Juice case (water/sugar, not juice) said corporation could deduct legal expenses
   iii. Four Ways to Classify
      1. §162 – trade or business expense (even criminal)
      2. §212 – investment expense; tax advice
      3. capital expenditure – cost to acquire an asset; cost to defend title
      4. §262 – non-deductible personal/family expense
      5. §263 – capital expense – mostly with real estate

d. <u>Vacation home (§280A)</u> ⇒ Profit = Pay tax; Loss = No deduction

e. <u>Office in the home (§280A)</u> ⇒ Profit = Pay tax; Loss = No deduction

f. <u>Illegal Businesses</u>
      1. Can deduct the legal expenses just like any other business
      2. Can deduct usual expenses: rent, depreciation, wages, interest, telephone, etc.
         a. Exception: Drug Dealers—can only deduct cost of goods sold (drugs)
      3. Sullivan case—if have an illegal business fill out the occupation line—5th Amendment
   ii. Legal Business where charge of illegal activity—can deduct legal expenses

g. <u>Personal living expenses and Family expenses - §262</u>
   i. General Rule: except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses
      1. Can only deduct 2nd phone line
   ii. Commuting to work is a personal expense b/c you determined how far away you wanted to live

h. <u>Disallowance Policies</u>—Public Policy limitation
   i. Don't want to encourage certain behaviors
      1. Can't deduct fines or penalties—given by government
      2. Can't deduct fines and penalties from running business (Penalties for paying bills late)
      3. Illegal bribes or kickbacks are NOT deductible—legal bribes or kickbacks ARE deductible

i. <u>Legal Fees</u>
   i. Deductible when hiring an attorney to determine a tax or business related issue

j. <u>Political Contributions and Lobbying Expenses</u>
   i. Political contributions—helping get someone elected
      1. Can't deduct no matter what
   ii. Lobbying Expenses—helping to get a law passed or repealed
      1. General Rule: cant deduct
         a. Exceptions:
            i. Local lobbying: city of government (not federal or state)
            ii. Monitor legislation—sending someone to capital hill to monitor and report back
            iii. De minimus in house expenses—you have someone who works for you act as a lobbyist and don't hire a professional
   iii. Trade Industries—can't deduct portion spent on lobbying but can fees paid to organizations (Ex. Chamber of Commerce)

k. **COST OF INVESTIGATING A NEW BUSINESS**
   i. if already in same/similar business as the one you are investigating, expenses are deductible
   ii. if not in business and incur expenses, but do not go into business investigated – not deductible
   iii. if not in business, but do go into business investigated – considered a capital expenditure (see infra)

CAPITAL EXPENDITURES (NOT DEDUCTIBLE)

a. Typically payment for something that has value at the end of the year, expense has no value at end of year
b. NOT deductible—get future non-cash deductions for expenditure made in prior year
c. 3 types of non-cash future deductions (Tax breaks)
    i. Depreciation (MACRS)— Tangible asset w/ ascertainable life, deducted as depreciation over life of the asset
    ii. Loss—sudden, unexpected devaluation or property can be deducted (employee wrecks van) – Take tax loss for value for property
    iii. Basis—when you sell you property you have (sales price-cost=profit)—taxed on profit
d. Repairs = expenses (Deductible as an expense)
e. Routine maintenance—painting a building is always a repair unless it is done as part of remodeling (Deductible)
f. Replacement = Capital Expenditure (Can't deduct – Must use depreciation)
g. Improvement=expenditure
    i. Extends the useful life OR makes something more productive
    ii. When you buy things you have to capitalize everything it took to make it operational
        1. Example: bought printing press, have to include in the capitalization costs, shipping, installation, purchase price, etc.
h. Legal Fees (As you prepare bills for client, keep in mind client's tax purposes)
    i. 162—trade or business—give business advice
    ii. 212—investment or tax expense—review lease for landlord
    iii. 263—capital expenditure—2 situations when fees are capitalized
        1. Acquiring an asset – (Real estate lawyer)
        2. Defending title to property
    iv. 262—personal expenses—non-deductible (divorce, etc.)
    v. Example: Bill for $7,000, would give bill to client like below
        1. $1000 trade or business expense
        2. $5,000 personal expense b/c of divorce
        3. $500 investment expense
        4. $500 Capital expenditure
i. Investigating a Business
    i. Same trade or business—(fast food owner wants another restaurant in a different location)—Will be able to deduct total amount
    ii. Different trade or business—(ex: lawyer wants to open fast food business)
        1. If you don't build the facility—can't deduct
        2. If you spend less then $50,000, you deduct $5,000 immediately, rest is deductible over 15 years
        3. If you spend more than $50,000, you reduce the amount over $50,000 from the first year and then amortize the rest (ex: $51K. Deduct $4000 this year (5000-1000) and then amortize $47K over the next 15 years)

<table>
<tr><td rowspan="2">CASH</td><td>
A. Expense (Note: Expenses ARE deductible)
1. Has no value at the end of the year – you couldn't sell it for something.
2. What about expenses that are incident to a Capital Expenditure?
a. All costs that make the capital expenditure a useable asset are themselves part of the capital expenditure.
b. <u>Routine Maintenance</u> IS an expense
c. "<u>Improvements</u>" are part of the Capital Expenditure
i. Extends the useful life of the asset
ii. Makes the asset more productive
3. Legal Fees
a. §162 – General legal fees are deductible on Schedule C
b. §212 – If it's an investment expense (i.e. rental property), its deducible on Schedule E (as is tax advice)
c. If the legal fees are incurred in the process of those listed below are NOT deductible as an expense
i. Acquiring an asset (buying property – cap exp.)
ii. Defending title (capital expense)
iii. Personal Legal Expenses - §262
iv. Will
v. Divorce
vi. Criminal defense related to your job IS deductible on Schedule C (Tellier case)
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B. Capital Expenditure (Note: These cannot be deducted as expenses)
1. Has value at the end of the year – you could sell it for something.
2. The key question is what was the underlying purpose of the expense?
a. If you have to tear down and replace a wall, it looks like a capital expense, but not if you had to do so in order to get to the pipe that's leaking behind the wall.
b. Paint is NEVER a capital expenditure, UNLESS it is part of a major renovation project
3. Where do you get a tax break for capital expenditures? (§263)
a. Non-Cash Deductions
i. Depreciation – the decline in value of an asset on a year-to-year basis (Based on expected life of the asset)
ii. Loss – the unexpected loss of an asset (i.e. hurricane damage losses – though offset by insurance)
iii. Basis – subtracted from your gross selling price, with a consequent reduction in your gain.
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Travel and Entertainment Expenses

1. General Rule:
   1. Is travel ordinary and necessary for that trade or business? (§162)
   2. §274 weeds out the personal expenses—must keep very detailed records
      iii. Limits deduction
2. **Special Limits**
   3. Meals and entertainment—only get to deduct 50% (logic is that you have to eat anyway)
   4. Employee—your deductions are itemized on schedule A
      iv. Hit w/ 2% limitation
      v. Ex: you are an associate in law firm you pay out of pocket for trip to St. Louis, must itemize to deduct
3. Travel—must spend the night away from home
   5. Reasonableness test: was it reasonable to spend the night away from home
      vi. Home refers to tax home (generally where you live)—people who don't have tax homes can't deduct these expenses (people who live in RV's)
      vii. Has to be less than a year (temporary work)
   6. Can deduct fare, lodging, meals (50%), incidental cost
      viii. Can't deduct for spouse
   7. 162—Ordinary and necessary & helps trade or business
   8. 274—restrictions b/c people were trying to deduct vacations
      ix. Requires good, detailed record keeping
      x. Cohan Rule: judge will estimate and let you deduct when you don't have accurate receipts-Does NOT apply to Travel & Entertainment expenses
      xi. 274 Subsections: no deduction unless you keep strict records
         1. the amount of such item or expense
         2. the time and place of travel, entertainment, amusement, recreation, or use of the facility or property, or the date and description or the gift
         3. the business purpose of the expense or other item, AND
         4. the business relationship to the taxpayer or persons entertained, using the facility or property, or receiving the gift
      xii. Tax payer commonly forgets to keep records of all of this stuff—if get audited and don't have records you can try to submit a notarized affidavit saying that there are sufficient records to back up taxpayers receipts
      xiii. Transportation—local use of your personal car for business
         1. Commuting to and from work is NOT deductible—However, if you drive to different work location than normal, can deduct
         2. Two options for deductions
            a. Mileage: you keep track of mileage IRS allows you to deduct 50.5 cents per mile
            b. Actual Car Costs: you keep detailed diary and receipts for all mileage, gas, car maintenance, etc. and then you can deduct the actual cost of maintaining your car (% used for work)—must keep very detailed records (normally provides more tax savings)
      xiv. Work Assignments—Temporary or indefinite assignment
         1. General Rule: what does it look like at the outset
            a. If job is expected to take less then 1 year—okay if it takes more (still considered temporary)
            b. If job is expected to take more then 1 year—IRS says you should move there (indefinite assignment)

EDUCATION AND MOVING EXPENSES

1. **When are Education Expenses Deductible? Regulation § 162-5**
   - **a. Basic Test**
     - **i.** In order to maintain or improve existing skills (not develop new skills for new job).
     - **ii.** Required by law or the employer as a condition for employment.
   - **b. Exceptions**
     - **i. Regulation § 162-5 (B)(2) –** Not allowed where the education expense is incurred in order to meet the minimum education required to get a job in the field.
     - **ii. Regulation § 162-5 (B)(3) –** Not where the education qualifies you for a new trade or business.
   - **c. Examples**
     - **i.** CLE Program or a conference is allowed, because a lawyer must have 15 hours of education a year to keep license.
     - **ii.** Lawyer going to school to get taxation masters is allowed, because it is improving his skills as an attorney.
     - **iii.** Getting the law degree to become an attorney would not be allowed, since that is the minimum education required.
     - **iv.** If you have a JD, but not working, then take tax masters, that is not deductible since not improving skills (still getting them).
     - **v.** Not allowed if you are getting skills to do stuff you couldn't do before.
       - **1.** Accountant taking classes to become a CPA does not qualify, since CPA do things accountants can't do (audit, etc).

9. Exclusions
   - xv. School
   - xvi. 529
   - xvii. 127
10. Deductions
    - xviii. 222—Education Deduction
      1. Can deduct up to $4,000 tuition FOR AGI
      2. If rich get less of a deduction table 9-16 shows
      3. If forgot to deduct can amend 1040X
      4. Over 4K then goes to the FROM AGI and must hit 2% floor with other itemized deductions
    - xix. 162—Business Education
      1. have to stay in same profession—Lawyers need 15 hours a year of CLE's
      2. can deduct education fee and travel expenses if education does 2 things
         - a. maintain you current skills in your current job, OR
         - b. meets the minimum requirements of the employer or law to keep you current job
           - i. Example: Lawyers getting master of tax in NY at NYU can deduct all expenses if they are there for less then 1 year (MBA is starting to be no longer deductible)
      3. Deduction Killers (2 things)
         - a. To meet the minimum educational standards for qualification in the taxpayers existing job
         - b. To qualify the taxpayer for new trade or business (*Gore case*)
    - xx. *Gore case*: guy was engineer and law degree would be helpful, accountant told him he could deduct, IRS said no
      1. Private letter ruling allowed him to deduct in the end b/c he had no college degree and he went to an unaccredited law school and he would never actually be able to practice law—so didn't qualify him for new trade or business
    - xxi. General Rule: Can't deduct law school tuition b/c it qualifies you for a new trade or business
11. Credits
    - xxii. 203

MOVING EXPENSES

12. Can *deduct* if meet 3 tests:
    - xxiii. Distance test: work location has to be 50 miles more then it was to get to previous place of employment
    - xxiv. Full Time Work w/ new ER/in new work location:

1. Can use when you get your 1st job
2. Or if 1 spouse moves w/ another and has to get a new job

xxv. Time Test: have to be a full time employee for 39 weeks (3/4 of year), if self employed must be 78 weeks over 2 years (3/4 of 2 years)

1. If move to KC in Aug. and spouse loses job in May no longer qualify for the moving expenses deduction—what do you do?
    a. You can amend prior years return, OR
    b. Add it to taxable income for upcoming year (tax benefit rule)

13. 3903 Form for moving expenses—Can only deduct 3 things

xxvi. Cost of moving your actual family (airplane, train, car (only get 18 cents/mile))
xxvii. Cost of moving goods (moving van or company, storage, etc.)
xxviii. Hotels/lodging in route, **but not** meals
xxix. List of nondeductible expense on 9-12

14. Employer reimbursements

xxx. If your employer reimburses you for these expenses, including ones that are not deductible, they are taxable to you

1. What employer does is pay what you owe to government, then they have to pay taxes on that and it is a complex formula, give W2 to employer and they will generally do your taxes

EMPLOYEE DEDUCTIONS

15. Deductions subject to 2% of AGI limitation
    a. Job travel
    b. Union dues
    c. Job education
    d. Tax preparation fees
    e. Investment expenses
    f. Safe deposit box
    g. Non-accountable plans
    h. §212 expenses
    i. Professional dues and expenses
    j. Union dues and work uniforms
    k. Employment-related education
    l. Malpractice insurance
    m. Job hunting expenses
    n. Legal, accounting, tax prep
    o. Investment expenses
16. Itemized Deductions NOT subject to 2% of AGI limitation
    a. Impairment related work expenses for handicapped employees
    b. Gambling losses (to the limit of gambling expenses)
    c. Certain terminated annuity payments
17. **Employee**—ER *reimburses* you for expenses—Is this taxable?
    xxxi. Accountable v. Non-accountable plan
        1. **Accountable Plan**—2 requirements (If you have a choice, take this)
            a. Employer must reimburse you to the penny for every expense you have—non-taxable (like it never happened)
            b. When you go to the location they give you certain amt of cash and what you don't use you give back (allowance option)
        2. **Non-accountable Plan**—treated as compensation and must deduct it on Schedule A
            a. Any reimbursement that does not meet the above criteria – Subj to 2% AGI limitation
            b. Most common is allowance for sales managers—you use what you need and then keep the profit or deduct the difference b/t what was needed and what was used
                i. *Even though it is a travel allowance it is still taxable → treat as taxable compensation*
            c. One time where the reimbursement can be about the same as tax free
                i. *Per diem reimbursement*—government gives you a certain amount of money to use and you get the keep the rest—only for meals and hotels, and must keep receipts
    xxxii. Can only deduct up to 2% of AGI—good ERs should provide everything, Congress made b/c EEs deducting personal items
    xxxiii. *Trans-Box Case* – Trans-Box wanted to pay 45% as wage and 55% for job expenses; IRS said all was taxable b/c employees didn't substantiate their income or give back excess money.
18. **Independent contractor**—(NOT subject to 2% AGI limitation)
    xxxiv. If you have clients come to you and you collect the money from them and it goes straight to you not your employer
    xxxv. If employers had the choice, they would always take this option
        1. Don't have to pay payroll tax (7.65% per year)
        2. Don't have to collect income tax from them
        3. Don't have to give fringe benefits
        4. Don't owe duties
        5. Don't have legal rights (such as can discriminate against them if don't want to hire them)
    xxxvi. Different tax consequence—can deduct everything on Schedule C
        1. Have to pay the self-employment tax
19. Employee v. Independent contractor—how to tell the difference
    xxxvii. Does the person that pays you control how the person does the job? (don't have to control the outcome)
        1. If they can control→EE

2. If they just care about the outcome, not how job is done→Independent contractor

xxxviii. National problem w/ people classified wrongly—IRS wants everyone to be EEs

1. SSA Form has 20 questions that will classify the person correctly
   a. Example questions: ask where they work, who provides equipment, etc.

20. Itemized deductions (*see 9-28*) – MAY BE DEDUCTED ON SCHEDULE A, subject to 2% AGI limit

xxxix. Job travel
xl. Job education
xli. Tax preparation fees
xlii. Investment expenses
xliii. Safe deposit boxes
xliv. Professional dues or subscriptions
xlv. Union dues
xlvi. Un-reimbursed employee expenses
   1. Ex: School supplies for use in classroom (up to $250)
xlvii. Special Clothing that are used for work and can NOT be worn in public (firefighter's uniform)
xlviii. Job Hunting expenses
   1. MUST be in same trade or business
   2. Don't have to actually take the job however and is still deductible

- **Retirement Plans – IRAs**
  a. Tax deduction contribution – income compounds tax free
  b. Taxed upon distribution
  c. Several types of deposits you can make to earn interest / withdraw later… but when do you pay taxes on it is the key.
     a. Deposit – Tax Deduction
     b. Trust – Tax Exempt
     c. Distribution – Pay the Tax
     d. Key: Taxes stunt your growth. Therefore, tax deferral is good.
  d. Deductible / Non-Deductible IRA
     a. Deductible IRA – Must earn less than $62k (married) or $42k (single) AND not have a retirement plan at work to be eligible to deduct your IRA account.
     b. Non-Deductible – If you earn more than $62k (married) or $42k (single) you are limited to a non-deductible IRA.
     c. A **non-deductible IRA is no good** (A Roth IRA is a good thing, however).
        i. Better off investing the money yourself in a mutual fund.
        ii. The bulk of the investment still grows tax-free (because there's no tax on the growth until you sell).
        iii. If you buy and hold, you'll pay capital gains tax (20% rate) instead of income tax rate (c. 40%).
  e. **Roth IRA**
     a. No tax deduction for investing (you are nailed as you make money and invest it, but at lower-income bracket because I am not a wealth lawyer yet).
     b. Trust grows tax-free (i.e. no taxes paid every year on its growth).
     c. Distribution is tax free (i.e. When you take it out, no taxes).
     d. This is a GREAT prospect – regular IRA an Roth IRA always come out the same in terms of gain, as long as your tax bracket remains the same.
        i. Especially good when you're in a lower tax bracket now than you will be when you retire
        ii. If you expect your tax rate to drop significantly on retirement, a traditional IRA may be better.
        iii. Other Roth Benefit – Estate tax comes off the top before income tax, so traditional IRA will be hit much harder with the 55% estate tax.

BAD DEBTS

21. Two Types
    - xlix. Uncollected Loans
        1. when you loan your money and don't get it back
        2. Cash Method and Accrual Method
    - l. Uncollected Bills
        1. applies to services and merchandise – stuff that is not a loan, but payment for goods and services. This can only be deducted by people on the accrual method
        2. Accrual Method only
22. Worthless Securities – Only deduct up to $3000/year
23. 5 Legal Issues to consider before declaring it a bad debt
    - li. Is it truly uncollectible?
        1. When person files for bankruptcy may only be getting reduced payment
        2. Don't have to file a lawsuit to prove it's uncollectible—only have to do what a reasonable creditor would do
        3. Family members—if it is truly a loan, make sure you act exactly like you would if they weren't family, keep detailed records, make a contracts
    - lii. How much is Deductible?
        1. 2 limits
            - a. Only deduct the portion of the debt that has gone bad (portion you aren't getting back)
            - b. Cash method can NEVER deduct for bad debt – no basis in the debt, never reported it as income
                - i. Accrual basis can deduct bad debt
            - c. Basis in the debt
                - i. Example: Lawyers cash and accrual sent 5 bills out in 2005, 4 were paid, 1 never will be:
                    1. Cash
                        - a. 2005 - Recognizes only the 4 paid bills as income
                        - b. Can't take deduction for 5th unpaid bill b/c never was recognized as income—can only deduct out of pocket and business expenses
                        - c. Basis is always $0.
                    2. Accrual
                        - a. 2005 - Recognized all 5 bills as income
                        - b. Can deduct the 5th unpaid bill b/c he recognized it as income
                        - c. Basis is whatever the unpaid bill amount is.
    - liii. What year is the debt bad?
        1. The year it went bad, ends up being a factual debate with the IRS
        2. When in doubt, deduct
        3. Were hoping to be paid in 2005, so we waited but were never paid, IRS will say no it was 2004—Make sure you document
    - liv. Do you have a Business bad debt OR a Non-business bad debt?
        1. Business bad debt—better for you
            - a. Bad debt in your trade or business—Schedule C
            - b. You can deduct it ALL the year it goes bad (whereas in non-business bad debt, you have to wait until final settlement to get take the deduction)
        2. Non-business bad debt—better for IRS
            - a. MUST wait until the final settlement to take the deduction (then you can only take $3000/yr)
                - i. Exception – worthless security/bonds – these can be taken right away even if some tiny value (fraction of penny)
            - b. Can be either
                - i. Personal loan (family or friend)
                - ii. Investments (Enron Bonds)
            - c. 2 problems w/ these types of debts

i. Treated as short term capital losses—can ONLY deduct $3,000 per year until the bad debt is released -- Schedule D (CAPITAL LOSS)

ii. You deduct in the year of final payment

1. The business (Enron) can deduct in year of loss
2. Individual can only deduct in year of final payment, and then only $3,000 a year till they get to full amount of loss

lv. What happens to amount of money that is not insured?

DIVORCE

24. MO Law
    lvi. You can break a K by mutual consent—*except marriage* ⇒ must go to ct for divorce
    lvii. Once a spouse hires a lawyer, other's lawyer can only talk to the lawyer of the other spouse—if don't have lawyer can talk directly to them
    lviii. Property Settlement
        1. Divide all property
            a. If you don't list some of the assets, the other side will get them
        2. Determine who has custody and who will pay, how much child support, *alimony* (in MO called maintenance)
            a. Don't really see much alimony now w/ women in workforce
            b. Alimony only good for max of 5 yrs (usually 3)
            c. Child support is always stat'y (can always be changed)
    lix. **Separation Agreement** – new K that has details of divorce settlement
        1. Two kinds of alimony (maintenance)
            a. *Contractual*—two parties agree in K how much should be paid (fixed amt) and for how long—is final once agreed to (most people prefer this)
            b. *Statutory Maintenance*—judge decides how much should be pd and how long, one spouse can always take another back to court and get amt/length changed
25. Tax Planning w/ Contractual Divorce
    - *Property settlement, children, alimony*
    lx. **Property Settlement**—What happens if everything is titled in one person's name?
        1. Transfers of property - §1041
            a. Gen Rule: No gain or loss shall be recog'd on a transfer of prop to:
                i. A spouse, or
                ii. A former spouse, but only if the transfer is an incident of divorce
                    1. A transfer of property is an *incident of divorce* if the transfer is:
                        a. w/in 1 year after marriage ceases OR
                        b. is related to the cessation of the marriage
            b. Transfer treated as gift; transferee has transferors basis
                i. Original basis moves over (not fair market value)
                ii. Ex: Wife receives stock which cost $25K to buy but has market value of $60K. She has no taxable income unless she sells it and then she would have $35K in taxable income
        2. Capital Gains – Tax rate arbitrage
            a. Rich have higher tax bracket
                i. If spouses end up in different tax brackets, can barter saying I'll take this asset to reduce your taxes if you pay me more in child support, etc.
        3. If divorce agreement says payments of alimony will decrease to $X if child dies before payments are scheduled to end, payee's income from alimony is $X b/c the rest is considered child support

        4. **Payor**
            a. Property settlement—Not deductible
            b. Child support—Not deductible
            c. Alimony—Deductible
        5. **Recipient**
            a. Property settlement—Tax free
            b. Child support—Tax free
            c. Alimony—Taxable
    lxi. **Are there children in the marriage**?
        1. Tax Credits
            a. Child tax credit—$1000/child
                i. Don't get it if you rich
                ii. Phases out, want person who can use it to have it
            b. Child Care credit

c. Earned Income credit—if income is under certain amt and have a child, get a tax credit just for that situation
   i. Must be a custodial parent to get this tax credit
2. Head of Household tax rates for custodial parent
   a. If have 2 kids, can get this rate if 1 kid lives w/ each parent
3. Child Support
   a. Recipient gets tax-free
   b. Payor gets no deduction
4. Dependency Exemption – ($3,650)
   a. Law is that *custodial parent* gets this deduction—doesn't help if woman gets no income
      i. Can transfer this right w/ Form 8332 (custodial parent signs, non-custodial parent attaches to tax return)
         1. Can negotiate for this as part of divorce, can allow higher income person to use if they pay more in child support—generally is a deal for both people
         2. Problem is that have to have it signed for every year
            a. Custodial parent can use as tactic
            b. Non-custodial parent can have it signed once, and list a number of years, but they can then stop paying and custodial parent has no recourse
   b. Way to make both better off
      i. Man in 30% tax bracket, Woman in 10%
         1. She can let him have the deduction which will save him $900 in tax as opposed to her $200, so then he can agree to pay her $700 more a year in child support—both better off

lxii. For AGI - §215 Payor section
   1. If taxable to recipient under §71, it is deductible for payor
   2. If it is tax free to recipient under §71, it is taxable to payor

lxiii. From AGI - §71 Recipient section
   1. General Rule: gross income includes amounts received or maintenance payments
   2. Itemized deductions
      a. §71: ***Alimony*** **or separate maintenance payments defined**; For purpose of this § it must be considered ***cash or check***, if:
         i. Such pymt is rec'd by spouse under divorce or separation instrument
            1. Must be in ***writing***
         ii. The divorce or separation instrum doesn't designate such pymt as a pymt which is not includible in gross income under this § and not allowed as a deduction under §215
            1. Parties could draft doc that states 1 party won't take deduction so other party won't incur taxable income
         iii. In case of indiv legally sep'd from his spouse undee decree of divorce or of sep maintenance, the payee spouse and the payor spouse are not members of the same household the time such pymt is made
         iv. There is no liability to make such payments for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of payee spouse
            1. MO law makes this the default if not specifically mentioned
         v. Can't file a joint return

j. **Alimony/Maintenance** – Code § 71(a)
   i. Alimony is included in Gross Income, and therefore **taxable to recipient and a part of AGI §71(a)** (i.e. she pays tax on what she gets every month).
   ii. Alimony is **deductible to payor** (*See* § 215) (he deducts what he must pay her).
   iii. Deductible in the year paid.
      1. Ex: H pays ex-W $1000/mo -- $600 alimony, $400 child support. He deducts the $600 for alimony and she is taxed for $600 alimony received. He cannot deduct the $400 for child support, nor is she taxed on it.

2. Rule of Thumb: If someone deducts, the other is taxed. If someone can't deduct, the other will pay taxes on it (IRS wants its money).

iv. **§ 71 – What is Alimony?**
1. Any payment in cash or check – not property
2. Any payment received by or on behalf of former spouse under the direction of a divorce/separation instrument (i.e. decree of divorce or a written separation agreement).
3. Tax court says the key is something in writing (even counter-signed letter) is required for the deduction. Verbal agreements are not sufficient for deduction for alimony payments.
4. Can be fixed or flexible
5. **Requirements**:
   a. has to be PAID IN CASH - not property
   b. payment received is under a WRITTEN DOCUMENT (not necessarily a formal agreement, but at least a written one)
   c. CANNOT LIVE TOGETHER
   d. payments do not go to the estate of a deceased spouse (if so, it is a property settlement)
   e. **§71f** in the first 3 years, payments cannot change (they must be substantially equal) by $15,000 – 71f requires recapture of any disproportionately high amounts of alimony (payor spouse has excess alimony as income in yr 3 and payee spouse has a deduction in yr 3)
6. **EXCEPTIONS** (§71(f)) to paying alimony (LOSING JOB IS NO EXCUSE)
   a. spouse dies
   b. payee spouse remarries
   c. payor is self-employed and payments go up and down

v. Alimony can be used to disguise child support – allow high-income husband to pay extra alimony (deductible) to allow him to get out of higher taxes; she pays taxes on that income, but at a lower rate – difference to help child.

1. §71(c): **child support** is not deductible by payor spouse, not taxable to recipient
   a. Money received IS NOT part of AGI
   b. Tax Planning can keep money in the "family unit" here, too.
      i. Ex: Dad is in a very high tax bracket (40%), which means he must earn almost twice the money so that he can then pay it to Mom for child support. If he gives her the extra money in the form of alimony (which IS deductible), he can take the deduction for what he pays her (economically better for him) and she is taxed on what she receives from him at a lower tax rate (20%). That way less money is paid to IRS (he deducts more, she pays less tax on same amount), keeping it in the family unit.
      ii. Note: Even though paid out as alimony, there is still a "fixed" amount that is unofficially designated for the kids. That way the child support doesn't disappear when his alimony obligation is reduced / goes away, or "Drops" are stipulated so that he is not stuck with a high amount after the kids grow up / die / etc.
   c. Shifting: You can arrange to pay a lot more alimony for these certain years and then have the payments go down and none count as child support— but date when pymts go down, can't coincide w/ some major event in life of child, such as they turn 18 or 21
   d. *Fix* (in terms of amt of $ or part of pymt) as sum which is payable for support of children of payor spouse
2. Separation instrument means
   a. Decree of divorce or sep maintenance or a written instrum to indicate such decree
   b. Written separation agreement

c. Decree req'ing spouse to make pymts for support/maintenance of other spouse

26. Alimony Recapture (p 4-21) **§ 71f**
   vi. In the 1st 3 years, the pymts can not fall by $15k
   vii. If pymts ever drop by more then $15k, the payor will have to report extra income
      1. is fall by more than $15k, assume front end loading
   viii. Example: Year 1 $70K, Year 2 $20K, Year 3 $20K—bad b/c drop from year 1 to 3 is more then $15k

1) **Income Shifting and Divorce**
   a) Basically, Tax Planning as discussed earlier to help keep money within the "family unit."
   b) **Code § 71**

	Payor	**Recipient**
Property Settlement (§ 1041)	NO Deduction	Tax Free
Child Support (§ 71c)	NO Deduction	Tax Free
Alimony Code § 71(a)	Deduction Allowed	Taxable

   c) As to the alimony, might do a little tax-planning if H/W are in different tax rates.
      i) Shift the income to the poorer spouse – she would pay less taxes on alimony.
      ii) Shift the deductions to the richer spouse – he can deduct more of the money he would have to pay higher taxes on.

2) **Front-Loading Alimony Payments**
   a) Essentially, trying to shift a lot of alimony up front to a spouse in a low tax bracket before that other spouse starts to make money / gets into a higher tax bracket – disguised $$.
   b) This was often done to pay for the legal expenses incurred during the divorce, since the court used to require the one with the money to pay legal fees for both parties.
   c) In order to cover those attorney's fees, couples would negotiate front-end loaded alimony agreements, so wife could pay her own legal fees and pay tax on that income at her rate.
      i) **§71 (f)** was added to the Code to deal with these front-loading situations. Payments in first three years can't drop-off by more than $15,000 TOTAL across the 3 years.to include it income year three.
      ii) **§71(f)** excess alimony paid in yrs one and two is recaptured by requiring payor spouse
      iii) **§71 (f)(5)** allows for **exceptions** under which the variation will be allowed to exceed $15,000:
         (1) Re-marriage before year 3;
         (2) Death before year 3;
         (3) Alimony based on percentage income from a business, profit from a rental property, etc., the excess fluctuation is OK.
   2. Note: Job loss is no excuse. If you can't afford to pay you'll end up stuck with **recapture** (i.e. must pay later on).

1) **Losses ($3000 limit per year) – Different Types**
   a) Net Operating Loss – total expenses are greater than total receipts for the year
   b) Capital loss – sell stocks for less than you bought them
   d) Casualty/Theft Loss – Assets that are destroyed or stolen/embezzled/etc.
      i) Basically, the stuff that is considered an Act of God or Act of Convict.

(1) Kinds of Assets that can be Lost

Business Assets – your work computer, law library (prop used at biz)
Investment Assets – rental property (rented office, furnishings, etc.).
Personal Use Assets – home, car, jewelry, apartment, furnishings, etc.

(2) When an Asset Can Be Deducted as Lost

Loss from Sale – When you sell property for less than you paid for it.
Business Asset – deductible
Investment Asset – deductible
Personal Use Asset – **No Deduction**
Loss from Casualty/Theft
Business Asset – deduct (i.e. flood destroys office).
Investment – Deduct (i.e. Stockbroker runs off with money).
Personal Use – **Yes, Deduction** (decreased by 10% of income) **(** (home flooded)
<u>Limitations</u>
Reduce the deduction by $100 for each casualty
Can only deduct the amount that exceeds 10% AGI
Limitations designed to prevent rich folks from taking advantage of these deductions and to not provide an incentive to get stuff stolen.

(3) What is Casualty and Theft?

Casualty – sudden and unexpected. Sometimes there's a debate with the IRS about what is sudden and unexpected.
<u>Rosenberg</u> – Court allowed deduction from termite damage; IRS said no because termites should be expected.
Natural disasters are always unexpected
Theft – something has been stolen (taken by someone, not ring fell of finger).

(4) What year do you take the deduction for Casualty Loss?

Casualty = Year of the disaster (estimate if you're not sure just how much you lost).
Theft = year of discovery
Two exceptions:
Hoping for reimbursement – if you have an insurance claim or a claim against a defendant, you have to wait until the claim is settled. (Note: if you could file insurance, but you choose not to, you still can only deduct as if you had filed the insurance claim).
President (not gov.) declares your area a Federal Disaster Area, then choice:
Can deduct on this year's return OR
Can AMEND LAST YEAR'S RETURN (so that you get the refund faster to start rebuilding)

How Much is Deductible for a Loss?

	Complete Destruction	**Partial Destruction**
Business/ Investment Loss	Deduct your Adjusted Basis of Property (What you paid for it, adjusted for any improvements, depreciation, etc.).	Deduct the Lesser of: a) Adjusted Basis *or* b) Change in Value (the difference in value before destruction and after, accounting for repairs, loss in value, etc).
Personal Use Loss	Deduct the Lesser of: a) Adjusted basis or b) Change in Value	Deduct the Lesser of: a) Adjusted basis b) Change in Value

i) Additional Limitation on Deduction: Personal use is further limited by the subtraction of 10% AGI and $100 per casualty/theft. This keeps the millionaires honest, who are willing to risk having their limo stolen rather than insure it, knowing they can just write it off as a loss.

DEPRECIATION—MACRS

- when you buy an asset, you're no poorer; however, assets become worth less over time
  - businesses can deduct the decline in value over time of their assets, because the asset declines in value and will eventually need to be replaced
  - the faster you can deduct an asset for depreciation, the easier it is to do stuff – tax incentive, encourages building, etc.
- **Definition:** tax deduction for the change in value of an asset
- (1) Straight Line depreciation
  - Cost / Life = Amount you get to deduct every year for the life of the object
  - Ex: Buy a van w/ life of 5 yrs. $10k/5 yrs = $2k deduction/yr
- (2) Accelerated depreciation (MACRS) —real property
  - 1981- the tax law matched the accounting law and replaced tax law w/ ACRS (accelerated cost recovery system)
  - 1986 - MACRS (modified accelerated cost recovery system)
- **Steps to ask:**
  - **(1)** Is it depreciable or amortizable? Does it have determinable useful life?
    - Depreciation—For tangible property
    - Amortization—For intangible property (copyright, patent, goodwill, computer software)
    - Does it have a determinable useful life?
      - Buildings ⇒ Yes, deduct over that lifetime
      - Land, Antiques, Artwork ⇒ No
  - **(2)** When do you begin the depreciation?
    - when was it placed into service—when you started using it NOT when you bought it.
      - Example – "the Death Star is now fully operational" – depreciation begins
    - It becomes an issue when an asset becomes available at the end of the year, but isn't actually put into use until the new year
  - **(3)** What type of property?
    - Tangible Real/ Personal ⇒ use MACRS
    - Intangible ⇒ use code §197—deduct straight line over 15 years
  - **(4)** How many years to depreciate it?
    - **Tangible personal property**: (pg. 8-5)
      - IRS suggested depreciation guides (pg. 8-6)—lawyers generally get 5-7 years to depreciate expenses
        - 3 years: agricultural assets
        - 5 years: computers, light and heavy general purpose trucks)
        - 7: office furniture, agricultural machines
        - 10: vessels, barges, tugs
        - 15: land improvements, landscaping, sidewalk, parking lot, etc.
        - 20 (farm buildings, public utilities
    - **Real Property**
      - 15 years: land improvements Buildings are generally depreciated over 39 years
      - 27.5 years: residential rental property (done to encourage development) – apartment, duplex, long-term rental
      - 39 years: commercial buildings (most fall under this category) (1/39 each year) – office, factory, school, hotel
  - **(5)** How fast?
    - (pg. 8-27 has table that tells you what the numbers are for % and the year)
    - **Tangible personal property**
      - *General rule: rapid depreciation (150% or 200%)*
      - but you can elect straight line
      - Example: car bought for $10,000, 5 year life
        - Straight-line would be $2,000 a year for 5 years (only get to deduct ½ a year in 1st year so would be $1,000 in years 1 and 6—doesn't matter when bought asset)
        - MACRS—year 1 (2k), $3200, $1920, $1152, $1152, what is left over for last year (must equal $10,000)
    - **Real Property**
      - *Straight line only*

	How Long is the Deduction Term?	How Fast a Decline?	What Convention?
Tangible Personal Property	3 – tractors & ag stuff	200% MACRS	**Mid-Year Convention** (Assume all bought in the middle of year – on July 1) **Mid-Quarter Convention** is mandatory if > 40% of TPP in the last three months of the year.
	5 – cars, office tech.	200%	
	7 – office furn. & fixtures	200%	
	10 – maritime & petrol.	200%	
	15 – land improvements	150%	
	20 – Farm buildings, public utilities (other than electric)	150% (Table on p. 7-27)	
Real Property	27½ - apt. buildings	Straight Line Only (Table on pg. 7-32)	**Mid-Month Convention** of the month purchased.
	39 – all other real property		

- **(6)** What Convention?
  - **Tangible Property**—generally rapid depreciation is best
    - ***General Rule:*** **Mid-Year Convention**—you deduct 1/2 in first year and the other ½ in the last year. (Table 8-1, Pg. 8-27)
    - ***Exception***: If you purchased more than 40% in last quarter of the year, then you MUST use the mid-quarter convention
      - **Mid-Quarter Convention**: if you buy more then 40% of your purchases in the last quarter of the year you MUST use mid-quarter for ALL assets)—table 8-2 (pg. 8-28)
  - **Real Property** (pg. 8-28, Table 8-6) MACRS table needed for straight line depreciation (for 39 and 27.5 yrs)
    - ***General Rule:*** **Mid-Month Convention**—always assume bought in middle of month (15^{th} of month)
      - Table tells you after what year the property was acquired and what month you began using it
      - When you sell it, multiply (.5/12) x Deduction for that year.
- **Exceptions**:
  - *Good* Exception: **§ 179**
    - You can elect to write off tangible personal property up to $125,000 and below you can deduct all in 1 year—if you bought more than $ 500,000 then you can use this and deduct all at once (schedule C)—always want to use for property w/ longest depreciation
    - When you make an election for an asset, elect the longer term asset
    - **Qualification for § 179**
      - **Basically, §179 allows you to deduct $24K right off of one asset as an expense**
      - Must make an election to do so
      - **Must be property in your trade or business (not rental)**
      - **Only tangible personal property** (equipment, furniture) (not real estate)
      - There is a phase out if your purchases are greater then $500,000 (in 2008 it is up to 800K but that is just this year)
      - Maximum deduction is equal to your taxable income (250K this year is max but next year it returns to 125K)
        - Example: income is $80,000 and you bought $100,000 of furniture—this year can only deduct $80,000
        - Must carry the $20,000 difference forward

        - CANNOT BE A LUXURY CAR
    - *Bad* Exception:
        - Listed Property (p 8-12)– Stuff that can be used for personal and business use. Must keep written records – §274
            - To use rapid depreciation for listed property, you must use the asset for more than 50% in your trade or business (otherwise have to use straight line)
                - If fall below 50% you have to do recapture to see what you should have deducted (if there is a chance you won't make the 50% elect to do straight line, cuz then you don't have to worry about the recapture)
                - Have to use straight line
            - Any passenger automobile
            - Any other property used as a means of transportation
            - Any property of a type generally used for purpose of entertainment, recreation, or amusement
            - Any computer or peripheral equipment, w/ the exception of equipment used exclusively at a regular business establishment qualifying as a home office
            - Any cellular telephone or other similar telecommunication equipment
            - Any other property specified in the regulations
                - Generally good idea to just use straight-line and don't have to worry
        - Luxury Car—for passenger automobile (table pg. 8-13)
            - Car that is totally used for business over $15K
                - A car is defined as an automobile that weighs less than 6000 lbs
            - Vehicles that weigh more than 6000 lbs, limited to $25,000 but you can deduct an entire delivery van (non-passenger) (pg 8-14)
                - Ex: $60K Ford Excursion. (60k – 25k) x .20 = 9000 + 25k = $34k deduction
            - **Deductions are limited as follows**
                - **Yr 1 ($3000), yr 2 ($4,900), yr 3 ($2,850), any yr after yr 3 ($1,775)**
            - If luxury car is used for 80% business ⇒ .80 x 2960 = $2368 deduction
            - *Any car that costs more then $15,000 would be considered a luxury car* (20% deduction = $2960)
                - Luxury car lmt trumps $100,000 deduction
                - If your deduction is less than the $2,960 (like b/c of mid-quarter convention) you MUST to use the lower number
        - If you fail to take a deduction, the basis of the property must still be reduced by the amount of cost recovery that should have been deducted.
- **Intangible assets**—depreciation **§197**
    - now all deducted over **15** years
    - Often used w/ covenants not to compete—stretch payments for certain number of years, and if they compete stop payments
    - Software is quicker (three years)
    - **Goodwill** – what you pay over and above the underlying value of the assets
        - The reputation and built-up business of a company.
        - When you buy a business for goodwill, you deduct over 15 years and covenant over 15 years
        - Different tax consequences for seller b/c goodwill is taxed as capital gain and is taxed at lower rate, covenant taxed as wages
    - If actual use life is under 15 yrs, doesn't matter. It is still a 15 year asset

SPECIAL IN 2008 – additional first year depreciation

1) **Intangible Assets (Amortization)**
    a) **Code § 197**
        i) **Most intangible assets have a 15-year life for depreciation purposes.**
        ii) **Exceptions**
            (1) **Patent** – by law, patents have a 17-year life. If you buy a "used" patent after 10 years, you can deduct over 7 years.
            (2) **Computer Software** – can be deducted over a 3-year period
            (3) **Covenant Not to Compete** – Tax law treats this strangely
                (a) Treated like an intangible asset
                (b) Must deduct over 15 years (even though the covenant only runs for 2 years)
                (c) Method around this – hire the person as a "consultant" and deduct it as a salary expense

(4) **Goodwill** – any price paid over the value of a business in a purchase. Must be deducted as an intangible asset over 15 years.
(5) **Trademark** – This is the exception – potentially an infinite life.
(a) **Ex**: Coca-Cola has been around a long time, and likely will be around for a long time, so you can't really put a limit on when it will become "obsolete."

2) Goodwill ONLY BUYER CAN DEDUCT!!!

a) This is the price you are willing to pay over and above the price of the actual asset. When you have choice go low on asset (ie Building) and high on Goodwill (when allocating prices).
b) Goodwill is an intangible asset
i) Ex: If you want to open up a new Cheesecake Factory, you are willing to pay more for the name, rather than just the physical plant (building, cooking stuff, cost of set-up, advertising of new place, etc).
ii) Essentially, you pay more for existing name so you don't have to mess with start up.
c) Covenant Not to Compete
i) MO requires a reasonable time and a reasonable space.
(1) You buy the Cheesecake Factory, and the prior owner signs a covenant not to compete for 5 years or within 125 miles.
(2) Must be reasonable – cant say that prior owner cant open a new Cheesecake factory in the Western Hemisphere.
ii) Typically pay him off to do so – ex: You pay $100k for not doing this
(1) Pay him a "salary" for not competing;
(2) Also threaten him with lawsuit (breach) if he does.
d) Goodwill and covenant not to compete, like other intangible assets, are both deductible.
i) 15 years (Others are listed above).
e) This works out great:
i) Ex: You have choice of purchasing a business (used, but with goodwill) for $1.2m; or a new business for $1.5m. You can deduct the new business over 39 years (non-residential property), or you can deduct the goodwill difference over 15 years – faster deduction and more money saved!

NON-BUSINESS DEDUCTIONS

- Something that is not a trade or business
- General Rule – you cannot deduct your personal expenses
- Two types:
    - **§212 investment expenses**
        - Schedule A (appear as itemized deductions on line 22)
            - Commissions don't go on Sch A- can reduce them from your profit
        - Schedule E Rental (1040) (p. B-6)
            - Deductible whether you itemize or not
    - **personal expenses** (itemized) 1/3 itemize; 2/3 take std deductions
        - med, charity, interest, state tax
            - Medical: if you are self-employed, you can deduct 100% of med expenses???
                - if not self-employed, you can only deduct that which is over 7.5% of your income
                - what can you deduct?
                    - prescription drugs
                    - drugs that dr prescribes that are available OTC
        - Most Sch A
- Tax deductions you get for something other than Schedule C
- **§ 212** expenses for the production of income
    - Individual
        - Production or collection of income
        - For the management, conservation, or maintenance of property held for the production of income
        - In connection w/ determination, collection, or refund of any tax
            - Ex: commission on selling stock—most itemized of all deductions
    - Overall limitations on deductions (pg. 10-29)
        - 1040 schedules A & B
        - Only 1/3 of taxpayers itemize unless you own a home
        - Don't itemize unless you own a home
        - Deduct mortgage interest, etc.
            - § 212 not as good as § 162 deductions—easier
- ***"For AGI"*** (always prefer "for")
    - (pg. B-6)—use on front page of 1040 (lines 23-35)
        - Non-business deductions that that aren't itemized deductions
        - <u>Commissions</u> are added to purchase and sale price of stock—they are a capital expenditure and NOT INVESTMENT EXPENSES
    - One investment expense ⇒ Line 17 Rental Real Estate
        - If you are a LL you can deduct maintenance etc *for AGI* on Schedule **E**
        - 2% limitations: 0 apply to rental real estate—pay tax on net profit
            - No social security tax
    - Examples: Alimony, Pension Plans, Moving Expenses, penalty on early withdrawal of savings, student loan interest, tuition and fees deduction
    - educator expenses
        - can deduct school supplies up to 250 bucks
- ***"From AGI"***—means it is an itemized deduction and you deduct on schedule A, may only deduct if over 2% of AGI
    - ***See page 10***-30
    - *Must itemize*
    - *Exception: Rental property*
    - **<u>Schedule A Itemized Deductions</u> – From AGI**
        - <u>Biggest 3</u>
            - State/local taxes
            - Interest
            - Charitable gifts
    - **Certain Personal Expenses**
        - Not as good as business expenses which deduct on schedule C
        - Personal expenses are deductible on Schedule A, the total deductions on Schedule A are only deductible to the extent that they exceed 2% of AGI
        - ***<u>(1)Medical/health</u>—***

- Medical expenses defined: expenditures incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body
- most people don't deduct—because congress only lets you deduct excessive expenses---must exceed 7.5% of income
  - Ex.: Iris has medical expenses of $4,800 w/ $1,000 reimbursed. If her AGI for the year is $40k, the itemized deduction for medical expenses is limited to $800. [$4800 - $1000 = $3800 – (7.5% x $40k)]
- Med expenses are exception to depreciation- all deductible in 1 yr
- <u>Nursing home</u>: depends on whether necessary for medical care, or whether elected for lifestyle.
  - If for medical care, then is deductible at 7.5%
  - If just getting old, then can't deduct because a personal expense
  - If you can point to a medical reason you are at the home (ex: physical therapy after stroke, the whole thing is deductible---including lodging and meals)
- Capital Expenditures for medical purposes
  - Ex: elevator, swimming pool, dust elimination system, special room for iron lung – where it is reasonable to have on premises
  - Upon advice of physician, primarily used by patient alone, and expenses is reasonable, then can deduct all in one year (don't have to depreciate)
    - ex: 500,000 FMV before swimming pool and you pay 180K for pool but FMV of house is only 600K, you can make a medical deduction for amount you paid that did not increase value of house
- Transportation, meal, and lodging expenses
  - Lodging must be primarily for and essential to medical care
  - Medical care is provided by a doctor in a licensed hospital or similar facility (clinic)
  - Lodging is not lavish or extravagant under the circumstances (cannot exceed $50 a night per person, where accompaniment is necessary)
  - No significant element of personal pleasure, recreation, or vacation in the travel away from home (15 cents per mile)
- Includes un-reimbursed medical premiums
  - If taxpayer is **<u>self-employed, insurance premiums paid for medical coverage are deductible</u> as a business expense** (for AGI) (unless taxpayer is eligible to participate in health plan provided by spouses employer)
- **Can't deduct** <u>elective</u> cosmetic surgery or gen health (like vitamins)
  - if there was a fire and had reconstructive surgery for burns you can deduct because not elective
- Abortions are deductible

▪ ***<u>(2) Taxes you paid</u>***

- See page 10-11; General taxes are deductible—may deduct state & local income or sales tax—choose if itemize; use income tax (lines 5-9 on form 1040
- can deduct med expenses of dependent
- **<u>Deductible</u>** (p10-11 exhibit 10-2)
  - Real estate taxes – state, local, and foreign
  - State and local personal property taxes (not foreign)
  - Foreign income taxes
  - Environmental tax
- Can only deduct your own taxes/interest paid (can only deduct payments for which you are liable)
  - Ex: your parents pay your property tax bill, they cannot take a deduction for the property tax payment—no one can
    - Solution 1: parents write you the check, you take the deduction
    - Solution 2: make them co-tenants or co-signers so that they have liability
    - Exception to the general rule that you can't deduct other peoples expense
- **<u>Not deductible</u>** (p10-11 exhibit 10-2)
  - Federal income taxes
  - FICA taxes imposed on EEs
  - Social security taxes
  - Estate, inheritance, and gift
  - Excise taxes (gas, spirits, tobacco)
  - Fees (state parks, toll roads – not taxes; although can deduct if business)

- Special assessments (city charges you to replace sidewalk in front of your house – added to your tax bill; adds to cost basis of your home and increases value of your home)
  - special assessments include curbs, sidewalks, sewers---instead of deducting you add it to cost of house
- Apportionment of real property taxes between seller and purchaser
  - see page 10-12
- Can't deduct fees to local gov't

- **(3) Interest you paid** (not cc, auto loan)
  - Includes student loan interest
  - Bank or savings and loan form
  - Home Mortgage interest
    - Can deduct
    - Form 1098, itemized on schedule A, lines 10-14; From AGI
    - ONLY deductible for primary/principal and 2nd "dwelling unit". (can't have 5 vacation homes)
    - Deductible if meets 3 requirements:
      - **(1) Dwelling unit**: any place that has bed and toilet (ie boat, Winnebago, etc can be a second home)
      - **(2) Secured mortgage:** Loan must be secured by the dwelling unit -**-if** default, house can be sold (there must be a lien against property)
      - **(3) Max amt**: Indebtedness must be via a primary (qualified) indebtedness or home equity loan (second)
        - **Qualified indebtedness**: what you actually borrowed to pay for the house; max debt of $1mil qualifies for interest deductions (doesn't mean that $1mil is deductible, only that interest on up to $1mil is)
        - **Home equity loan**: use your house as collateral for any kind of debt---what you borrowed for other things; max debt is $100k (most you can deduct is interest of loan up to $100k)
    - Policy issues: where home loan interest is deductible but car loans, etc., are not, encourages people to get HELs and to be reckless w/ their most valuable asset
  - Points for mortgage on principle residence
  - Investment interest
    - If you borrow $ to make investment
    - 2 categories
      - Rental expenses: sch E ⇒ Deductible; For AGI (don't need to itemize to deduct)
      - Stocks and bonds (margin account): sch A ⇒ Deductible; From AGI (can only deduct if you itemize)
    - Business interest: Schedule C ⇒ Deductible; For AGI
    - Student loan interest ⇒ Deductible; **For AGI**
      - on front page of 1040
      - Max tax deduction = lesser of investment interest pd or net investment income; Take % of taxable income x interest pd
        - Ex: Interest expense = 15k, Municipal Interest = 40k, Taxable dividends and interest = 160k. 160+40=200. 160k/200k = 80%. 80% x 15k = 12k deduction.
        - ***Investment interest lmtn***- can't deduct unless your investments produce income that yr
          - **Investment income is: *Interest, dividends and rent NOT capital gains***
      - No tax deduction to invest in tax exempt income
- ***Cannot deduct: credit card interest, car loan interest, etc (personal interst)***
  - **See problem 60 on 6-41**
  - Charitable gifts (Cash)
  - Charitable gifts (property)—40% of charitable gifts
  - Casualty & theft losses (hard to get)

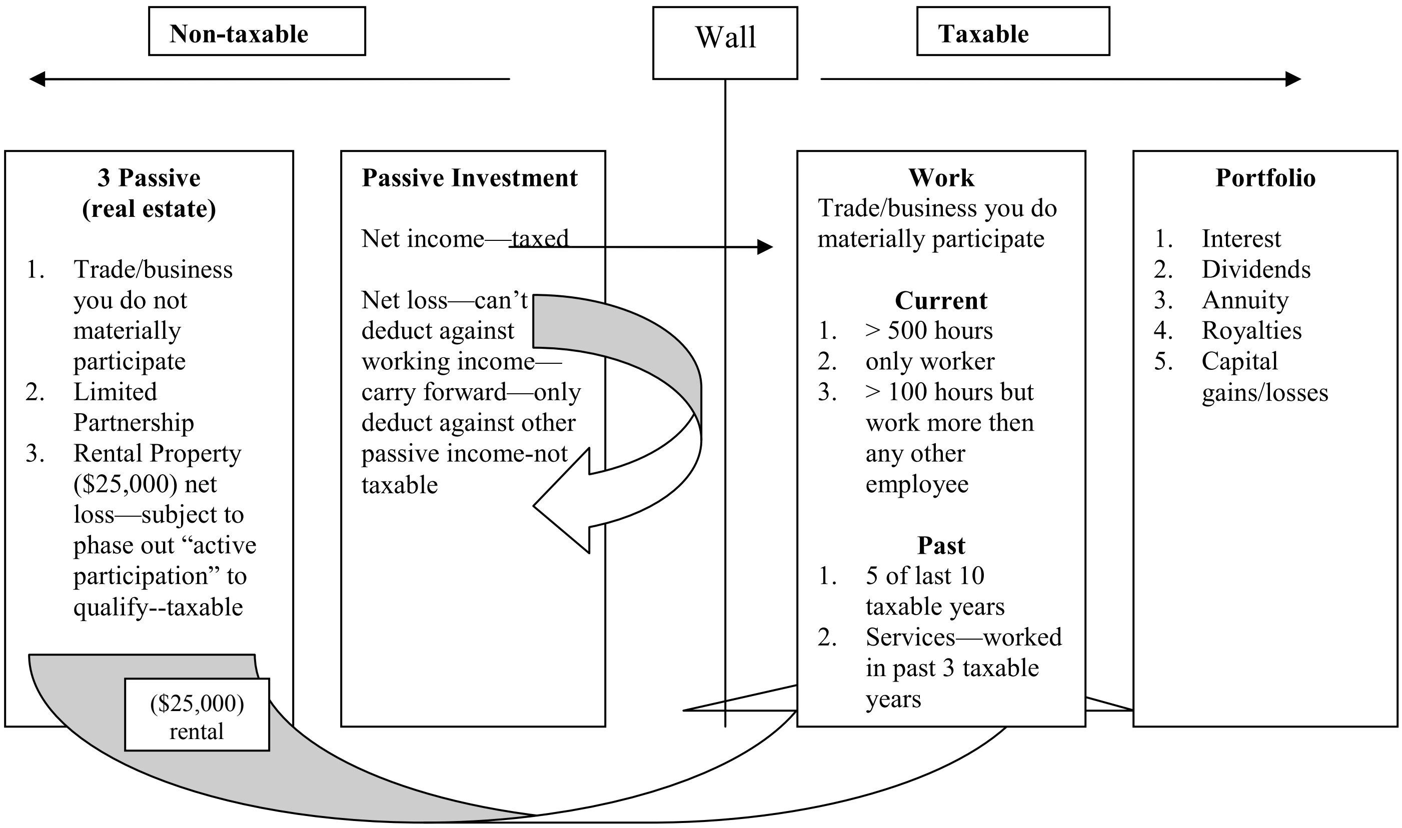
- **Allowed as itemized deductions:**
  - what interest can you deduct?
  - Bus interest- Sch C

- Home Mortgage interest- Sch A
- Investment interest
- Schedule A: for stocks/bonds
- Sch E: rental property
- Student loan- front pg of 1040; don't have to itemize income

- Investment Expenses
  - §212 – expenses for production of income
    - ordinary and necessary 1) for production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; (3) in connection w/ the determination, collection, or refund of any tax
    - not stock sales commissions b/c this is capital expenditure, instead add to cost of stock
    - not trade or business related
      - Ex: rental properties, stocks, bonds
    - For stocks and bonds: can deduct expenses which exceed 2% (from AGI)
      - 2% doesn't apply to rental property; no limit
- Charitable Contributions
  - Charities lessen the burden on gov't
  - If gift to family- don't get income tax deduction; if give too much $, pay gift tax
  - If gift to charity- get deduction
  - For most people: clothing to thrift shops
  - More than $11k gifted; giver must file gift tax return
  - Lifetime limit of $1 million (unless charity)
  - **8 Rqmts for charitable gifts:**
    - Only get deduction for cash or property (**not** time/services)
      - Ex: if give cake, can deduct flour, but not value of cake
        - you can deduct your out of pocket costs (like cost to get to the free clinic where you volunteered but not the cost of your services
    - Only for **USA** charities→**501(c)(3) charity** organization
      - Cannot deduct by giving cash to homeless (non-organization)- have to give it to charity to give to them
    - Must be completed gift (must have delivery, acceptance, etc.)
      - Must reduce tax deduction by FMV rec'd
      - Ex: banquet tickets cost $100, dinner is worth $20, so $80 would be deductible
      - remember that clothing and cars go down in value
        - *Stamoulis v. Commissioner*—investment banker buys clothes and wears once. Tries to deduct 55,000 after she gave the clothes to charity. Tax court said this was not ok. New clothes sell for more than used clothes (even if it is a day later)
      - If it is an appreciated amt, you must subtract anything that isn't a long term capital gain
        - Asset must produce a capital gain
        - See flow chart
        - When you sell stock, it is a capital gain
    - Must obtain a letter from the charity stating what you gave (cancelled check is not enough)
      - $250+ is not deductible w/o certain, specific receipt (cancelled checks are not enough); must get letter from charity that:
        - describes that you gave (describe the prop)
        - says if you got anything in return from them for your donation-- Must clarify you received no goods or services from your contribution
        - beginning in 2007: can't get tax deduction for charitable gift unless have canceled check or receipt from charity
    - Long-Term Capital Gain Requirement- Best Asset
      - If donated item isn't held for at least 1yr and 1 day, the deduction is the basis of the item and not the FMV
        - Ex: Amy donates stock on 5/5/06 worth $20k (Purchased on 1/1/06 for $8k). Charitable contribution is $8k.
        - Long-term capital gain- get double benefit—only for appreciated stock
    - Tangible personal property
      - you can move it
      - ex: paintings to 2 museums

- if the charity does not "use for tax exempt purpose?"
- Must have appraisal attached to return if:
  - You give property (a painting, land) and it is worth more than $5k (and if charity sells your gift w/n two years, must tell IRS what they sold it for—is compared)
    - Exceptions:
      - Publicly traded Stock (value = avg b/t day's high and low)
      - Car (and boats) (deduction is what charity actually sells for)
      - Closely- held stock (family business then appraisal jumps to $10k)
- Maximum annual deduction
  - **Cash to public charity** = 50% of AGI
  - **Cash to private foundation** = 30%
  - **Property to public charity** = 30%
  - **Property to private foundation =** 20%
  - **carry forwards occur in line 17 on Sch A**
  - IRS prefers appreciated property
    - Ex: Years previously, Lois buys stock for next to nothing. It appreciates to $100k in value. She wants to sell the stock and she wants to donate $10k to charity. If she sells stock and writes check for $10k, she has 100k gain on sale; $90k taxable income. If she donates 10k worth of stock, she has $90k gain on sale, $10k deduction, $80k taxable income
    - If produces long-term capital gain, is best asset for gift
    - Casualty and theft losses (not covered)
- Miscellaneous deductions (2% of AGI); see pg. 10-29; line 27 Schedule A
  - *certain deductions are only deductible if, in total, they exceed 2% of taxpayer's AGI
  - Professional dues to membership organizations
  - Educational expenses
  - Uniforms or other clothing that can't be used for nomal wear
  - Fees incurred for preparation of one's tax returns or fees incurred for tax litigation before IRS/other courts
  - Job hunting costs
  - This also includes employee job expenses, investments etc
- Miscellaneous Deductions not subject to the 2% AGI limitation
  - Gambling losses (what you won)
  - Impairment related work expenses of a handicapped person
  - Federal estate tax income in respect of decedent

Deduction for repayment of amounts under a claim of right if more than 3,000
The unrecovered investment in an annuity contact when the annuity ceases by reason of death
See problem 47 on 10-44
?????????????



PASSIVE LOSS LIMITATION-Sch E

- Affects people in partnerships that don't work there or people that have real estate rental property
- People investing in partnerships that produced losses to reduce income to go to lower tax bracket.
- If you have passive investments where you don't work and you have a net loss in these activities, you can't deduct it against other active income where you materially participate
- Applies to Sch E
- Loss in an investment where you don't work, can't deduct the loss!
- If during yr, txpyr has net passive losses, the non-deductible loss is carried forward and used upon the earlier of: net passive income or when asset is sold.
- Passive income was formally protected by a tax shelter
  - If making a profit are taxed like your working income
  - Losses can be deducted from your working income
  - Passive income is making an investment in a place where you don't work/materially participate
  - Example: have Partnership M and N, M makes $60,000 profit, N has a $40,000 loss—could use them to offset one another and then you would only have $20,000 taxable income
  - Example: Bob earns $200K from job, $45K from dividends and has a loss of $50K from investment in passive activity. Net income is $245K. Can't deduct passive losses.
- Types of Income
  - **Active** – Wages, Profit from trade/business where taxpayer materially participates, Gain on sale of assets, Income from intangible property
    - Prefer to have losses to be active income b/c they can be deductible.
  - **Passive** –§ 469(c)
    - Trade/Business (schedule C) where you don't materially participate→could be a general partnership
    - Rental Activity,
    - interest in a Limited Partnership
      - *Prefer to have gains to be passive income b/c you can offset it w/ your active losses
  - **Portfolio** – Interest, Dividends, Annuities, Royalties, Capital Gain/Loss
- (§ 469 (h))**Material Participation** defined: A taxpayer shall be treated as materially partic'ing in an activity only if the txpyr is involved in the operations of the activity on a basis which is

    - regular,
    - continuous, and
    - substantial
- Is this Active income?
    - **Current Participation**: (Can taxpayer answer yes to any to make it active?)
        - Did individual put in more the 500 hrs/yr? (10 hrs/wk) this is ¼ time
            - This is about 1.5 days/week
        - Is the individual the only worker/employee?
            - No 500 hour test. Get to deduct it all
        - Did individual put in at least 100 hrs, but still more than any other EE?
        - Did individual's aggregate participation during the year exceed 500 hours?
    - **Past/Prior Participation**:
        - Did you work there (materially participate in the activity) any 5 out of last 10 taxable yrs?—If yes, active income
        - Is the activity a personal service activity and did the individual materially participate for any of the 3 preceding taxable years?—If yes, active income
            - This includes legal/medical services
- **Three Passive Activities**
    - Do you have net income? Do you have net loss?
    - *Trade or Business where you do not materially participate* (T/B where you don't work)— ex: gas/oil exploration team; AB Software where A doesn't work
    - *Limited partnership/partnership interest*
    - *Rental property*
        - 3 situations where a rental activity is *non-passive*—must have active participation (less than material) and you can deduct
            - If the *rental activity is really a business* and not just a rental
                - When the average rental period is 7 days or less—DVD rental store, car rentals, hotel
            - If you are a *real estate professional*—you can deduct your losses under normal business rules
                - *Must put in at least 750 hours* a year into the business
                - You pick the tenants and the lease terms, but let a management company run—if management company does everything, it doesn't work
                - *see* page 11-19
            - *Active participation*- designed for people who have a duplex
                - aunts and uncles
                - to qualify:
                    - actively participation in real estate rental activity
                        - ie pick tenants, design lease, control tenants activity
                        - AGI < 100K. Phase-out starts. See below
                            - Once your income is over 150K, you can't use this break! It was designed for small time landlords
                        - own 10%+ of all interests in the activity during the entire taxable year
                - Can deduct losses up to $25k. Anything over $25k is subj to passive loss lmtn and is carried forward to next year. Phase out begins at $100K (AGI exceeds $100k, phases out $0.50 on the $1)
                - Subject to phase out—if AGI is $100K then you get phased out by 50%
                    - Ex] income of $110k, had a loss from rental of $25k—can deduct $20k b/c he is over the income limited by $10k and you take ½ of anything over the AGI lmt of $100k
                - The income limit is $150k. Once income is > $150k, there is no deduction.
                    - Ex] income of $160k, loss of $25k—can't take a deduction of anything (not even $25k) b/c your income is $60k over the AGI limit and ½ of $60k is $30k which is greater the $25k (no deduction is allowed)
    - § 469 Passive Activity Losses and Credits Allowed
        - (a) general disallowance
        - (b) disallowed loss or credit carried to next year
            - Exception: 2 times when you can take the loss
                - When you make a profit—could be carried over for rest of you life
                - When you sell the asset—get to deduct all of the loss

TAX CREDITS

- Credits affect everyone the same – (Doesn't matter what tax bracket you are in)
- There are spots for the credits on the 1040
- Foreign tax credit—see page 12-18
- **Refundable Credits** – Credits paid to taxpayer even if the amount of the credit exceeds taxpayer's tax liability (Line 64,65)
  - Taxes withheld on wages, Earned Income Credit
- **Non-Refundable Credits** – Credits which aren't paid if they exceed the taxpayer's tax liability. (pg. 12-5) (Lines 46-54 of 1040)
  - Ex: Child tax credit, Education tax credits, Credit for child and dependent care expenses
- ***Earned Income Credit*** (line 66(a) is refundable—designed for working poor (if income is below poverty line ⇒ pay no income tax)
  - A lot of people compute this incorrectly (# 1 source of problem)
  - If you work below the poverty line, you won't pay income tax, but you will pay social security tax
  - See page 12-16 for earned income credit and phase-out expenses
  - Only applies to people w/ kids—gives them their social security back, much harder if don't have a child
  - Table (pg. 12-16)
    - Between $11,000 and $14,000 get the peak credit of $4,716 w/ two kids
    - One kid - $2,853

Qualification for ***Earned Income Credit***		
TESTS:	**Kids**	**No Kids**
Do you have a Qualifying Child?	Must be under age 19 if dependent (under age 24 if full-time student and live with them for more than 6 months), permanently disabled	N/A
What is Income?—must have paid social security taxes	Must be less than 40,000 (2) kids—agi Must be less than 33,000 with 1 kid	Married - Less than $14,000; Single – Less than $12,120???
What is filing status?	Can't take if married filing separately	Can't take if married filing separately
Age of Taxpayer	Doesn't matter—can be any age if have kids	Must be 25-64—don't want elderly or students using this deduction
Elderly—if income is over $12,000 phases out completely		

- ***Child Tax Credit***
  - **Generally non refundable**
  - Credit is based on the number of qualifying children
  - $1,000 per child
  - Qualification:
    - under age 17 (up to and including 16)
    - Child must be your dependent
  - Phase out—credit goes down by $50 for every $1,000 you are over income limit per child
    - Married joint return—phase out if income over ***$110,000***
      - Phase you by $50 for every $1k over the limit
    - married filing separately—phase out if income over ***55,000***
    - Single—phase out if income over ***$75,000***
      - Example: If single and make $80,000, your child tax credit would be $750 ($80,000-$75,000 = $5,000 (5 x $50 = $250) ⇒ $1,000-$250 = $750).
      - Example *see* 12-33 problem 37
- ***Education Credits*****—form 8863**
  - **Both are non refundable**
  - **§ 222** in 2005: you could take tax deduction up to $4k of law school tuition
    - expired in 2006
  - *can't* pick both Hope Credit and Lifetime learning; must choose
  - *both* are phased out for higher income tax payers
    - *page 12-24*
      - credit is completely eliminated when AGI reaches
        - **$114,000** for married filing jointly

        - **$57,000** for single
      - Married $94,000 - $114,000
      - Single $47,000 - $57,000
  - To determine if credit or deduction is better
    - If your tax rate is more than 20%, you will want to take the deduction rather than this credit

	HOPE SCHOLARSHIP CREDIT	***LIFETIME LEARNING***
Who can take it?	TP, spouse or dependent	TP, spouse or dependent
Amount of credit	max: 1,650 per year, per student. (100% of first 1,000 and 50% of second 1,000)	Permits a credit of 20% of qualifying expenses (up to 10,000/year) so the max is: $2,000 per year/per tax return (20% of first 10,000)
when do you qualify?	First 2 years after high school	Anytime
what qualifies?	Tuition and fees (*does not include room and board)*	Tuition and fees (does not include room and board)

- ***Child and Dependent Care Expenses*-form 2441**
  - **Non refundable**
  - If parent(s) are working and have to put child or parent in day care, get tax credit---get the tax credit so you can work
  - Can't pay a dependent child to watch the other kids
  - Qualifications:
    - (1) must work (exception for full time student)
    - (2) have to make payments to take care of:
      - Dependent under the age of 13 (up to age 12)
      - A dependent or spouse who is physically or mentally incapacitated (can put spouse in adult day care)
    - (3) Can't pay a dependent (under age 19) to watch another dependent child or incapacitated adult
      - could pay another family member, i.e. grandparent
    - (4) if married, must file joint return
  - Amount of Credit:
    - FIRST: Take the **lesser** of the following
      - (1) Amount actually paid
      - (2) Earned income of the lesser paid spouse (if full time student n/a so choose (1) or (3)
      - (3) $3,000 for 1 qualifying individual or $6,000 for two or more
    - SECOND: multiply the least amount by the credit percentage
      - This chart is located on **Form 2441** and in book on page 12-22
    - Ex: Jane earns $36K. She paid $2900 to her 17-year-old sister to watch her son. Credit is $2900 x .24 (from table on 12-22) = $696
    - *see problem 39 on 12-33*
  - If company has a dependent care plan—you can't take a tax credit—have to choose
    - Gen'lly, much better to take the exclusion if offered at work then to take the credit b/c don't have to pay taxes like social security on that income (ex: if company offers a plan (fringe benefit) to put certain money from pay check into account (tax free) to be used for child care)
    - *see problem 19* on 12-31
- ***Adoption Expenses Credit***
  - **Non refundable**
  - In 2007, up to $11,390 of costs incurred to adopt is eligible for credit
  - Person must be under age 18 OR physically or mentally incapable of caring for self
  - Won't be on the test

REALIZATION PRINCIPLE

- Property transactions
- realization principal: Congress said you can't be taxed until you have realized a gain or loss
- **A/R (selling price) [minus] A/B (cost, depreciation, improvements=realized gain or loss**
- Realized Gain/Loss – Actual gain or loss on property
- Recognized Gain/Loss - Amount that can be either taxed or deducted
  - Some realized losses aren't recognized like condemnation for personal property
- ***Eisner v. MacComber*** —lead case for realization principle [can't tax stock dividends because they are not "income"
  - Facts: MacC owned 2200 shares in Standard Oil, Stand Oil gave her 1000 more shares as a stock dividend, IRS went after her.
  - Rule: MacC is not taxed on the 1000 shares
    - Fruit from the tree: income is the fruit on the tree, not taxed on growth of the tree until you sell the tree
    - Growth is merely capital and is not taxable
- Examples where stock dividends can be taxable
  - **Stock Split**
    - Dividend reimbursement program: Stock split is taxable **IF** you have a choice b/t cash or more stock (**§ 305**)
    - Disproportionate Distribution: some people will get more stock than others-uneven split
    - If distribution is at the election of stockholder—***taxable*** as either stock or property
  - ***Not taxable*** if at the election of the company if you just get more stock
- **What if you just sell a portion of what you bought:**
  - General Rule—**allocate→**you apportion your purchase price to the part that you are selling (1/8th of land = 1/8th of selling price)
    - Exceptions: ***Cost Recovery***
      - ***Inaja Land v. Commissioner***: guy bought land in 1925 for $60k and LA paid him $50k in 1939 to flood the land and put it under water but said he still had ownership of the land
        - IRS argued: sale of property (easement) $50k was taxable.
        - Taxpayer said it was tax-free. He used the cost recovery method and it was tax-free.
    - **Cost Recovery Method**: *When you can't determine % of original price that was paid for certain rights, payment to you is tax free until you get the entire purchase price back*
      - Reduce your basis to what the difference is between your purchase price originally and what you were compensated
        - Example:
          - bought land for $10,000, utility company gets easement on land and pays $8,000—the basis of the land is now $2,000 (difference between the $10,000 purchase price and $8,000 in compensation that was paid)
          - Then when sell the land you subtract that $2k, so land bought for $15k - $2k = $13k (pay taxes on the $13k)

GAINS AND LOSSES

Realized gain or loss is the difference between AR from the sale and the prop's AB on date of sale.
AR > AB = Realized Gain
AR < AB = Realized Loss

a) "Amount Realized" (comes from **Eisner v. MacComber**)
Amount Received
Cash
Property (Fair market value)
Services (Fair market value)
Add Liabilities Assumed (like when a buyer assumes your mortgage)
Subtract Selling Expenses (like a commission)

a) "Adjusted Basis"
i) Cost
ii) Substituted Basis – where the seller doesn't have any actual cost
(1) Gift
(2) Inheritance
iii) Add Improvements

- iv) Subtract MACRS (Greater of "allowed" or "allowable")
- v) Subtract return of capital (like *Inaja Land* sale of an easement and use of Cost Recovery)
- vi) Subtract Losses (like a casualty loss)

b) **Example of Allowed vs. Allowable Depreciation**
- i) Buy a property asset for $10,000
- ii) Choose to forgo the $2,000 and $1,000 depreciation deductions in years 5 & 6 (because you had losses and you want to save them)
- iii) Sell in year 7; you have to adjust your basis **as if** you had taken the deductions.

c) **Substitute Basis**
- **i) Gift that is Sold –** use **"Carryover Basis"**
  - (1) Sold for Gain – use the Donor's "Adjusted Basis"
  - (2) Sold for Loss – take the **lesser** of
    - (a) Donor's adjusted basis
    - (b) Fair market value at the time of the gift
  - (3) Ex: Owner purchases for $500; gives to you, when valued at $750; you sell it: Must use either the
  - (4) Ex: Owner purchases for
- ii) **Inheritance that is Sold** – use **"Step up in Basis"**
  PICK EITHER:
  - (1) Basis is the ***Fair Market Value at the date of death*** (value of the item when they died, not when they purchased)
  - (2) Called "Step Up" because of the assumption that property increases in value over time.
    - (a) Planning Point – have older people NOT sell stock, so that when it transfers on their death the basis is higher at the time of the transfer and the tax burden is reduced.

  OR:
  - (3) ***Alternate Valuation Date*** (6 months after death) – you can pay the estate tax based on the valuation of the property use only if amount is less than estate tax.
    - (a) All or nothing for all assets
    - (b) If you choose an alternate date for estate tax, the same valuation applies for other taxes
    - (c) Cannot use this method if the value of the property increases in the interim.
  - (4) Ex: Owner purchases at $500; when he dies, it is at $750 – you would use the $750 FMV,

- ***Amount Realized*** **(A/R)**
  - **Formula:**
    - **FMV of amount received**
    - **Add liablities assumed by buyer**
    - **Subtract selling expenses (commission included)**
  - Sale or exchange: is taxed
    - sale=selling for cash
    - exchange=property and you swap for services
      - look at the value of the services you received
  - Realized—Congress **could** tax you
    - For Services: There has been a sale or exchange
      - FMV or what you received—generally cash, could be property
        - FMV of Services (=) liabilities assumed (amt left on loan) (-) selling expenses (commissions)
  - Recognized—Congress **does** tax you
- ***Adjusted Basis*** **(A/B)**
  - Basis=amount that you paid---financing won't change it
  - A/B = Original Cost (basis)+ Improvements/Cap. Expenditures – Depreciation – Any Return of Capital – Loss (casualty)
    - interest is an expense and is deductible
- ***Cost (or "substituted basis")***
  - **Cost**—original purchase price
    - Ex: Bought property for 250K (200K for building/50K for land). Built tennis court for $5K. Deducted 30,900 for depreciation on house and 1,300 on court. Sell house and tennis court for $400K. A/R = $400K; A/B = 222,800 (250K + 5K – 30900 – 1300). Realized Gain = 400K – 222,800 = 177,200.
  - **Substituted Basis**—gift or inheritance
    - **(1) Gift** (13-12-13)—also true for conversions
      - Depends on if you sell for a *gain* or a *loss*

- ***If sell for a gain:*** the general rule: carry over basis: you use the **donor's A/B**
- ***If sell for a loss:*** you use the lesser of the donor's A/B *OR* FMV at date of gift
  - Don't have people give you property that is falling in value
  - Example:
    - Mom paid $10,000 for stock, FMV at time of gift is $12,000, you sell for $14,000
      - Adjusted basis is $10,000 b/c less then $12,000 (FMV) at time of gift. Taxable income is $4000
    - Mom paid $10,000 for stock, FMV at time of gift is $7,000, you sell for $6,000
      - Adjusted basis is $7,000 b/c it is FMV at time of gift and is less than the $10,000 original purchase price. Loss is $1000

- **(2) Inheritance/death [bequest] §1014**
  - General Rule: ***Step-Up Basis***: FMV of stock/property at date of death *(don't care what person bought it for)*
  - ***OR:*** If the estate elects the ***alternate valuation date—(only when estate state tax return is filed)***
    - When you calculate estate tax, may look at FMV *6 months* after death to determine A/B
    - Can't elect this if it increases the estate tax
    - At time of 9 mo pymt—can pick the 6 mo if it's lower
    - if you elect this on state tax return, this will be your basis
- **(3) substitute basis also applies when you convert an asset from personal use to business or investment use→use same rules as gift.**

LOSSES or GAINS ON SALES

Type of Asset:	**Gain**	**Loss**
Trade/Business *Schedule C	Pay tax	Deduction
Investment *Schedule E rental property and stocks and bonds	Pay tax	Deduction
Personal Use *house, car, furniture	Pay tax	**No** Deduction (EXCEPTION: casualty/theft)

- **3 Rules for losses**
  - ***(1) Personal Use Assets***
    - Can't deduct (houses, cars, clothes, etc.)
      - can't deduct house even if sell for loss
    - **see problem 70 on page 13-59—**
    - Can't deduct even if you convert to another use (*ex: trying to convert your home to a rental property right before you sell it)*
      - Cost less FMV at time of conversion
        - Parents have house $300k, parent buy house for kids $300k (use as rental) (this house depreciates in value b/c it is rental property MACRS)
          - Both houses appreciate to $400k
          - Sell own house for $400k and kids house for $200k
          - if sell rental prop for loss and convert to personal use- you get lesser of Orig A/B or FMV at conversion
            - If houses decline in value the basis would be reduced on the rental property to the FMV, the loss on the personal residence will not be deductible, however, the loss on the rental property is deductible
      - MACRS deductions
        - ex] they sell house they live in for $350k, it costs them $300k; gain = $50k; sell rental prop they bought for $300k but take over 9 yrs of 100 of MACRS deductions; when they sell the rental prop, basis will be $200k so gain will be $150k
        - ex] bought 2 houses for $300k/each; sell each for $130; on house they live in, they lost $170k, but recogn'd loss is zero; other house was converted to rental prop at $210k

      - You depreciate house for only the 9 yrs it was a rental, from 1999-2008; on MACRS 27 yr scale, you can depreciate it 1/3; so your depreciated value is at $140k so then you're A/B is $140 so you can only deduct $10k of loss
  - ***(2) Wash Sales*** **[no deduction for loss] § 1091**
    - this is only for stocks and securities; does not apply to rental properties
    - People who buy stock that falls in value will sell the stock at a loss (to get the deduction) and then the next day buy it back if it begins to go up in value—this way they get to take the tax deduction for the loss
    - RULE: If you sell any stock for a loss, you can't deduct the loss if you repurchase identical securities (same stock) within 30 days (30 days looks both forward and backward)—must look at month before and month after the sale—if you do repurchase the security w/in the 30 days, can't take the deduction
      - *see* example 13-53 problem 22
  - ***(3) Related Party Sale*** **(p. 6-25) [no deduction for loss] §267(a)(1)**
    - applies to business and investment assets
    - Can't deduct a recogn'd loss on a sale to a related party (family member)
    - Loss that is realized by selling to a related party can only be used to offset a **gain** by the family member→CAN'T DO THIS IF THERE IS A LOSS:
    - Code provides for disallowance of any losses from sales or exchanges of property directly or indirectly b/c family members
      - If you pay farm hands in Jan and they're not related you can deduct in Dec, but if they are related, can only deduct on cash basis method
    - **<u>Related Parties</u>** (p. 6-26)
      - Brothers and Sisters
      - Spouse
      - Ancestors (lineal) (parents, great-grandparents)
      - Descendants (lineal) (children, grandchildren)
      - A corporation owned more than 50% by taxpayer (if sell to own business, there is no loss deduction) (not only do you own your own stock but also stock of family members)
    - **<u>Not Related Parties</u>**
      - Uncles, Aunts, Nephews, Cousins, etc.
  - see problem on page 6-40 problem 57
    - bought for 55, sold for 90. That is a gain of 35. That can be offset by sister's loss of 13 so amount recognized is 32.
    - 13= stock basis was 68 and sold to brother at 55. (55-68)
    - Bought for 55 sold for 49. That is a <u>loss</u> of 6 and that can't be offset by sisters loss
- **Stocks**
  - When buy stock, you buy different amounts at different times—general bought at different prices
  - 2 ways to figure out what **basis** for stock is
    - *<u>(1) specific identification</u>*—tell broker what you want to do (sell stock acquired on this date)
    - *<u>(2 FIFO</u>* (first in first out)—if you can't figure out which shares were sold, tax law says you are always deemed to have sold the oldest stock
      - This is usually to your disadvantage because it is your lowest cost
- **Mutual Funds (form of stocks)**
  - *3 ways to figure out basis*
    - *<u>Specific identification</u>*
    - *<u>FIFO</u>*
    - *<u>average cost election</u>*: you can elect to just average all the costs of all the shares regardless of when they were acquired
      - this is the easiest way to do this because the mutual fund company will tell you the average price
      - once you make this election you are stuck with it for life.

PROPERTY: EXCHANGE v. SALE

- Sale = normal cash sale; Exchange = barter or swap
- All exchanges and sales are taxable
- Realized Gain or loss
  - General Rule: Sale or Exchange
    - Gain
      - Business/investment/personal use ⇒ Taxable
    - Loss

- Business/investment ⇒ Deductible
- Personal use ⇒ Not deductible

- Special Rule**: *§ 1031 Like Kind Exchanges***
    - Gain
        - Business/investment ⇒ Not Taxable (mandatory)
        - Personal use ⇒ n/a
    - Loss
        - Business/investment ⇒ Not Deductible (mandatory)
        - Personal use ⇒ n/a

DEFERRED GAINS:

- **4 types: like kind exchanges, involuntary converstions, sale of principle residence, causalty losses**

(1) LIKE KIND EXCHANGE § 1031—MANDATORY

- Usually, barters are taxable, but like kind exchanges are ***not taxable*** *(exception:* will be taxable if you realize gain and received ***boot)***
- 1031 - statute is very big deal for real estate law and it is a planning statute because exchange isn't taxable but it is deferred later until you sell
- ***General Rules to Qualify***
    - *(1)* Must have an exchange (barter)—*no cash*
    - *(2)* Must be business or investment property swapped for other business or investment property (could swap business for investment and vice versa) (Must be USA property)
        - *not eligible for like kind exchange:*
            - Inventory
            - Stocks and securities
            - Partnership interests
            - Personal use assets (ex: home for condo)
    - *(3)* Must be Like Kind Property—different standards depending on what you are dealing w/ real v. personal property
        - *Real property*—anything goes
            - Can be unimproved for improved
            - Ex: client can swap a condo on the plaza for a farm up north
        - *Personal property*—has to be the same category
            - Can't swap a truck for a copier (b/c not in same category)
            - Can't swap an airplane for a car
            - Office furniture and office equipment *can* be swapped
                - Could swap a computer for office furniture (b/c in same category)
    - this law is mandatory: if you have like kind exchange you cannot recognize a gain or a loss
        - ex: Pabst has KC Real Estate Building and Paulman has St. Louis Farmland
            - FMV=100 for both
            - a/B 60 for farm and a/b 30 for building
        - Ex: Ann traded in truck (A/B of $2000) for a new truck costing $10000. Dealership gave Ann a $7000 trade in allowance and Ann paid $3000 in cash. New A/B is $10k – 2000 – 3000 = $5000 (A/R – A/B – Cash paid)
        - Boot= I'll give you my $300k in real estate and $100 to boot
            - Like kind prop there is no recogn'd prop but you should pay tax on that boot

QUALIFIED INTERMEDIARY—1031 deals are done this way

- Situation where one person wants cash and the other wants property but both want to do a like kind exchange - Use a qualified intermediary
- Steps:
    - The qualified intermediary buys the property from the person who wants cash
    - The qualified intermediary then transfers the property to the person who wanted to buy property for cash
    - The basis would be the same as the selling price, therefore no gain or loss on the transaction
- Loop hole (pg. 13-28)
- Exchange period is 180 days to find like kind property through a qualified intermediary before it can no longer be considered a like kind exchange—1/2 a year to find new property before lose the tax break
- Identification period is 45 days

BOOT (pg. 13-28 to 13-31)

- ***Boot defined:*** property that is not "like kind"→includes cash
    - When you have an exchange where one property is worth more than the other, you make up the difference w/ boot (generally cash but can be anything other then like kind property)
- When a like-kind exchange occurs and someone receives property or cash (which is not like-kind property)
- Receipt of boot triggers recognition of gain if there is a realized gain.
    - Recognized gain = *Lesser* of boot received or realized gain
- Example: Hoyt has property worth $300k, F has property worth $400k
    - $400k land price, A/B of $20k = *realized* gain of $380k
    - *recognized* gain of $100k (amt of diff b/t land prices—also known as ***boot***)
    - want to recognize gain of $100k b/c less than $280k ($380k price of land - $100k in boot (automatically taxable))

- this means that $280k is deferred b/c basis in the property is going to be less then FMV—the basis would be the same $20k and if F ever sells the property his basis would be $20k b/c the it stays the same and carries over to the new property—means the $280k gain is deferred
- FMV of real estate is $400; Cost is $390; Realized gain is $10; so recog all $10 and defer nothing
- is cash is more than realized gain?
- ask seller what was your gain/what did you realize- taxable- tax is on lesser of the real gain or FMV boot

	Receive Boot	**Pay Boot**
Realized Gain	Have to recognize lesser of realized gain or FMV of boot (cash or goods) (pay tax)	No recognized gain—no tax
Realized Loss	Can't recognize loss	Can't recognize loss

- **Formula** ⇒ A/B of like-kind property surrendered + A/B of boot given + Gain recognized – FMV of boot received – Loss recognized = New A/B
  - **A/R – A/B = Realized gain/loss**
  - ***FMV of like kind property – deferred gain = A/B of new property-shortcut***
    - Ex: Clarence swaps his truck for a similar one. A/B of old truck was $17K (FMV was $11K)
      - 11k (A/R) – 17k (A/B) = (6k)
        - No recognized gain; Deferred Loss of (6k)
        - 11k – (6) ⇒ (FMV new) – (Deferred Gain) = 17k = A/B of new property
      - Ex: Stephanie owns a machine (A/B = 60k; FMV = 95k). She exchanges it for another machine (worth 70k) and stock (worth 25k).
        - A/R = 95
        - A/B = 60
        - 95 – 60 = 35 (Realized Gain) (We rec'd 25k in boot = recognized gain)
        - Recognized Gain = 25
        - Defer = 10 (35 – 25; Realized gain – Recognized gain = Defer)
        - A/B New = 60 (FMV – Defer; 70 – 10)

Shortcut: FMV of new land (minus) deferred gain= A/B in new land

(2) **SPECIAL TAX EXEMPT TRANSACTIONS**

- **Gains - §1033; Losses - §165**
  - §1033
    - If insurance check is more than basis, you can avoid paying taxes if you
      - make election
      - you plan to reinvest that money to rebuild
  - § 165
    - you deduct loss (don't have to reinvest)
    - could take the money and spend it on a vacation
- ***Casualties***—fire, tornado, shipwreck, etc.**—*"sudden and unexpected" destruction of property*** (Golsen rule [8th Cir] termite damage counts…keep in mind this isn't the same everywhere)
  - other events for casualty loss must be:
    - sudden, unexpected, and unusual in nature
    - damaging to property
  - ***General Rule:*** Deduct in year of casualty
  - ***2 Exceptions:***
    - *(1) if you expect to be reimbursed for the damage and you have insurance policy*
      - fully reimbursed→no deduction
      - partial reimbursement: can deduct difference
      - if you have filed claim for reimbursement or filed claim in lawsuit, cannot deduct until claim is settled
      - if you choose to not receive the claim, you are taxed as if you had received it
    - (2) *if President has declared your area a disaster area (pres must be the one to do it, not local gov't)*
      - You can either:
        - (1) deduct in the year of the casualty OR
        - (2) amend a prior year's return: reason: FEMA comes in and they make low interest loans and ifyou deduct on prior return you get return/refund sooner so you can begin rebuilding

- ***Loss ⇒ Take loss in year of the event***
  - ***Business/investment—deduct under § 165***
  - ***Personal use—deduct (reduce deduction by 10% of income and $100)—must be more than $100 to deduct***
- Gain ⇒ Taxable
  - Exception: elect 1033 (*involuntary* conversion)—rebuild or replace your property

- ***Theft***—lost items are not deductible, must be stolen
  - ***General rule***: Take the loss in the year theft is discovered, rather than actual year of theft
    - issues arise in embezzlement actions
      - if embezzled for 5 years and find out in 5th year, take the entire 5 year loss in year 5
- ***Condemnation*** – See Below in "Summary of All"
  - § 1033 (only applies to gains): if you have condemnation (farmer has to give some of their land to build hwy) or if its sold under a threat of condemnation, you can also do the involuntary conversion thing; that means that any gain can be tax free
  - if you have condemnation where you didn't want to sell and have loss, deduct the loss
  - if have condemnation for vacation home (personal use) and you don't want to sell, can't deduct
  - if sell personal principal residence (special break)- gain is taxable but can exclude $250k from income

How much can you deduct? ⇒ Complete v. Partial Destruction

- Complete
  - Business/investment ⇒ Deduction = A/B – Insurance (or any other reimbursements)
  - Personal Use ⇒ Deduction = Lesser of A/B *OR* Change in FMV (decline in value of the property)– Insurance – $100 – 10% of AGI
- Partial
  - ex: roof taken off, fender replaced
  - Business ⇒ Deduction = Lesser of: A/B OR Change in FMV – Insurance
    - IRS accepts cost of repairs as the difference (theory:Could take entire amount if can prove what the difference would be, Ex: area declared a flood plain)
  - Personal Use ⇒ Deduction = Lesser of: A/B OR Change in FMV – Insurance – $100 – 10% AGI

*****IF YOU ARE COVERED AND YOU CHOOSE NOT TO FILE YOUR CLAIM, you can't take the deduction***

- Hypo
  - Tornado, FMV $150k, A/B $100k, Insurance check $80k (A/R)
    - (-) A/B $100k
    - Casualty loss of $20k (80k-100k)
  - Tornado, FMV $150, A/B $100k, insurance check $140k
    - Tax law bases the loss on the basis of the property, not the FMV—would have a gain of $40k that is taxable
    - If they elect 1033, then they buy a replacement building or buy one that is at lease $140k they wont have to pay taxes
- **When can you elect to use §1033? (Gains Only)…Requirements**
  - (1) Must have a casualty/theft/condemnation where A/R > A/B
    - If you have a loss, you can use §165
  - (2) Must elect §1033 in the year you get the check (or you will have to pay tax)
    - I will not pay taxes b/c I am going to reinvest in the eligible time period
  - (3) Must Replace Property—reinvest in same property
    - *Trade or Business* ⇒ has to be replaced w/ the **same** functional use - **"similar or related in use"**
      - Sch C
    - *Rental property/ Investment* ⇒ if taxpayer uses it then it is okay (if landlord before and landlord after it's okay even if different tenant)
      - Same "T/P" use
      - More relaxed standard than trade or business
      - Sch E (Rental)
      - If you get the check on Fed 12th, 2006 have to replace the prop by Dec 31st 2008
      - get ***2 yrs*** to replace and you won't pay tax on the check
    - *Condemned*
      - Like kind rules—anything goes for property; can be business, investment (§1031)
      - Most generous standard
      - Get ***3 years*** to replace for a condemnation

            - These rules apply f you receive proceeds for selling property under condemnation OR under threat of condemnation, it will qualify
    - Time
        - Casualty/Theft ⇒ have 2 years to replace property from Dec 31 of the present year
            - Ex: If you receive check on 6/28/06, you have until 12/31/08 to replace property to not pay tax on the check
        - Condemnation ⇒ have 3 years to replace property from Dec 31 of the present year
    - Amount you pay to replace it
        - It should be *more* than the A/R. You will defer anything you make on the property to the new property
        - The basis of the new property will be the basis for the old building
            - If you don't replace it w/ like kind property, the new A/B is equal to amt of ins proceeds
                - If you don't replace it, the recognized gain is the amt of money you received above old A/B.
                    - Ex: Bill's house is destroyed by a tornado. A/B was $170,000. He buys a duplex, which he rents for $200,000. Recognized gain is $30,000. New A/B is $200,000.
                - If you spent more than insurance check, you add that amount to the old basis
                    - Ex: Old A/B = $25K. Destroyed by tornado. Insurance check is $50K. You buy a building for $60K. New A/B = $35K.

General Rule: Summary of All

- (for general sale or exchange)
    - Loss
        - Business/investment ⇒ Deduct Loss, recognize loss
        - Personal use ⇒ Not Deductible, not recog loss
    - **(A/R – A/B = REAL G (L))**

	GAIN	**LOSS**	**LOSS**
		Bus/invest use	**Personal use**
Sale	Taxable	deduct	No deduction
1031 like kind	Mandatory: no tax unless boot	Mandatory: no deduct	n/a
Casualty/theft	Taxable, unless you elect to defer gain under 1033 (replace with like kind property within time limit)	Deduct under §165	Deductable* Deduct loss but must be reduced by 10% of AGI income and $100
Condemnation	Elect to defer gain 1033—replace property and defer taxes	Deductable	No deduction
Personal residence	Bus/invest/pers use→121 first 250K tax free, 500 if married filing jointly	n/a	No deduction

SALE OF A RESIDENCE

- §121 Exclusion
    - ***Requirements***
        - Must own AND use the principal residence for last 2 of 5 taxable year ⇒ the 1st $250k of profit on the sale of the house is tax free
            - max is *$250k*
        - but 1st *$500k* is tax-free if couple filed **joint return** and they *both used the principal residence for 5 yrs* but only 1 has to have owned it
            - Neither of them could have taken that election in the past 2 yrs
        - if you are married filing separately: 125K
        - *Can only make this election once every 2 years* (can't have elected this in part 2 yrs)
    - ***Exceptions to 2 yr rule***: Change in Place of Employment, Health, Unforeseen Circumstances (like a fire, natural or manmade disasters, death of spouse, divorce or multiple births) (*see pg. 13-38-39)*
        - See problem 92 on p. 13-63

CAPITAL GAINS

- Generally, there is a lower tax rate for capital gains
- **Capital Assets** – **§ 1221**---Personal use assets and Investment Assets
  - Personal use assets include clothing, recreational equipment, a residence, and automobiles. (pg. 14-3)
  - Investment assets include corporate stock and bonds, investments in mutual funds.
    i. Reason we have this: Doctrine of fruit and the tree
- **§ 1221 defines what is *not* a capital asset (**page 14-4**)**
  - Profits on the sale of inventory (where main purpose is to buy and resale- is ordinary income)
  - Accounts and notes receivable acquired from sale of inventory
  - MACRS depreciable property or real estate used in business *(§1231 asset*--building, carpet, furniture, etc)
  - Copy rights; literary, musical, or artistic compositions—*when artists sell their own work they must pay tax* (ordinary income)
    - When *ordinary person* buys it and they resell it, it is a *capital gain*
    - If you cause it to be created (Ex: autograph), it is ordinary income if you sell it and have to pay regular tax
  - Government publications; if you get it for free and sell for a profit it is ordinary income
  - (courts added this, not in statute) Supplies of a type regularly used in business—*Corn Products case***:** if something is an integral part of business, you have ordinary income and not a capital gain.
  - Pg. 14-7 real property subdivided for sale—have large amount of land and subdivided and sell lots
    - If you divide it into *5 or fewer* lots ⇒ Capital Gain
    - More then 5 lots (once you get to lot 6) ⇒ Ordinary Income
  - Can you ever get capital gain tx is you are a dealer- yes (14-7); must identify any securities being held for investment; specifically identify as stock, but must be "dated by" to be capital gain
- **Long term**—general rule: 1 yr and 1 day
  - Long term capital gains are taxed at a lower rate than ordinary gains
  - Problem is that if buy stock and over years price increases b/c of inflation, you are still taxed as though it was a gain
- **Questions to Ask?**
  - When you sell an asset are you selling a capital asset?
  - Do you have a long/short term capital gain?
    - If hold for 1 year and a day ⇒ *long term capital gain*
      - Inheritances are ALWAYS long term capital gains
      - 1031 like kind exchanges: you can tack on the holding period (time owner 1 had it)
    - If hold for 1 year or less ⇒ *short term capital gain*
      - **Short term capital gains**—taxed at your normal income tax rate
- **Long term capital gains**—How to calculate tax
  - General rule: **Maximum tax rate is 35%** (people who are in a tax bracket higher than 15%---like 25%--35%)- if you held for 1 yr and 1 day
    - **Exceptions**:
      - If in a 10% or 15% tax bracket—you pay 5% tax
        - In 2008, it will be ZERO
        - Special rule: if you are a dependent, you will pay your parents rate
      - Rule also applies to qualified dividends (if you own stock and when they pay a dividend those are also taxed at the lower tax rates (15% or 5%)
      - **Collectibles** (pg. 14-23)
        - Work of art, stamps, rug, etc.—28% is the maximum tax rate
          - ?????If in a lower bracket (10%-15%), you pay your normal tax rate of 10-15%
      - **Real Estate Depreciation recapture**
        - Maximum rate is 25%
        - If in 10-15% tax bracket, you pay 10-15%
  - Do you have a Capital Loss? ⇒ must deduct **$3k** a year until reach the amount of the loss
  - All personal use assets (pg. 14-4) are generally capital gains

CAPITAL TRANSACTIONS *§1221*

	Capital Asset	Ordinary Asset
Gain	LTCG→max tax rate is 15% (*Good)* **inheritances are always LTCG*	Ordinary income tax rate (*bad)* *(short term capital gains taxed as ordinary income)*
Loss	Max deduction is $3,000 per year, carry forward rest of it until reach the amount of loss *bad)*	100% deductible (*good—no limit)*

Note:

- For gifts you can add on donor's holding period- so can get long term rate (5% tax)

§1231 Assets and Transactions

- gain is a capital gain→max tax rate: 15%
- Loss is deductible as an ordinary loss (fully deductible)
- Requirements for 1231 assets/transactions
  - Loss from §165 casualty or theft
  - Involuntary conversion gain (§1033): makes these like gains (if you get a check from insurance and you don't rebuild: taxed like LTCG)
  - Any recognized gain/loss on sale/exchange or property being used in business
  - Schedule C MACRS property and land
    - Depreciable prop used in T/B (equip, carpeting, etc)
    - real estate used in T/B

DEPRECIATION RECAPTURE

- only applies to gains
- RULE: when you sell moveable tangible personal property for MORE than the price you paid, depreciation recapture occurs and is taxed at regular rate
- under MACRS allowed to take a depreciation deduction for both tangible and intangible assets
- When sell depreciated property for profit
  - **Tangible personal property: §1245 (TPP)**
    - Car, chairs, etc
    - ***Taxed like Ordinary income on the recapture***
      - Ex: if bought a car for $10k and depreciated it down to $3k, then sold it for $11k--would have a $1,000 (difference b/t gain above purchase price is taxed at §1231 capital gains max tax rate 15%), difference b/t the orig purchase price and the depreciated price is taxed at §1245
        - Equal to depreciation taken
        - Depreciation is assumption car will decline in value (in real world, equipment usually always goes down in value- rarely see §1231 gain)
        - But if car for some reason goes up, over-depreciate
        - ***GIFT:*** 1245 depreciation recapture carries over from gift
        - ***DEATH:*** 1245 depreciation recaptures does not carry over from death—see problem 31 on 14-54
  - **Real property: §1250**
    - Buildings—you often sell for more than what you bought it for
    - ***Maximum tax rate of 25%***
      - Ex: pay 400K for building/land. Took MACRS deductions of 100K. A/b is 300K. Sell for 480K. You need to recapture the deprication and only the excess growth is 1231. Gain of 180K of which 100K is depreciation recapture and 80K is 1231 gain. What it means for the client; 80K is at a 15% tax rate but depreciation recapture is 25%.
      - Ex] if bought a building for $1mil, and depreciated it down to $940k, and then sold for $1.1mil, the extra $100k above purchase price is taxed at §1231 capital gains--max tax rate 15%
        - difference b/t depreciation price and original purchase price is taxed at 1250
        - buildings- likely to see incr in value w/ inflation and will get some sort of §1231 gain
          - Equal to excess of sales price over original cost (See Final #25)

INSTALLMENT SALES

- (these are tax deferrals)
- Sale of property where one or more payments is in future tax year
  - What qualifies as an installment sale?
    - *(1) Selling Property (***no** services)
      - **3 types of Property are not eligible for installment sales:**
        - (1) Inventory (doesn't qualify) – must recogn whole profit
        - (2) Publicly traded stock—year you have K to sell it is the year you recognize it all
        - (3) Depreciation recapture (§ 1245)—recognize in the year you close the deal Gains only
    - *(2) For a gain*
        - *(you just deduct the whole loss)*
    - *(3)At least one payment of sales price in future year*
      - Guarantees are ok (asking someone else to guarantee the note to ensure you will be paid)
  - **You CAN elect out; can pay tax on whole gain in the year**
  - Example:
    - FMV $2M. Cost to you was $1.4M. Gain is $600k
      - Buyer says I will buy the building for $2M. They pay $1M this year and next year pay $1M + 6% interest
      - In 2005 have interest and long term capital gain. Would get LTCG (long term capital gain) of $300k (1/2 of the $600k)
      - In 2006 would get LTCG of $300k (1/2 of $600k), and then also interest of $60k (6% interest)
    - What if there is a down payment
      - Figure out profit ratio:
        - Gain/price=profit ratio
    - Computing numbers of installment sale; wont be on test

(AMT) (pg. 15-2 & 15-3)—**will not be on test**

- *See back cover of book for the formula*
- **Form 6251** (p 15-25)
- When you do tax return, you are supposed to do it twice--once as we have learned all yr and once w/ AMT
- Steps:
  - You add AMT to your regular tax income and see if it is larger then the **AMT rate of 28%**
  - This ends up taxing a lot more people then it was originally intended to affect
- 15-25 is the form you are supposed to fill out
  - Take regular income and then you add back a whole lot of deductions and then get your AMTI
  - 95% of people w/ income ↔ $100k & $500k will be taxes using the AMT

INTEREST RATES

- **§1274**—when you sigh a K and if the interest rate is less than AFR, then you have to recompute everything as if you charged that
    - AFR= applicable federal rate
  - AFR also applies to interest free loans
    - Short term—less than 3 years
    - Midterm—somewhere between
    - Long term—more than 9 years
- No violation of State law if you adjust the price of whatever to include no interest (higher K price but no interest)
  - Tip: Find out what the AFR is (ex: 4.5%) and structure your deal with *at least* that as the interest rate
  - See problem 28 on 16-35

IRS AUDIT

- Tax return that is signed goes to IRS, IRS opens envelope and then they check a bunch of stuff
- Then your numbers are added into a computer and then w/n 3 months of when you filed if you made an error then they send you a notice
- Then later in year your numbers go into another computer to be matched against employer
- **Two functions of IRS audit**:
    - (1)To make sure that the return is correct
        - Chance to visit w/ you about your return
    - (2) Put fear in the rest of us--if you know someone who has been audited, you are more likely to comply
        - Less then 1% of returns are audited
- Audit takes place about 12-18 months after return is filed
    - They have a computer (DIF) they have determined the type of return that is least likely to generate more income
        - Highest audit rate is in Alaska and lowest is NH
        - If you have a lot of cash in your business, you are most likely to be audited (LL's underreport their rent usually so they get audited)
        - Office in the home
        - Large contributions of property to charity
        - People who take deductions for casualty losses
        - "fuzzy" deductions where valuation can be disputed
            - Ex: giving away a painting, casualty loss
- **Two types of audits**--does IRS agent do it from office or go out in the field
    - **(1) Office Audit**
        - Doesn't take much time
        - Tend to be for small things such as medical deductions, charitable contributions
        - Should ask what they are looking for and bring those records
            - NEVER give the original; always give a copy
                - Might get lost in mail or lost in office
        - Organize your stuff and be on time
            - Generally want to bring everything for that year
        - IRS will look at the documentation
        - Never want to volunteer anything to them, wait till they ask and then honestly answer
        - Lot of turn over, might have educate the IRS agent about the law b/c they don't know much
    - **(2) Field Audit**
        - Come to you; expect to stay there for several days and sometimes longer
        - Typically how businesses are audited
            - Don't put them in a room w/ filing cabinets--put them in room w/ table and chairs
            - You want to control the flow of information
                - Before docs go in room w/ agent, want to look at them and want to be able to know everything the agent knows b/c you know more than they do
                    - You could tell this way if the agent makes an offer if it is good or bad offer
            - Appoint 1 person at the bus to be the contact person for IRS agent, don't want EEs to tell the IRS agent a bunch of stuff
                - Want to pick a person who has knowledge of all financial matters of business (treasurer) and who won't send the agent on a wild goose chase because they know business and the Code
                        - who is there all the time
                        - who has a personality who could handle it (want person who is happy w/ job and who talks very little)
                        - (pick Clint Eastwood over Rosie O'Donnell)
                - Goal to settle at agent level rather then go to court
- **Three types of agents**
    i. *Revenue Agent*
        1. auditor who sees if tax return correct and accurate
    ii. *Revenue Officer*
        1. Collections agent--there is no question that you owe the tax and they come to take your assets; tax collector
        2. you don't really negotiate (BECAUSE YOU OWE THE MONEY, NO QUESTION)

        a. But can ask for installment plans etc
    3. Can take your checking accts, etc and completely shut down your business in 24 hours
  iii. *Special Agent*
    1. Has 1 purpose in life--to get criminal conviction (w/ jail time) for criminal tax violations
    2. more dangerous work than revenue officers—carry guns
    3. If they're targeting your client, they will give them Miranda warnings
    4. Often they aren't after your client, but someone who did business w/ them
    5. They prove you had more $ then reported by going to places to where you spent $ and add it up
    6. Can refuse to give info w/o summons--will generally get a summons
        a. Could assert 5th Amendment rights
        b. They have lmtd resources--are pretty selective about who they target
        c. Want people who will make it into the paper—they go after high profile people

- 80% of tax court cases are pro se
  - You can represent someone else (family member) but you must be uncompensated
- IRS will not talk to you, as atty, unless you have a power of attorney on an IRS form (form **4868**)
  - Reason: there can be a lot of impersonators
  - Who can be a POA
    - Atty
    - CPA
    - Enrolled agent (typically ex-IRS agent….usually someone who passes an IRS test)
    - Law student can represent family member—as long as you are not paid
  - EE???
- IRS agent will work w/ you and try to figure out what law is and they eventually say "I can't fight you anymore" -file report- **RAR (Revenue Agent Report)**—also called a **"30 day letter"** and says that the agent has determined you owe _______ in tax
  - you have 30 days to appeal this determination to the appeals office within the IRS
  - You can write a **protest** to try to get out of it--this is your chance to tell your side of story
    - Some attys see this as strategy--want to surprise them so they don't know what is coming or lay it out for them
    - Or you can ignore 30 day letter. Then you will get a **90 day letter (shouldn't ignore and always comply—*see below***
  - Appeals office in IRS can handle the uncertainty of a ct case
  - They can say things like we'll settle 40/60 or something (want numbers that add up 100)
    - Want to try to settle things w/o going to court, however if they think they have a really good chance, they will go to court
- 90 day letter--this is serious
  - Must respond, if don't there are consequences
  - Says that IRS is going to slap a tax on you and only way to stop collection is to file a petition in the tax court w/in 90 days from date of this letter
  - Want to use certified mail or UPS or something that has tracking records
  - If you are one day late, you have to pay the tax
    - Only choice is to pay and then sue for a refund

- 3 courts
  - Tax court--stops the collection process
  - Rest of them have to pay and wait for a refund

CODE OF ETHICS

- **Duties:**
  - Have to represent your client w/ "Zeal"
  - Never lie yourself or to a judge or IRS agent
    - ABA disciplinary rule 7-102
  - Can never permit your client to lie
  - Cannot reveal client confidences and secrets--attorney client privilege (DR 4-101)
    - Have to be careful b/c if you make a "noisy withdrawal" one that gives away a confidence indirectly, you could be liable
    - Example: client lies to IRS and then they told you they lied, have to tell client must tell truth or you can't represent, if they refuse, then you have to withdrawal which would give away to IRS that something happened that made you withdrawal—"noisy withdrawal"
- **Legal Positions:**
  - legal position must be based on existing law *unless* have good faith argument to overturn the law
  - for litigation: must have a: Reasonable possibility of success; have to have **reasonable basis**
    - Possible (30%) is a lower standard then probable (50%)
    - Probable- more likely than not (50%)
    - Possible- there is a reasonable chance (30%)
  - (2005)**Covered Opinion** (more likely than not)- all you have to say that argmt has a realistic possibility of success- some people put this at 1/3
  - (2007) tax return: more likely than not
  - **Circular 230** (IRS's ethical standards)
    - The IRS will stop you from practicing before IRS if you violate this circular 230
    - Could ban entire law firm from practicing before IRS b/c of actions of 1 lawyer
    - When you give written opinion ("covered opinion") in advance of a tax deal--std from IRS is more likely then not (probable standard)
      - This is very controversial--can effect anything from drafting wills and trusts, etc.
- What happens if find **mistake on tax return**--also in circular in 230
  - Must tell client if find a mistake and urge him to correct it
  - You don't have to tell the IRS about the mistake b/c it is a client confidence--do have a duty to tell the tax payer (would have to get client consent to tell the IRS
  - Helps to tell the IRS b/c a good agent will catch it so it makes sense to volunteer the info to them
  - Would help to make IRS more likely to settle faster and more favorably**--**creates good will
- **Due diligence** --also in circular **230**
  - Can't ignore conflicting info--can't argue one thing knowing there is evidence to the contrary
- Statute of limitations is 3 years
  - Could extend to 6 if there is fraud (generally criminal case)
  - If you didn't report 25% of revenue--this is a 6 yr SOL