

FEDERAL INCOME TAXATION OUTLINE

I. Tax Dispute Procedures.

- A. **Audit.** The IRS will send the taxpayer a letter saying that a particular deduction or particular deductions from a specific year are being audited. This means that the taxpayer must explain to the IRS why the deduction should be allowed and send in all corresponding proof.
- i. **Correspondence, Office, and Field Audits.** Correspondence audits typically involve simple issues and are conducted through the mail; office audits involve more complex issues and are conducted at the IRS office closest to the taxpayer's residence; field audits typically involve business returns and are conducted at the taxpayer's place of business.
- B. **Thirty-Day Letter.** If the IRS auditor that the deduction should not have been taken, or that the deduction was improperly high, then he will send a letter to the taxpayer stating that the taxpayer owes a deficiency. Taxpayer has 30 days to file a written protest with the IRS appeals office. If taxpayer fails to file a written protest, then taxpayer loses the right to appeal within the IRS.
- i. **Appeals Office.** If taxpayer files a written protest within 30 days, then the taxpayer, or his attorney, sets up an appointment to meet with an IRS Appeals Officer to discuss the case. The attorney or taxpayer brings in evidence to support taxpayer's position that the deduction was properly taken.
- C. **Ninety-Day Letter.** If taxpayer does not file a written protest within 30 days or the case is not settled on appeal, then the IRS will mail a letter to taxpayer stating that the taxpayer owes a deficiency. The taxpayer has 90 days to pay the deficiency or file a petition with the U.S. Tax Court. If the taxpayer does neither, then the IRS may assess the tax and the taxpayer has no way to contest the tax. If the taxpayer files a petition within 90 days, then the IRS cannot collect the deficiency until after the case is settled or the Tax Court decides the case. If the taxpayer pays the tax and decides to contest it later, then the taxpayer may file a petition for a refund in a Federal District Court or with the U.S. Claims Court.
- i. **Different Courts.** In the U.S. Tax Court, the amount in controversy (the deficiency) does not have to be paid until the case is settled or decided, no jury trial is allowed, and the deficiency must be \$50,000 or under. In a Federal District Court, the taxpayer must pay the deficiency first and jury trials are allowed. In the U.S. Claims Court (in Washington, D.C.), taxpayer must pay deficiency first and there are no jury trials.
- D. **Statute of Limitations.** The IRS has 3 years from the time the tax return was due to be filed or, if filed late, when the return was actually filed to mail the 90 day letter. However, there is no statute of limitations if: (1) no return was filed; (2) the IRS can prove fraud; or (3) the taxpayer and the IRS agree to an extension.

II. **Basic Tax Formula.** Everything in this section is discussed in sections below. This is a general overview.

$$\begin{array}{r} \text{Gross Income (income subject to tax)} \\ - \text{Specified Deductions} \\ - \text{Business Deductions} \\ \hline \text{Adjusted Gross Income} \\ - \text{Itemized or Standard Deduction (whichever is higher)} \\ - \text{Personal Exemption} \\ \hline \text{Taxable Income} \\ \times \text{Tax Rate} \\ \hline \text{Tax Due} \end{array}$$

- A. **Gross Income.** Gross income is income from whatever source derived.
- B. **Specified Deductions.** Specified deductions are above the line deductions that include (1) payments to an IRA; (2) alimony payments; (3) reimbursed employee expenses; (4) moving expenses; (5) losses from sales of capital assets (\$3,000 maximum); (6) student loan interest; and (7) other specified deductions listed in Section 62.
- C. **Business Deductions.** Ordinary and necessary expenses arising from the carrying on of any trade or business is deductible as an above the line deduction.
- D. **Adjusted Gross Income.** You arrive at adjusted gross income by determining the taxpayer's gross income and then subtracting specified and business deductions.
- E. **Itemized or Standard Deduction.** The taxpayer is allowed to subtract from AGI either itemized deductions or the standard deduction, whichever is higher. The standard deduction is a statutorily set amount. Itemized deduction categories are all personal expenses, and include: (1) medical expenses in which the taxpayer paid more than 7.5% of AGI; (2) taxes; (3) interest, subject to interest limitation rules; (4) charitable donations; (5) casualty expenses in which the taxpayer paid more than 10% of AGI plus \$100; and (6) other miscellaneous deductions, including non-reimbursed employee expenses, investment, and tax related expenses.
- F. **Personal Exemption.** A personal exemption is an amount allowed as a deduction from every individual taxpayer's adjusted gross income, and includes exemptions for dependent children.

III. **Gross Income.** Section 61 of the code defines gross income broadly as all income from whatever source derived. Income can also be defined as undeniable accessions to wealth, clearly realized, and over which taxpayers have complete dominion.

- A. **Source.** The source of the income derived has no bearing on whether or not such income is taxable, unless there is a code provisions expressly excluding certain sources of income from gross income. For example, in Commissioner v. Glenshaw Glass, taxpayer was taxed on an award of punitive damages. However, if taxpayer receives a gift it is not taxable, even though it is a clear accession to wealth, because gifts are expressly excluded from income under Section 102.

- B. **Realization.** Realization of income does not occur, and income or gain is not recorded, until a provider of services or a seller of property has fulfilled all the material steps on his side of a bargain.
- i. **Treasure-Trove.** The finder of treasure-trove is in receipt of taxable income to the extent of its value in the taxable year in which it is reduced to undisputed possession. For example, in Cesarini v. United States, taxpayers found old currency in a piano they bought, and the court held that such a find was taxable upon discovery of the money. Another example: a taxpayer who finds a diamond ring is taxed on the fair market value of the ring in the year in which the ring was found.
 - ii. **Windfalls.** Property already owned before discovery is not taxable until sold. For example, if taxpayer finds oil on his land after purchasing the land, extracts the oil, and then puts it into a tank on his property, he will not be taxed on the gains from that oil until it is sold.
 - iii. **Personalty v. Realty.** A person cannot be taxed on something they already own. In the case of the found money in the piano, both objects are personalty, and so can be separated out, which does not result in a tax on something the taxpayer already owned. The oil in the ground, by comparison, is already owned once the real estate is purchased, and so the oil cannot be taxed until sold. The important distinction here, for determining whether somebody is taxed on something they already own, is that the piano is personalty and the real estate, along with the oil, are realty.
- C. **Debt.** A taxpayer that receives money or property with a contractual obligation to repay is not taxed on the receipt of such money or property. However, discharge by a third person of that taxpayer's legal obligation to repay is equivalent to receipt of that amount by taxpayer, and so taxpayer is taxed on that economic benefit. For example, in Old Colony Trust v. Commissioner, taxpayer was taxed on money paid by his employers to satisfy his tax obligation. (See also "Discharge of Indebtedness" below)
- D. **Non-Cash Taxable Benefits.** The fair market value of services received or property used for free must be included in taxable income. For example, if taxpayer's end of the year bonus is given in the form of painting his house for free, or use of valuable rental property for free, the taxpayer must pay taxes on the fair market value of the bonus.

IV. **Gains Derived from Dealings in Property.** Gross income includes gains derived from dealings in property. Gain from the sale or other disposition of property is defined as the excess of the amount realized from the disposition less taxpayer's adjusted basis in the property.

- A. **Tax Basis Generally.** Tax basis is the value assigned to a taxpayer's investment in property and used primarily for computing gain or loss from a transfer of the property.
- B. **Tax Basis Specifically.** When property is *purchased*, the basis is cost. When property is *exchanged*, the basis is the fair market value of the property received so long as it is a taxable exchange. When property is *gifted*, the donor's basis transfers also. When

property is *inherited*, the basis is generally the fair market value at the time of decedent's death (called stepped up basis). On a *taxable find*, the basis is the fair market value of property at the time of discovery.

C. **Realization.** Realization does not occur until there has been a dealing, sale, or other disposition of property. This includes: (1) sale of property for money or other property; (2) transfer of property to satisfaction of a debt; (3) exchange of property for different property; and (4) compensation by insurance or otherwise when property is destroyed, stolen, or expropriated.

a. **Trading Property.** When there is a taxable exchange in property, the amount realized by the taxpayer is the fair market value of the property received minus the basis of the property given up.

D. **Co-ownership of Property.**

a. **Joint Tenancy and Tenancy in Common.** When property is purchased and held in joint tenancy or tenancy in common by a husband and wife and one spouse dies, the surviving spouse's basis in the property is half of his cost basis and half of the stepped up basis.

b. **Community Property.** When property is purchased and held as community property between a husband and wife and one spouse dies, the surviving spouse enjoys a double step up in basis, meaning that his basis in the property is entirely the fair market value of the property on the date of the decedent's death.

V. **Gifts and Inheritances.** Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. Whether or not a transfer of property is a gift is determined by the transferor's intent: a gift must proceed from a detached and disinterested generosity out of affection, respect, admiration, charity, or like impulses. The court will look to the substance of the transaction, not the form, in determining the transferor's intent.

A. **Factors.** A transfer may be a gift when there are no strings attached to the gift, it is to family or based on some other non-commercial relationship, there is no obligation to make the transfer, and the transfer is made out of love and affection.

VI. **Personal Injury and Sickness.**

A. **Worker's Compensation and Insurance.** Gross income does not include amounts received under worker's compensation as compensation for personal injuries or sickness or amounts received through taxpayer paid accident or health insurance for personal injuries or sickness.

i. **Exception.** Gross income does include amounts received through employer paid insurance if the benefits cover more than medical care costs.

B. **Compensatory Damages.** Gross income does not include personal physical injury or physical sickness damages. Such damages are excludable when (1) they are received in a tort-like cause of action and (2) they are received on account of a personal injury.

- i. **Physical Injuries.** Direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries.
 - ii. **Emotional Distress.** Emotional distress by itself is not treated as physical injury. However, reimbursement of medical expenses attributable to emotional distress is excludable. Further, damages for non-physical injury or sickness that are on account of physical injury or sickness are excludable.
 - C. **Punitive Damages.** Punitive damages are always included in gross income and are taxable.
 - D. **Settlements.** Where damages are received pursuant to a settlement agreement, it is the nature of the claim that was the actual basis for settlement controls whether such damages are excludable. If the settlement agreement lacks express language stating what the amount paid pursuant to that agreement was to settle, it is the intent of the payor that is critical.
 - i. **Dennis Rodman.** By way of example, Dennis Rodman entered into a settlement agreement with a camera man that Dennis kicked in the nuts. Dennis paid \$200,000 for the claim of physical injury and as consideration for silence. The court ruled that \$120,000 was for the physical injury, and was thus non-taxable; the remaining \$80,000 was for silence, which is not for physical injuries, and thus is taxable.
 - ii. **Validity of the Claim.** A settlement is excludable even if the physical injury claim was possibly invalid. As long as a good faith claim is made, the validity and likelihood of success are not relevant.
 - iii. **Structured Settlement.** The recipient of a personal physical injury can agree to a structured settlement arrangement providing for periodic payments. In such a situation, the money is often put into a trust for the victim. As a result, the trust can often increase in value because of interest. Such a gain is not taxable.
- VII. **Divorce.** For tax purposes there are three possible ways to treat payments from one spouse to another as part of a divorce: alimony, child support, or property settlement
 - A. **Alimony.** A payment that is alimony is ordinary income to the payee and is deductible by the payor.
 - i. **Requirements.** For a payment to constitute alimony, the payment must be: (1) in cash under a written contract (not property or services); (2) received by or on behalf of the spouse or former spouse (to a third party can qualify as alimony so long as the payment satisfies an exclusive obligation of the payee); (3) made under a divorce or separation instrument; (4) must not be designated in the instrument as excludable from gross income of payee and nondeductible to payor (parties must not agree that such payments to not constitute alimony); (5) payor must have no obligations to make payments after death of payee; and (6) the

payments must not be front loaded (must be at least 3 years of payments; can't be front loading if under \$15,000 per year).

- B. **Child Support.** Payments denominated as child support are not deductible by the payor and are not included in the gross income of the payee; it is treated as a gift to the child.
- i. **Dependency Deduction.** The dependency deduction is allowed to the parent that has the greater physical custody (time wise) of the child during the tax year, unless the divorce decree or written agreement between the parents provides that the non-custodial parent shall be entitled to the deduction, or the custodial parent signs a written waiver.
 - ii. **Alimony and Child Support Obligations.** When a payor is obligated to pay alimony and child support, any shortfall in meeting those obligations first reduces the alimony deemed paid, thereby disallowing his alimony deduction until he first fully satisfies the child support obligation.
- C. **Allocation between Alimony and Child Support.** When the payor makes a combination payment that is both alimony and child support (sometimes called spousal support or family support), it will be considered alimony unless there is a portion of the payment fixed as child support. For such payments to be partially considered to be child support, the agreement must explicitly say that a certain sum per month is child support.
- i. **Exception.** The document need not specify the amount of the payment that is child support when the payment is reduced by a fixed amount of dollars when the child reaches the age of 18. Courts will consider the reduction in payment the child support portion.
 - ii. **Family Support.** In CA, a divorced spouse sometimes makes “family support” payments instead of alimony and child support payments. In such cases, the payment will be deemed to be alimony unless it is explicitly written in the agreement that the payments will continue after death (so long as it comports with the rest of the alimony requirements).
- D. **Property Settlement.** There is no gain or loss on a property transfer between spouses or incident to divorce. The transfer is treated as a gift for income tax purposes, with the transferee taking the transferor's basis.
- i. **Incident to Divorce.** A transfer between former spouses is deemed to be incident to the divorce if it occurs within one year from the date on which the marriage ends or is “related to the cessation of the marriage. A transfer is “related to the cessation of marriage” if it is pursuant to a divorce or separation instrument and the transfer occurs within 6 years of the marriage's end.
- E. **Prenuptial Agreement.** Prenuptial agreements are used to contract out of the community property so as to maintain separate property ownership after marriage. If a transfer of ownership under the prenuptial agreement occurs before the marriage, then it is a taxable event. To get around the tax problem, the contract should provide that the transfer of property will occur after the parties are married.

- VIII. **Discharge of Indebtedness.** A discharge of indebtedness is included in gross income, unless the discharge is treated as a gift (the intent of the forgiving lender is essential in such a determination).
- A. **Contested Liability.** If a taxpayer disputes the original amount of a debt in good faith and later settles that dispute, the settled amount is treated as the amount recognizable for tax purpose.
 - B. **Bankruptcy.** Gross income does not include a discharge of indebtedness that occurs in a bankruptcy. Unpaid taxes that are discharged in a bankruptcy are not included in gross income if the taxes are more than 3 years in arrears at the time of the bankruptcy filing, no fraud is involved, and the IRS did not have a prior lien on the taxpayer's property.
 - C. **Insolvency.** Gross income does not include a discharge of indebtedness that occurs when the taxpayer is insolvent. The maximum amount excluded, however, cannot exceed the amount by which the debtor is insolvent.
- IX. **Fringe Benefits.** Generally, anything an employee receives from his employer as compensation for work performed should be included in gross income. However, some such compensation is excludable if it is a fringe benefit.
- A. **No Additional Cost Service.** To qualify as an excludable no additional cost service: (1) the service must be one offered for sale to customers in the ordinary course of business; (2) the service must be in the line of business that the employee is working for; (3) the employer must incur no substantial additional cost; and (4) there must not be discrimination in favor of highly compensated employees. By way of example, a free airline ticket to an employee of an airline when the employee flies standby is a no additional cost service.
 - B. **Qualified Employee Discount.** An excludable qualified employee discount for services is limited to 20% of the price at which the services are being offered by the employer to customers. For property, it is limited to the gross profit percentage; generally the employee cannot purchase the goods for less than the employer's purchase cost of the goods.
 - C. **Working Condition Fringe.** A working condition fringe is a benefit given to an employee where if the employee paid for the benefit he would be entitled to deduct the expense either as a business expense or a depreciation expense.
 - i. **Examples.** Examples of working condition fringe benefits include: (1) employer-paid subscriptions to business periodicals for employees; (2) employer paid expenditures for on the job training or business travel for employees; and (3) use of employer-provided vehicles for business purposes.
 - D. **De Minimis Fringe.** A de minimis fringe is a non-cash benefit so small that to keep track of it would be administratively impracticable (e.g., coffee, copies, turkey at holiday season).

- E. **Qualified Transportation Fringe.** This applies to parking on company premises, car pooling, transit passes, etc.
 - F. **Qualified Moving Expense Reimbursement.** This has to do with an employer that paid moving expenses when it involves a new hire or transfer to a new job site.
 - G. **Required Employee Living.** An employee does not need to include in gross income the gain from free lodging when: (1) the lodging is furnished on the business premises of the employer; (2) the lodging is furnished for the convenience of the employer; and the employee is required to accept such lodging as a condition of his employment.
- X. **Buyout Agreements and Life Insurance Policies for Businesses.** A good tax planning idea for a partnership business in a community property states is a combination of a buyout agreement and life insurance policy. Under such a plan, the partners will take out life insurance policies with the other partners as the beneficiaries. At the same time, each partner and their wife signs a buy-sell agreement whereby upon the death of a partner, the surviving partners have the option to buy the surviving spouse's interest at a prescribed price. This price is the same amount due to the surviving partners from the life insurance proceeds. Receipt of such life insurance proceeds is not taxable.
- A. **Example.** A and B are both married, both live in CA, and are 50-50 partners in a business. The business is worth \$2 million. They both take out life insurance policies worth \$1 million and name the other as the beneficiary. Further, they and their wives all enter into a buy-sell agreement. A dies, his 50% interest in the business passes to his wife, and B collection \$1 million in life insurance. Under the buy sell agreement, B has the option of paying \$1 million to A's widow in consideration for her interest in the business.
- XI. **Residential Real Estate.** This section deals with the tax consequences of (1) using part of a residence for business purposes, (2) the use of a vacation property as rental property, and (3) the exclusion of the gain from the sale of a residence.
- A. **Home Office Deductions.** Generally, the expenses associated with the maintenance of a household are non-deductible personal expenses. However, a taxpayer may deduct expenses to maintain part of a household to the extent that part of the house is used as an office.
 - i. **Requirements.** In order to deduct expenses for conducting business activities from a home, taxpayer must use part of the home exclusively and regularly as: (1) the taxpayer's principle place of business for conducting any trade or business; or (2) a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of the taxpayer's trade or business.
 - a. **Principle Place of Business.** This includes a place of business which is used by the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.
 - ii. **Deductions.** If the requirements are met, the taxpayer is allowed to deduct the

portion of the household maintenance attributable to the home office. This amount is found by subtracting the square footage of the office from the square footage of the home. The percentage of the total square footage of the home that corresponds to the office is the percentage of the maintenance deductible.

- B. Vacation Property as Rental Property.** If a vacation home is deemed not to be a residence under the test below, then the taxpayer may three categories of expenses in a prioritized order, subject to a cap equal to the gross income of the property.
- i. **Categories.** Deductions are to take place in the following order until the gross income cap from the property is reached:
 - (1) The expenses that would be deductible in any event that are properly allocable to the days when the unit is rented (basically just mortgage interest and property taxes); then
 - (2) The expenses attributable to the rental activity that are not allocable to the actual use of the property (e.g., advertising and management fees); and finally
 - (3) The expenses attributable to the rental activity that are allocable to the actual use of the property (e.g., utilities, maintenance, and depreciation, with depreciation taken last). The deductions that are disallowed in a given year because they exceed the gross income cap carry over to the next taxable year.
- C. Sale of a Residence.** A taxpayer may exclude from gross income up to \$250,000 of gain realized on the sale or exchange of real property that the taxpayer has owned and used as a principal residence for at least two of the five years before the sale or exchange, so long as the taxpayer has not claimed the exclusion for another sale within the immediately preceding two years.
- i. **Principle Residence.** The term “principle residence” refers to the property that the taxpayer used for the majority of the time during the year. Relevant factors in so determining are: (1) proximity of taxpayer’s place of employment, banks, church, clubs, etc.; (2) where taxpayer’s family usually live; and (3) whether the address is used for official purposes (e.g. driver’s license, tax returns, etc.).
 - ii. **Time Period.** The required two years of ownership and use do not have to be continuous, and that short temporary absences for vacations are counted as periods of use.
 - ii. **Married Couples.** A husband and wife may exclude up to \$500,000 of gain if: (1) the spouse files a joint return for the year of sale; (2) either spouse meets the two-year ownership requirement with respect to the property; (3) both spouses meet the use requirement with respect to the property; and (4) neither spouse used the exclusion within the last two years.
- D. Property Taxes and Mortgage Interest.** Expenses such as property taxes (always fully deductible) and mortgage interest (see “Interest Expense Limitations” below) are deductible without regard to personal or business use, and are governed by the applicable code provisions.

XII. Assignment of Income. The two strands of the assignment of income doctrine are assignments

of earned income and assignments of income from property.

- A. **Assignments of Earned Income.** Generally, income is taxed to the person who earned it. For married couples who file a joint tax return, each of the spouses is treated as earning half of their aggregate income. In community property states, any earning by one spouse is automatically split in half with the other spouse; this rule ceases to operate, however, from the date of legal separation, even if there isn't a divorce.
 - i. **Exceptions.**
 - a. **Agent.** A person who earns a fee while acting on behalf of his employer, and who endorses that fee over to his employer by prior agreement, is not taxed on those earnings.
 - b. **Disclaimer.** A disclaimer is an unconditional refusal to accept earnings to which one is entitled. If a disclaimer is done before the right to receive the income has been fixed, the taxpayer does not pay taxes on that income. However, the taxpayer can in no way exercise control over dominion of that income, but he may suggest, in a non-binding way, where the money ought to go.
- B. **Assignments of Income from Property.** The owner of property must pay taxes on income gained from that property even if he gratuitously assigned the income from that property. In order to avoid being taxed on gains from property, a property owner must transfer a partial ownership interest (e.g., an interest in a tenancy in common or a life estate) to a transferee who has the right to collect income from the property.
 - i. **Assignments of Gain on a Sale of Property.** A property owner who wishes to sell his property and assign the gains of such sale can, but he must transfer the ownership of the property to the assignee before a tacit agreement to sell the property is entered into. The gain is said to be realized on the date of the tacit agreement in such circumstances.
 - ii. **Totten Trust Bank Account.** A Totten trust bank account is a bank account that is owned solely by the parent that stipulates that, when the parent dies, the account passes to the child or other named beneficiary. Income from such accounts is taxable to the settlor parent because the child retains no rights and the parent can revoke the account at any time.
- C. **Acceleration of Income.** A taxpayer may accelerate income, or realize income in the current year as opposed to a later year to take advantage of tax benefits, by assigning his rights to future income if the assignment is made for consideration in a bona fide commercial transaction.

XIII. **Business and Investment Expenses.**

- A. **Business Deductions.** A taxpayer is authorized to deduct the ordinary and necessary expenses arising from the carrying on of a trade or business.
 - i. **Expense.** The expense must benefit the business within a one year period only;

otherwise it is a capital outlay and is subject to different rules.

a. **Repair v. Replacement.** A repair is deductible as a business expense and is an expenditure for the purpose of keeping property in an ordinarily efficient operating condition; it does not add substantially to the value of the property, nor does it appreciably prolong its life. A replacement is a capital outlay and not only fixes a problem, but prolongs the life of the property, significantly increases its value, or makes it adaptable to a different use.

ii. **Ordinary and Necessary.** An expense is “ordinary and necessary” if it is appropriate and helpful. A cost is “ordinary” if it would be customary or expected in the life of a business, is not limited to something that everyone does in the same business, and there must be a causal connection between the expense and the business.

iii. **Trade or Business.** To be a trade or business, an entity must be engaged in selling a product or service to customers or clientele.

iv. **Education Expenses.** Education expenses are deductible if they are incurred in order to maintain or improve skills in a trade or business in which the taxpayer is already engaged, or if they are incurred to meet the minimum requirements of one’s employer or of one’s profession as a condition of retention of employment.

v. **Fines or Penalties.** No deduction is allowed for any fine or similar penalty paid to a government for the violation of any law; however, if a person or corporation voluntarily remedies a condition that might otherwise result in a fine, the expenses incurred in remedying the condition are deductible as business expenses.

B. **Investment Expenses.** A taxpayer is allowed to deduct ordinary and necessary expenses incurred or paid for the production or collection of income, for the management of income producing property, or in connection with the determination, collection, or refund of taxes. The costs of repairs and maintenance of investment real property are also deductible as an investment expense.

XIV. **Capital Expenditures.** A capital expenditure is any expenditure incurred in a trade or business used in order to create or acquire assets that provide a benefit beyond the current year. A capital expenditure cannot be immediately deducted in full. Important to this determination is whether the taxpayer will realize the benefits beyond one year of the expenditure.

A. **Acquisition of Property.** Costs incurred in the acquisition of an asset having a useful life extending beyond the taxable year are capital expenditures. Included in these costs are the purchase price (including delivery charge and sales tax), defending or perfecting title, making the asset suitable for its intended use, and other costs associated with acquiring the asset.

B. **Construction or Production of Property.** The Code also requires the capitalization of all direct and indirect costs allocable to construction or production of real property or tangible personal property.

- i. **Direct Costs.** Direct costs include the costs of materials that become an integral part of the asset produced and those materials that are consumed in the production process, as well as compensation paid for full-time, part-time, and contract labor.
 - ii. **Indirect Costs.** Indirect costs include, for example, purchasing costs, storage costs, depreciation, rent, taxes, insurance, utilities, maintenance, and interest on debt.
 - C. **Depreciation.** Depreciation allows a taxpayer to deduct the capitalized cost of an asset over certain period of time. Important time periods are: (1) 27.5 years for residential rental realty; (2) 39 years for all other commercial realty; (3) 5 years for office machines such as computers, copiers, and printers; (4) 5 years for automobiles; and (5) 7 years for office furniture and fixtures such as desks and filing cabinets.
 - D. **Capital Outlay.** Capital expenditures include outlays for the permanent improvement or betterment of existing property that: (a) add substantial value to the existing property; (b) appreciably prolong its useful life; or (c) adapt property to a new or different use.
 - i. **Exception: Repairs and Maintenance.** Repair is an expenditure to keep a capital asset in good operating condition and is not a capital outlay (see distinction above).
- XV. **Tax Shelters and the Passive Loss Rules.** A tax shelter is a business venture, typically limited partnerships, that are designed to produce tax benefits without significant economic risk. The purpose of the passive loss rules is to attack those tax shelters that are determined to be passive activities.
 - A. **General Rule.** Losses from a passive activity are generally not deductible in the year in which the loss is incurred if the taxpayer retains the passive activity through the year.
 - B. **Passive Activity.** A passive activity is a trade or business in which the taxpayer does not materially participate.
 - i. **Material Participation.** To be material, the taxpayer's participation must be regular, continuous, and substantial. 500 or more hours per year involvement in a business constitutes material participation and 100 hours or less does not constitute material participation. Anything in between is arguable.
 - a. **Partnerships.** A limited partner is automatically one who does not materially participate in the conduct of the business or trade for purposes of the passive loss rules. However, a general partner or a member of a limited liability company can be a material participant.
 - C. **Passive Activity Loss.** A passive activity loss is the net loss from all of a taxpayer's passive activities for the year.
 - i. **Effect.** The net losses from a passive activity are first offset against net profits from other passive activities in the same year and any excess is carried over to

subsequent years for the life of the taxpayer.

- D. **Rental Activities.** A rental activity is a passive activity, even where the taxpayer is a material participant, unless the taxpayer is a real estate professional.
- i. **Real Estate Professional.** A person is a real estate professional if: (1) more than half of the personal services the taxpayer performs in the year are performed in real property trades or businesses in which the taxpayer materially participates; and (2) the taxpayer performs more than 750 hours of service during the taxable year in real property trades or businesses in which the taxpayer materially participates.
 - ii. **Exception.** There is a limited exception to the passive loss rule from rental real estate activities in which the taxpayer is at least a 10% owner and not a limited partner. Such a taxpayer may offset the net losses from all rental real estate up to \$25,000 of the taxpayer's non-passive income. This amount is reduced by one dollar for every two dollars by which the taxpayer's AGI exceeds \$100,000. Thus, a taxpayer with \$150,000 of AGI gets no benefit from the exception.
- E. **Dispositions of Interest in a Passive Activity.** If a taxpayer disposes of his entire interest in a passive activity, any suspended losses allocable to that activity (as well as any loss realized on the disposition) are no longer treated as passive activity losses. The carried losses are first used for offsetting income from the activity in the year of the sale, then against all other passive income for the year, and then are released for use against the gain on the sale or against non-passive income.

XVI. **Interest Expense Deductions and Limitations.** Certain interest payments are deductible as itemized deductions.

- A. **Trade or Business.** An interest expense in the trade or business of the taxpayer is fully deductible so long as the taxpayer materially participates in the business.
- B. **Qualified First or Second Home.** A taxpayer may deduct interest on a loan of up to \$1 million secured by the taxpayer's principal home or a second home. Additionally, the taxpayer may deduct up to \$100,000 on equity loans on the principal and second home combined.
 - i. **Improvement.** Interest paid on money borrowed to improve the home is fully deductible up to the \$1 million cap.
- C. **Investment Portfolio.** Interest on investment portfolio related profit making activities without customers are deductible only to the extent of net investment income (with lifetime carry over).
- D. **Interest on Passive Loss Activity.** Interest of a passive loss activity is treated as a loss subject to the passive loss limitation rules above.
- E. **Consumer Debt.** Interest on consumer debt is not deductible.

XVII. Capital Gains and Losses. A recognized gain or deductible loss is characterized either as capital or ordinary.

- A. **Gains.** Individual taxpayers generally prefer gains to be classified as capital gains rather than ordinary income because certain capital gains are afforded preferential tax treatment. The capital gain preference comes into play only if a taxpayer has a net capital gain for the year.
- i. **Short-Term Capital Gains.** Short-term capital gains are treated as ordinary income, and are thus not afforded the preferential tax treatment.
 - ii. **Long-Term Capital Gains.** Long-term capital gains are afforded the preferential tax treatment, and are defined as a gain from the sale or exchange of a capital asset held for more than one year.
 - a. **Capital Asset.** A capital asset is all property held by the taxpayer, subject to certain exceptions. The exceptions include performance of services, sale of inventory, sale of intellectual property by its creator or donee of the creator (other than a patent or musical work), and many other things. Examples of capital assets include: dividends on corporate stock, investment property (such as stocks, bonds, land, goodwill, patent and musical work), and property used in a trade or business.
 - b. **Holding Requirement.** In certain situations, a taxpayer can tack onto his actual holding period (1) the period during which another taxpayer held the same property, or (2) the period during which he held other similar property.
- B. **Losses.** Taxpayers tend to prefer that their losses be characterized as ordinary losses because of a statutory limitation on capital loss deductions. For individuals, capital losses can only be used to offset capital gains plus \$3,000 of ordinary income. Unused capital losses are carried forward and can be deducted in future years subject to the same limitation on deductibility.

XVIII. Like-Kind Exchanges. The like kind exchange is a widely employed tax avoidance technique, especially in the area of commercial real estate transactions. This doctrine grants complete non-recognition when a taxpayer swaps real property for other real property of equal value. In other words, gains and losses from exchanges of like-kind assets are deferred until the taxpayer otherwise disposes of the property.

- A. **Determining Like Kindness.** The general rule for determining like kindness is that the properties exchanged must be similar in “nature or character.” In this context any sort of fee interest in real estate is similar in nature or character to any other form of fee interest in real estate. The rule is stricter for exchanges of tangible personal property.
- B. **Business and Investments.** The like kind rule only applies to businesses and investments, not to personal property.
- C. **Delayed Exchanges.** For a delayed exchange, the taxpayer has 45 days to locate replacement property and 180 days to close on the replacement property after the date of

closing of the relinquished property.

- i. **Three Cornered Exchange.** This typically involves the buyer first purchasing the desired exchange property from a third party and then engaging in the exchange with the seller who is seeking non-recognition.
- ii. **Deferred Exchange.** . Since it is often difficult to arrange the timing of the title transfers to meet the requirements of the code section, the parties may need to “park” one of the exchange properties with an intermediary who can hold title to the property until the parties are ready for the exchange to proceed.

XIX. **Charitable Deductions.**

- A. **Cash Contributions.** A taxpayer can deduct only 50% of AGI for charitable cash contributions to charitable or non-profit organizations. What one cannot deduct in the same year carries over for up to five years or until the death of the taxpayer. Corporations can do this too, but the limit is 10% of AGI.
- B. **Property Donations.** A taxpayer can deduct the fair market value of property donated to charitable or non-profit organizations, and there is no taxable income on the appreciation to the taxpayer.