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Individual Income Taxation
An Application Approach

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Update
2017 Tax Cuts and Jobs Act

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Chapter 1
Introduction to Federal Income Tax

Pages 3–5.

Replace Chapter 1 with the following:

The Internal Revenue Code is the collection of statutes that make up our Federal taxing system. It is a system based on income, with an objective of imposing tax each year on a taxpayer's accession to wealth.

Unless otherwise permitted, each taxpayer must report all gross income. Income can be derived from many sources, such as salary, investment activities (e.g., interest, dividends), and business profits. To this end, the Code has several provisions defining what is included in gross income. It also has several Code provisions specifically allowing the taxpayer to exclude (not report) certain types of income.

  Accessions to wealth
– <u>Excludable income</u>
= Gross income

Each taxpayer must report his gross income from investment activities. However, the taxpayer's accession to wealth is income from the investment activity, less the costs he incurred to generate the investment income. The Code specifically identifies deductions related to generating investment income; the taxpayer can claim these deductions to determine his net investment income.

Each taxpayer must report his gross income from business activities. To tax only the taxpayer's accession to wealth, he is allowed to deduct costs he incurred to generate the business income. The Code specifically identifies deductions the taxpayer can claim to determine his net business income.

Even though the tax is to be imposed on the taxpayer's accession to wealth, he is not entitled to claim a deduction unless it is specifically allowed by the Code. In general, no deductions are allowed for personal expenses. That having been said, there are many such deductions authorized, such as for home mortgage interest, charitable contributions, and medical expenses. Given their personal nature, in most instances while some such deductions are allowed, the amount that may actually be deducted is very limited.

The Code provides the framework for identifying these different sources of income, identifying allowable deductions, and combining the amounts to determine taxable income. It provides the tax rates that apply to different types of income and to different layers of taxable income. In general, the taxpayer determines his tax liability as follows:

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First: Determine the taxpayer's gross income. It includes his net income from business activities, his net income from investment activities, and any other sources of gross income. It does not include any items specifically permitted to be excluded.

Second: Determine adjusted gross income. The taxpayer's gross income is reduced by specifically-identified deductions. Because there is no percentage limitation applicable to these deductions, they often are referred to as "above the line" deductions.

  Gross income
– <u>Above the line deductions</u>
= Adjusted gross income

Third: Determine taxable income. The taxpayer's adjusted gross income is reduced by either the standard deduction or itemized deductions (whichever is greater). Itemized deductions often are referred to as "below the line" deductions because some are allowed only to the extent they exceed a percentage of adjusted gross income. The 2017 Tax Cuts and Jobs Act increased the amount of the standard deduction to $12,000 for individuals and $24,000 for those married and filing jointly. Given the increase in the standard deduction amount, in most cases the taxpayer will use the standard deduction (as opposed to choosing to itemize).

  Adjusted gross income
– <u>Standard deduction or itemized deductions</u>
= Taxable income

Fourth: Determine the tax liability. The taxpayer's tax liability is determined by multiplying taxable income by the applicable tax rate. The tax rates are graduated, meaning that as the amount of income increases, the tax rate on additional amounts, or layers, of income increases. In addition, some types of income are taxed at lower, preferential, rates. If the taxpayer is entitled to a credit, he can reduce his tax liability by the amount of the credit.

It may seem the computation of a taxpayer's tax liability is nothing more than filling in the blanks on a tax return. However, the amounts that are reported on the tax return are based on an understanding and interpretation of the Code. As with any other statutory system, controversy can arise as to correct interpretation. To avoid possible imposition of penalties, the attorney advising his client generally must be able to establish that his interpretation is supported by substantial authority.

Moreover, an attorney knowledgeable about tax law can assist his client in structuring his business, investment, and personal activities so that they result in the least amount of tax liability. The legal minimization of tax liability has long been recognized as acceptable tax planning.

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be

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> doubted." As a general rule a tax avoidance motive is not to be considered in determining the tax liability resulting from the transaction.[1]

Finally, individuals (meeting a minimum income requirement), partnerships, corporations, trusts, etc. are required to file a tax return. Accordingly, any client may have a tax issue and that issue can arise in any area of legal practice, from divorce law to criminal matters to environmental concerns. Accordingly, every attorney, even those who do not practice tax law, must be able to identify a tax issue to properly assist his client. It may be helpful to understand that tax issues can be grouped into the following broad categories:

- What is gross income? What can be excluded from gross income?
- When there is gross income, who must report it?
- What deductions, whether personal, related to an investment activity, or arising from a business, is the taxpayer permitted to deduct?
- What tax rate applies to income and gains?
- Are there any limits on the amount of loss that can be claimed?
- In what year must the taxpayer report income? In what year must the taxpayer report deductions?

Take a moment and review the Form 1040, U.S. Individual Income Tax Return, and Schedule A, Itemized Deductions. Consider the following:

- Where is gross income reported?
- What gross income items are represented on this part of the return?
- What deductions are allowed in determining adjusted gross income? Are the deductions business related, investment related, or personal in nature?
- Where is "adjusted gross income" reflected?
- Where is the taxpayer asked to choose between the standard deduction and itemized deductions?
- If the taxpayer elects to itemize, where are those deductions listed?

[1] Cowden v. Commissioner, 289 F.2d 20, 23 (5th Cir. 1961), quoting Gregory v. Helvering, 293 U.S. 465 (1935).

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- What itemized deductions are allowed? Are the deductions business related, investment related, or personal in nature?

- Which itemized deductions are limited by the amount of adjusted gross income?

- Where is "taxable income" reflected?

- Where is the total tax liability reflected?

- Having determined total tax liability, how does the taxpayer determine how much he still owes or whether he is entitled to a refund?

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Chapter 1
Introduction to Federal Income Tax

Pages 11–16.

The marginal tax rates have been changed. For a single individual, the rates are as follows:

If taxable income is:	The tax is:
10%	$0 – $9,525
12%	Over $9,525 – $38,700
22%	Over $38,700 – $82,500
24%	Over $82,500 – $157,500
32%	Over $157,500 – $200,000
35 %	Over $200,000 – $500,000
37%	Over $500,000

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Chapter 15
Interest

The taxpayer's adjusted gross income is reduced by either the standard deduction or itemized deductions (whichever is greater). Itemized deductions often are referred to as "below the line" deductions because some are allowed only to the extent they exceed a percentage of adjusted gross income. The 2017 Tax Cuts and Jobs Act increased the amount of the standard deduction to $12,000 for individuals and $24,000 for those married and filing jointly. Given the increase in the standard deduction amount, in most cases the taxpayer will use the standard deduction (as opposed to choosing to itemize). Mortgage interest is an itemized deduction.

Pages 129–133

To address the changes to home mortgage interest, replace the chapter with the following.

A. Background

In general, personal expenses are not deductible.[2] Congress does not consider a personal expense an item that should offset the taxpayer's gross income. In other words, it is not considered part of the cost of earning or generating gross income. Any deduction permitted for a personal expense is an exception to this broad-based rule. Accordingly, if the taxpayer wants to claim a deduction on his income tax return for a personal expense, he must establish that Congress specifically provided an exception to the general rule.

B. Exception — Interest

Interest is the amount paid for the use of borrowed money. In general, a taxpayer is not entitled to claim a deduction for personal interest he has paid.[3]

> Section 163. Interest
>
> (h) Disallowance of Deduction for Personal Interest. —
>
> > (1) In General. In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

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[2] Section 262.
[3] Section 163(a), (h)(1), (2).

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There are two broad exceptions to this prohibition. The first, if the taxpayer itemizes his deductions, is for home mortgage interest.[4] The second is for interest on a student loan.[5]

Loans acquired prior to 2018. Prior to the 2017 Tax Cuts and Jobs Act, the Code allowed a taxpayer to exclude qualified residence interest from the definition (and thus the prohibition on deduction) of personal interest.[6] There are two different types of qualified residence interest: acquisition indebtedness and home equity indebtedness.

Acquisition indebtedness is indebtedness incurred in "acquiring, constructing, or substantially improving any qualified residence of the taxpayer."[7] It does not apply to interest to the extent the loan exceeds $1,000,000.[8]

Home equity indebtedness is indebtedness secured by a qualified residence.[9] It does not apply to indebtedness to the extent it qualifies as acquisition indebtedness. The relevant amount of the loan cannot exceed the excess of the fair market value of the qualified residence over the amount of the acquisition indebtedness.[10] Nor does it apply to interest to the extent the loan exceeds $100,000.[11]

Loans acquired after 2017. The Code continues to exclude acquisition indebtedness from the definition (and thus the prohibition on deduction) of personal interest.[12] However, for loans acquired after 2017, it does not apply to interest to the extent the loan exceeds $750,000 ($375,000 if married filing separately).[13] No deduction is permitted for interest related to home equity indebtedness.

A qualified residence is the taxpayer's principal residence (as defined by Section 121[14]) and one other residence of the taxpayer that is used by the taxpayer as a residence.[15]

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[4] Section 163(h)(2)(D), (3).
[5] Sections 163(h)(2)(F); 221.
[6] Section 163(h)(3)(A).
[7] Section 163(h)(3)(B).
[8] Section 163(h)(3)(B)(ii). The applicable amount of the loan is $500,000 if the taxpayer is married, filing a separate return. See Bronstein v. Commissioner, 138 T.C. 382 (2012).
[9] Section 163(h)(3)(C)(i).
[10] Id.
[11] Section 163(h)(3)(C)(ii). The applicable amount of the loan is $50,000 if the taxpayer is married, filing a separate return.
[12] Section 163(h)(3)(A).
[13] Section 163(h)(3)(B)(ii).
[14] Section 121 is discussed in Chapter 39. If the taxpayer uses more than one home, Section 121 provides guidance, if needed, to determine which home is the principal residence. In general, the residence he uses the majority of the time during the year is his principal residence. Treas. Reg. § 1.121-1(a)(2). The regulations set forth other, non-exclusive, factors to consider, including the taxpayer's place of employment; where the family members live; the address used for the taxpayer's federal income tax return, state tax return, driver's license, automobile registration, voter registration card; mailing address used for bills and correspondence; location of the taxpayer's bank; and location of the taxpayer's religious organizations and recreational clubs. Treas. Reg. § 1.121-1(a)(2).
[15] Section 163(h)(4)(A).

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Tell Me More

A taxpayer may be required to pay "points" when obtaining a loan. Points are a fee paid to the lender. One point is equal to one percent of the amount of the loan. Points are pre-paid interest but are deductible if incurred in connection with the purchase or improvement of, or secured by, the taxpayer's principal residence.[16]

When property is co-owned by two owners who are not married to each other, the limitations are applied on a per-taxpayer (as opposed to per-residence) basis.[17] For example, Charles and Bruce are co-owners of a house and are jointly and severally liable for the mortgage. They qualify for the maximum amount of acquisition and home equity indebtedness. Each may deduct interest on up to $750,000 of indebtedness.

Interest paid on student loans. The Code excludes interest paid on a "qualified education loan" from the definition (and thus from the prohibition on deduction) of personal interest.[18] Qualified loans include those incurred to pay for higher education expenses of the taxpayer, the taxpayer's spouse, or the taxpayer's dependents. Expenses include tuition, fees, room and board, and other related expenses.[19] Qualified loans do not include loans from a related person (as defined in Section 267(d) or 707(b)(1)).[20]

The maximum amount of interest that can be claimed as a deduction is $2,500.[21] This deduction amount begins to be phased out for a taxpayer with a modified adjusted gross income of $50,000 or more ($100,000 or more for a joint return) and completely phased out for a taxpayer with a modified adjusted gross income over $65,000 ($130,000 for a joint return).[22]

C. Application of Rules

Example 1. During the year Bill paid $3,000 in interest on his credit cards. He had used the credit cards to purchase food, gas, and household items. Because the interest is personal, not subject to any exception, he cannot deduct the interest.

Example 2. In 2015, Irene purchased a home for $300,000 and used it as her principal residence. She paid $50,000 down and obtained a $250,000 mortgage. The mortgage qualifies as acquisition indebtedness; to the extent she itemizes, she is entitled to deduct the interest she pays on the loan.

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16 Section 461(g)(2).
17 Voss v. Commissioner, 796 F.3d 1051 (9th Cir. 2015), rev'g and remanding Sophy v. Commissioner, 138 T.C. 204 (2012).
18 Sections 163(h)(2)(F); 221.
19 Section 221(d).
20 Section 221(d)(1).
21 Section 221(b)(1).
22 Section 221(b). These amounts are adjusted for inflation. Section 221(f). For 2011 the phase out amounts are $60,000 to $75,000 ($120,000 to $150,000 for joint returns).

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Example 3. In 2018, Dirk purchased a home for $300,000 and used it as his principal residence. He paid $50,000 down and obtained a $250,000 mortgage. The mortgage qualifies as acquisition indebtedness; to the extent he itemizes, he is entitled to deduct the interest he pays on the $250,000 loan.

This year, when the value of the house had increased to $350,000, Dirk borrowed an additional $25,000, secured by the home. He used the $25,000 to add a garage. The $25,000 is acquisition indebtedness. To the extent he itemizes, he is entitled to deduct the interest he pays on the $25,000 loan.

Example 4. In 2010, Candace purchased a home for $300,000 and used it as her principal residence. Several years later she obtained a $50,000 loan, secured by the home. She used the proceeds to remodel her home. The debt qualifies as acquisition indebtedness; to the extent she itemizes, she is entitled to deduct the interest she pays on the loan.

Example 5. In 2006, Dirk purchased a home for $300,000 and used it as his principal residence. He paid $50,000 down and obtained a $250,000 mortgage. The mortgage qualifies as acquisition indebtedness; to the extent he itemizes, he is entitled to deduct the interest he pays on the $250,000 loan.

In 2015, when the value of the house had increased to $350,000, Dirk borrowed an additional $100,000, secured by the home. He used $25,000 to add a garage and the remaining $75,000 for items not related to the home. The $25,000 used for the garage is acquisition indebtedness. The remaining $75,000 is home equity indebtedness. To the extent he itemizes, he is entitled to deduct the interest he pays on the $100,000 loan.

Example 6. Sebastian owns a home worth $500,000 that he uses as his principal residence. In 2013, he borrowed $150,000, secured by the house. He used the money to purchase a large boat. The loan qualifies as home equity indebtedness, but he can deduct interest only to the extent of $100,000 of the loan. With respect to the remaining $50,000 of indebtedness the interest is not deductible.

Example 7. Troy owns a home worth $500,000 that he uses as his principal residence. In 2018, he borrowed $150,000, secured by the house. He used the money to purchase a large boat. Because the loan does not qualify as acquisition indebtedness, Troy cannot deduct the interest.

Example 8. Maureen, a single individual, obtained student loans to attend college. In the year after she graduated she obtained a job and earned $45,000 per year. She paid $2,000 in interest on her student loans. Maureen can deduct the interest she paid on her student loans.

D. Problems

1. Bill has a gas card he uses for all the gas purchased for his personal car. During the year he paid $500 in interest for gas charged on the card. Can he deduct this interest?

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2. In 2018 Bobby purchased a home for $500,000 and will use the home as his principal residence. He paid $50,000 down and obtained a $450,000 mortgage. Will Bobby be entitled to a deduction for the interest he pays on the mortgage?

3. In 2018 Alfred obtained a $50,000 loan to add a three-season room to his home (which was his principal residence). He has no other outstanding debt. Is Alfred entitled to a deduction for the interest he pays on the loan?

4. In 2018, Jessica obtained a $50,000 loan, secured by her house. She used the proceeds to travel around the world. Is Jessica entitled to a deduction for the interest she pays on the loan?

5. In 2017 Eric purchased a home for $500,000 and will use the home as his principal residence. He paid $50,000 down and obtained a $450,000 mortgage. Will Erik be entitled to a deduction for the interest he pays on the mortgage?

6. In 2017 Andy obtained a $50,000 loan to add a three-season room to his home (which was his principal residence). He has no other outstanding debt. Is Andy entitled to a deduction for the interest he pays on the loan?

7. Carl, a single individual, obtained student loans to attend college. After he graduated he obtained a job, earning $30,000 per year. During the year he paid $5,000 in interest on the student loans. Is Carl entitled to a deduction for the interest he pays on the loans?

E. Analysis and Application

Is the deduction for acquisition indebtedness interest justified?

a. Why or why not?

b. Are there more efficient ways to support home ownership?

c. Would you consider the deduction a "loophole," allowing a taxpayer with a larger amount of gross income to unfairly reduce his tax liability by obtaining a loan to purchase his residence?

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Chapter 16
Taxes and Medical Expense

The taxpayer's adjusted gross income is reduced by either the standard deduction or itemized deductions (whichever is greater). Itemized deductions often are referred to as "below the line" deductions because some are allowed only to the extent they exceed a percentage of adjusted gross income. The 2017 Tax Cuts and Jobs Act increased the amount of the standard deduction to $12,000 for individuals and $24,000 for those married and filing jointly. Given the increase in the standard deduction amount, in most cases the taxpayer will use the standard deduction (as opposed to choosing to itemize). Both taxes and medical expenses are itemized deductions.

Pages 135–141. Replace the chapter with the following.

A. Background

In general, personal expenses are not deductible.[23] Congress does not consider a personal expense an item that should offset the taxpayer's gross income. In other words, it is not considered part of the cost of earning or generating gross income. Any deduction permitted for a personal expense is an exception to this broad-based rule. Accordingly, if the taxpayer wants to claim a deduction on his income tax return for a personal expense, he must establish that Congress specifically provided an exception to the general rule.

B. Exception — Taxes

1. General Rule

In addition to paying federal income taxes, most taxpayers also will have to pay state and local taxes. If he itemizes, the Code allows the taxpayer to deduct the following taxes if they have been paid:[24]

- State and local real property taxes;
- State and local personal property taxes;
- State and local income taxes; or, in lieu of state and local income taxes, state and local sales taxes; and
- Foreign income taxes.

To be deductible, the amount must constitute a tax. Local governments may make an assessment for a variety of reasons, not all of which constitute a tax.

[23] Section 262
[24] Section 164(a), (b)(5). Note that if the taxpayer pays taxes related to his investment activity, they could be deducted under Section 212 and if the taxpayer pays taxes related to his business activity, they could be deducted under Section 162(a).

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- An assessment for water and sewer services is not a tax;[25] and

- An assessment for funds to be used to maintain streets, sidewalks, or other benefits that increase the value of the property assessed and are assessed only on properties that directly benefit is not a tax.[26]

The deduction is allowed only to the person on whom the tax is imposed.[27] If a third party pays the taxpayer's state or local taxes, the third party is not entitled to a deduction.

To be deductible, the tax liability must have been paid.[28]

Finally, the amount a taxpayer can claim as an itemized deduction is limited to $10,000 ($5,000 for a married taxpayer filing a separate return) of the aggregate of:[29]
- State and local property taxes; and
- State and local income taxes (or sales taxes in lieu of income taxes)

paid or accrued in the taxable year.

Summary of Rule — Deduction for Taxes:

To be deductible, the taxes —

- Must have been imposed on the taxpayer; and
- Must have been paid by the taxpayer.
- But only deduction up to an aggregate amount of $10,000 or less.

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2. Exceptions

Federal taxes. No deduction is allowed for the payment of Social Security taxes[30] or the payment of federal income taxes.[31] Only one-half of employment taxes are deductible.[32]

[25] Rev. Rul. 79-201, 1979-1 C.B. 97.
[26] Section 164(c)(1); Treas. Reg. § 1.164-4(a). Such amounts paid may be considered capital expenditures and added to the basis of the property. If the amount is allocable to maintenance or interest, it can be considered at tax. Section 164(c)(1).
[27] Treas. Reg. § 1.164-1(a).
[28] Whether the taxes have been paid may depend on whether the taxpayer is a cash or accrual basis taxpayer. These accounting method concepts are discussed in Part VI. In addition, certain timing rules apply regarding the sale of real property. See Section 164(c), (d); Treas. Reg. § 1.164-6(d).
[29] Section 164(b)(6).
[30] Section 275(a)(1)(A); Treas. Reg. § 1.164-2(a).
[31] Section 275(a)(1)(C); Treas. Reg. § 1.164-2(a).
[32] Section 164(f)(1).

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Sale of real property during the year. The general rule is that taxes are deductible only by the person on whom they are imposed. However, if real property is sold during the year, the state or local tax liability must be apportioned between the buyer and seller irrespective of which party is liable for the taxes under state or local law. The seller is allocated the taxes attributable to the beginning of the real property tax year[33] to the day before the sale. The seller is allocated the taxes attributable to the day of sale to the end of the real property tax year.[34] Each party is entitled to deduct their allocable share, irrespective of how the taxes are allocated for state or local purposes and irrespective who actually effectively pays them. An agreement between the seller and buyer to allocate the taxes between them in a different manner does not change the allocation for tax purposes.[35]

Co-ownership of property. If the property is co-owned, each co-owner is entitled to deduct the amount of taxes paid, even if the portion paid is greater than that owner's respective ownership interest in the property. In *Powell v. Commissioner*[36] the taxpayer was a co-owner of property and paid more than her allocable share of state property taxes. In deciding whether she could deduct the entire amount of taxes paid, the court noted that, by paying the taxes, the taxpayer was protecting her interest in the property.[37]

C. Exception — Medical Expenses

Section 213 provides an exception to the general rule that no deduction is permitted for personal expenses. If he itemizes, to be deductible, the amount must have been paid for medical care, not have been reimbursed, and be a qualifying expense. In addition, the deduction is limited to the amount that exceeds a percentage of adjusted gross income.[38]

Qualifying medical care expenses. To be deductible, the expense must be a qualifying medical care expense. The Code provides a broad definition of medical care, including:

- Amounts paid for "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body."[39]
- Amounts paid for medically-related transportation costs and qualified long-term care services;[40]
- Medical insurance;[41] and

[33] The real property tax year is determined under local law and is the period to which the tax imposed relates. Treas. Reg. § 1.164-6(c).
[34] Section 164(d).
[35] Section 164(c)(2).
[36] T.C. Memo. 1867-32.
[37] Powell v. Commissioner, T.C. Memo. 1967-32.
[38] Section 213(a).
[39] Section 213(d)(1)(A).
[40] Section 213(d)(1)(B), (C).
[41] Section 213(d)(1)(D).

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- Lodging costs while away from home for medical care.[42]

Amounts paid for qualified long-term care services include amounts paid for diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services that are required by a chronically ill individual and provided pursuant to a plan of care prescribed by a licensed health care practitioner.[43] It includes a portion of the premiums paid for long-term care insurance.[44]

The deduction does not extend to amounts paid to promote general health (such as for a vacation).[45] A vast amount of expenses may fall between specifically-identified deductible expenses and those for general health care. To determine if an expense is deductible the Tax Court uses the following test: can the taxpayer establish that the expenditures were an essential element of the treatment and that they would not otherwise have been incurred for non-medical reasons.[46]

With respect to drugs, only the amount paid for prescription drugs (i.e., those requiring a prescription) and insulin is a qualified expense.[47]

The Code also includes in the definition of medical expenses amounts paid for the purpose of affecting any structure or function of the body.[48] This provision has been the source of disagreements regarding deductibility. Amounts paid for breast reconstruction surgery following a mastectomy for cancer, vision correction surgery to correct myopia,[49] and the costs of hormone therapy and sex reassignment surgery incurred by a taxpayer with gender identity disorder[50] have been held to come within this provision and be deductible. In contrast, amounts paid to whiten teeth[51] or for breast augmentation surgery did not.[52]

Amounts that otherwise would constitute capital expenditures may come within the definition of a deductible medical expenses.[53] A capital expenditure made by the taxpayer with the primary purpose of medical care may be currently deductible. For example, if the cost otherwise qualifies, the taxpayer may deduct the cost of wheelchairs, eye glasses, artificial teeth and limbs, and crutches. If the capital expenditure relates to a permanent improvement or betterment of property and would not otherwise be for medical care, a deduction is still allowed, but the amount of the deduction is limited. It cannot exceed the extent to which the cost of the item does not increase the value of the property.[54]

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[42] Section 213(d)(2).
[43] Sections 213(d)(1)(C); 7702B(c). If the provider is a relative, the payment may not qualify. Section 213(d)(1)(D), (d)(11).
[44] Section 213(d)(1)D), (d)(10).
[45] Treas. Reg. § 1.213-1(e)(1)(ii).
[46] Magdalin v. Commissioner, T.C. Memo. 2008-293.
[47] Section 213(b), (d)(3).
[48] Section 213(d)(1)(A).
[49] Rev. Rul. 2003-57, 2003-1 C.B. 959.
[50] O'Donnabhain v. Commissioner, 134 T.C. 34 (2010).
[51] Rev. Rul. 2003-57, 2003-1 C.B. 959.
[52] O'Donnabhain v. Commissioner, 134 T.C. 34 (2010).
[53] Treas. Reg. § 1.213-1(e)(1)(iii).
[54] Treas. Reg. § 1.213-1(e)(1)(iii).

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Unreimbursed expenses. To be deductible, the expenses must be unreimbursed. To the extent a taxpayer recovers the cost of medical expenses through insurance, he is not entitled to a deduction. The deduction is not permitted regardless of whether the taxpayer's employer provided the insurance coverage or the taxpayer paid for the coverage himself.[55]

Floor on deduction. The deduction is allowed only if the taxpayer itemizes and only to the extent the expenses exceed 7.5 percent[56] of adjusted gross income. By making a portion of medical expenses non-deductible, Congress retains the personal, nondeductible nature of a certain portion of the expenses. Only to the extent the medical expenses go beyond what might be considered normal or expected is the deduction permitted.

D. Application of Rules

Taxes

Example 1. For the year Lillie paid $5,000 in state incomes taxes. If she itemizes, she may deduct the amount paid.

Example 2. Josh sold his personal residence to Karlene on July 1. Under state law, the real property tax year was the calendar year and taxes due for the year were $5,000. If he itemizes, Josh is entitled to deduct the real property taxes from January 1 through June 30, or $2,500. If she itemizes, Karlene is entitled to deduct the real property taxes due from July 1 through December 31, or $2,500.

Example 3. Kaylie, Lennie, and Martha were co-owners of a cabin. Kaylie paid the entire amount of state property taxes. Even though Kaylie owns only one-third of the cabin, if she itemizes, she may deduct the entire amount of taxes she paid up to $10,000.

Medical Expenses

Example 4. Nan paid $100 for prescription drugs. If she itemizes, she may claim the cost as a medical expense.

Example 5. Samantha and Ted attending marriage counseling sessions each month for the entire year, paying $3,000. Because the counseling was not related to a medical condition, the cost does not qualify as a medical expense.

Example 6. Jane has heart disease and cannot climb stairs. Her doctor recommended she install an elevator in her home so she would not have to climb the stairs. The cost of installing the elevator is $5,000. Having an elevator in the home will increase its value by only $3,000. If she itemizes, Jane may claim as a deductible medical expense the excess, the difference between the cost and the increase in value, or $2,000 ($5,000 cost, less $3,000 increase in value).

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[55] Section 213(a).
[56] Section 213(f). Beginning in 2019, the deduction is allowed only to the extent the expenses exceed 10 percent of adjusted gross income.

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Example 7. Coral incurred $3,000 in qualified medical expenses. Her adjusted gross income for the year was $30,000. She can claim a deduction for the medical expenses only to the extent they exceed 7.5 percent of her adjusted gross income (7.5 percent of her adjusted gross income is $2,250). If she itemizes, she may claim a $750 medical expense deduction.

E. Problems

Taxes

1. Nan worked in Charlotte, North Carolina. In addition to paying federal income tax, Nan also paid state and city income taxes. If she itemizes, can Nan deduct the federal, state, and city income taxes she paid?

2. Drew sold his house to Efrin on March 1. Under state law, the real property tax year is the calendar year and the taxes due for the year of sale were $5,000.

   a. How much of the taxes are allocable to Drew?
   b. How much of the taxes are allocable to Efrin?

3. Fred sold his house to Gregg on March 1. Under state law, the real property tax year is the calendar year and the taxes due for the year of sale were $5,000. As part of the sales agreement, Gregg agreed to pay the taxes due for the entire year (and he did so).

   a. How much of the taxes are allocable to and deductible by Fred?
   b. How much of the taxes are allocable to and deductible by Gregg?

Medical Expenses

For each expense, the taxpayer did not receive any reimbursement.

4. Ossie injured her foot and was required to use crutches for one week. If she itemizes, may she deduct the cost of the crutches as a medical expense?

5. During the year Maley paid $200 for vitamins and protein powder. If she itemizes, may she deduct the costs as medical expenses?

6. Sue paid $500 for a year-long membership to the health club. If she itemizes, may she deduct the cost as a medical expense?

7. Tom paid $300 for cosmetic surgery to reduce the lines on his forehead. If he itemizes, may he deduct the cost as a medical expense?

8. Jeff, determined to get healthy, attended a clinic to stop smoking and joined a weight loss program. If he itemizes, may he deduct the cost of the clinic and the program?

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9. Karl has a degenerative spinal disorder. His doctor recommended he install a swimming pool so that he could swim every day. The cost of installing the swimming pool is $15,000. The pool will increase the value of his home by $10,000. If he itemizes, what is the amount of deductible medical expense Karl may claim?

F. Analysis and Application

Taxes

1. Ted sold his house to Jane on March 1. Under state law, the real property tax year is the calendar year and taxes due for the year of sale were $10,000. Ted had failed to pay the taxes in the prior year. As part of the sales agreement, Jane agreed to pay the $10,000 due for the previous year.
    a. How much of the taxes in the prior year are allocable to Ted? To Jane? If she pays the tax due for the previous year how much is Jane entitled to deduct?
    b. How much of the taxes due in the year of sale are allocable to Ted? To Jane? If Jane pays the entire amount, how much is she entitled to deduct?

2. Look through Form 1040 and Schedule A. Where on the forms do you find the amount paid for real property taxes taken into consideration?

3. Janice sold her home to Vince on a land sale contract. As part of their agreement, Vince was to pay the real property taxes. When Vince failed to pay the real property taxes, Janice paid them. Eventually, Vince defaulted on the contract; Janice instituted foreclosure proceedings and recovered possession of the house.

If she itemizes, is Janice entitled to claim a deduction for the amount of real property taxes she paid? In formulating your analysis and response, you may want to consider:

- Powell v. Commissioner, T.C. Memo. 1967-32
- Peters v. Commissioner, T.C. Memo. 1970-314

Medical Expenses

4. Look through Form 1040 and Schedule A. Where on the forms do you find the amount of medical expenses paid taken into consideration?

5. Jonathan suffered from chronic fatigue syndrome. When traditional medicine did not relieve his symptoms, he researched non-traditional remedies. He learned of healing sessions provided through Navajo healing ceremonies. He spent $5,000 traveling to and attending a ceremony. If he itemizes, may he deduct the $5,000 as a medical expense?

6. Drew was an attorney practicing in Minnesota. By the age of 43 he had suffered four heart attacks. A heart specialist advised him to spend the winter season in a warm climate. Accordingly, he spent December, January, and February in Orlando, Florida. For each month he paid $2,000 in rent. If he itemizes, may Drew deduct the $6,000 of rent payments ($2,000 in the first year, $4,000 in the following year) as a medical expense?

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Chapter 17
Education Expenses, Moving Expenses, Child Care Expenses

Pages 143–150.

The 2017 Tax Cuts and Jobs Act eliminated the deduction for moving expenses, except for members of the Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station.

In addition, the 2017 Tax Cuts and Jobs Act eliminated all deductions subject to the two-percent floor of Section 67. A majority of the items discussed in this chapter would be deductions subject to the two-percent floor.

Delete the chapter.

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Chapter 18
Charitable Contributions

The taxpayer's adjusted gross income is reduced by either the standard deduction or itemized deductions (whichever is greater). Itemized deductions often are referred to as "below the line" deductions because some are allowed only to the extent they exceed a percentage of adjusted gross income. The 2017 Tax Cuts and Jobs Act increased the amount of the standard deduction to $12,000 for individuals and $24,000 for those married and filing jointly. Given the increase in the standard deduction amount, in most cases the taxpayer will use the standard deduction (as opposed to choosing to itemize). The contributable contribution is an itemized deduction.

Page 156.

Replace the following paragraph, before Section E. Special Rules.

Percentage Limitations on Amount of Deduction. In general, the total amount of charitable contributions cannot exceed 50 percent (60 percent for cash contributions[57]) of the taxpayer's contribution base (the contribution basis is usually equal to the taxpayer's adjusted gross income). For contributions to most organizations, this will be the only percentage limitation that will apply. However, in some situations, depending on the type of property contributed and the organization the contribution is made to, the percentage limitation may be reduced to 30 percent or 20 percent of the contribution base.[58] (Note that, if the total amount of charitable contributions is 20 percent or less of the taxpayer's contribution base, no percentage limitation will apply.) A deduction that is not allowed due to a limitation may be carried forward for five years.[59]

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[57] Section 170(b)(1)(G).
[58] Section 170(b)(1)(A), (B). As with limitations based on the type of property, percentage limitations are also complex and the Code should be consulted for specific limitations.
[59] Section 170(d)(1)(A).

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Chapter 19
Casualty Losses

Pages 161–166

The 2017 Tax Cuts and Jobs Act in general eliminated the personal casualty and theft loss deduction during 2018 through 2025. (The loss can be used to the extent personal casualty losses can be netted against personal casualty gains.) A deduction remains only for losses incurred in a federally-declared disaster.

Delete the chapter.

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Chapter 23
Expenses

The 2017 Tax Cuts and Jobs Act eliminated all deductions subject to the two-percent floor of Section 67 and, in some cases, limited the deduction for business interest. Accordingly, please make the following changes:

- **Page 198–200**. Delete beginning with the paragraph *Clothing* until before the formula for Taxpayer's Taxable Income and replace with the following paragraph:

Business Interest. While a business is entitled to deduct interest, for businesses with average annual gross receipts of $25 million or more, the deduction is limited to 30 percent of its adjusted taxable income. Any disallowed interest deduction can be carried forward.[60]

- **Page 204**.
  - Delete the paragraph that begins *Section 212(3)* before the Application of Rules.
  - Delete Example 3.

- **Page 205**. Delete Example 11.

- **Page 206**. Delete questions 4 and 5.

[60] Section 163(j).

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Chapter 24
Travel, Entertainment, and Business Meals

Page 209–215.

The 2017 Tax Cuts and Jobs Act eliminated the business deduction for entertainment expenses. It also expanded the 50 percent limit on the deductibility of business meals to include those provided in an in-house cafeteria or otherwise on the employer's premises.

In addition, the 2017 Tax Cuts and Jobs Act eliminated all deductions subject to the two-percent floor of Section 67. To the extent expenses are unreimbursed employee business expenses, the majority of the items discussed in this chapter would be deductions subject to the two-percent floor. Accordingly, very little remains that could be deducted.

Delete this chapter.

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Chapter 25
Depreciation and Amortization

Pages 217–242: Replace the chapter with the following.

A. Background

Gross income. Gross income includes income (accessions to wealth) derived from any and all sources.[61] It includes every accession to wealth, unless there is an exception.

Basis. The basis of property is the amount the taxpayer originally paid for the property.[62] In general, a taxpayer will purchase an item for its fair market value. Thus, a taxpayer's basis in property is the fair market value of the property at the time of purchase.

Taxable income. In general, taxable income is the taxpayer's gross income, less all allowable deductions.[63] The taxpayer's liability is based on the amount of the taxpayer's taxable income.[64]

B. Depreciation

One of the overarching objectives of the Code is to impose tax on a taxpayer's accession to wealth. When the taxpayer operates his own business or has investments, his taxable increase in wealth is not his gross income. Rather, it is his gross income less the costs he incurred to generate the income.

The previous chapter discussed the allowance of a deduction for the expenses a taxpayer incurs related to his business or investments.[65] A taxpayer's accession to wealth would be skewed if he were similarly allowed to deduct expenditures that had an impact on his business or investments that span more than one year. For example, if a taxpayer was allowed to deduct the entire cost of a computer, desk, copy machine, building, and land in the year of purchase, his income would be artificially low in that year. In subsequent years, while he was still using those items in his business or investment activity (but not getting a deduction for the cost of those items), his income would be artificially high.

The more economically correct solution is to recover a portion of the cost over the length of time the asset is used in the business or investment activity. In essence, the decrease in value of the asset is the cost associated with using the asset in the business or investment activity. This method of recovering the cost of the property is called "depreciation" when associated with tangible property and "amortization" when associated with intangible property.

For an asset to qualify for depreciation or amortization, the asset must:

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[61] Section 61(a).
[62] Section 1012(a).
[63] Section 63(a).
[64] Section 1.
[65] Sections 162(a), 212.

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- Be purchased and used in the taxpayer's business or investment activity,[66]
- Have a life extending more than one year, and
- Wear out over time.

Section 167. Depreciation.
(a) General Rule. — There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) —
(1) of property used in the trade or business; or
(2) of property held for the production of income.

Consider

- Depreciation is the cost of the property broken down into the equivalent of expense deductions allowed each year, continuing for the tax life of the property (i.e., until the cost of the property is fully recovered).

- Even though the taxpayer may have recovered the entire cost of the property through depreciation, the property may still be of use in his business or investment activity. The actual life and the "tax life" may not coincide.

While the Code provides that a taxpayer is entitled to claim depreciation based on the cost of the property and the life of the property, the taxpayer and the Commissioner often disagreed on the useful life of an asset. To eliminate this controversy Congress provided for standardized useful lives for some assets. It also provided for alternative methods of recovering the cost of the asset.

1. Tangible Personal Property

In a break from the more economically correct solution of recovering a portion of the cost over the length of time the asset is used in the business or investment activity, under the 2017 Tax Cuts and Jobs Act, Congress provided that most tangible personal property can be expensed in the first year.[67] In effect, the taxpayer is allowed to treat the cost as if it were an expense, rather than a capital expenditure. An upside of this approach is its simplicity.

Example. In 2018 Phil purchased a drill press for $200,000 and used the equipment in his business. The equipment is classified as 5-year property. In the first year (*i.e.*, 2018), Phil is entitled to claim the full cost of the property, or $200,000.

[66] Section 167(a).
[67] Section 168(k). The 100 percent expensing is available until 2022, when it is phased out.

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The taxpayer can elect out of Section 168(k). To that extent, or if the tangible property is not eligible for expensing, the following rules, in the order indicated, apply. In addition, the following rules will apply when the 100 percent expenses of Section 168(k) is phased out in 2022.

a. Regular (MACRS) Depreciation

Tangible person property is placed into class lives based generally on the length of time over which Congress expects the taxpayer to recover the cost of the property.[68]

Examples

- Tangible personal property includes items such as computers, stoves, copy machines, cars, trees, equipment, desks, sidewalks, and furniture.
- Class lives and an example of a few of the assets included in that class life are as follows.
  - 3-year property: tractor unit for over-the-road use, race horse.
  - 5-year property: automobile, taxi, truck, computer, office machinery.
  - 7-year property: desk, files, agricultural machinery and equipment.
  - 10-year property: barge, tug, tree, vine bearing fruits or nuts.

With the class life dictating how long it will take the taxpayer to recover the cost of the property for tax purposes, a percentage of the cost is recovered each year.[69]

Because Congress wanted the taxpayer to be able to claim more depreciation in the early years (which leaves less to be claimed in later year), the amount of depreciation the taxpayer is entitled to claim changes from year to year. The amount is determined by multiplying the cost of the property by the applicable percentage from the depreciation chart.[70] When the depreciation allowed during each of the years is totaled it equals the original cost of the property. This recovery methodology is the modified accelerated cost recovery system (MACRS).

[68] Section 168 carries out Section 167 by providing for the depreciation of property based on specific rules.
[69] Section 168(c), (e); Rev. Proc. 87-56, 1987-2 C.B. 674.
[70] Section 168(b)(1).

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The depreciation charts are as follows:[71]

Recovery Period	**3-Year**	**5-Year**	**7-Year**	**10-Year**
Year 1	33.33%	20.00%	14.28%	10.00%
Year 2	44.45%	32.00%	24.49%	18.00%
Year 3	14.81%	19.20%	17.49%	14.40%
Year 4	7.41%	11.52%	12.49%	11.52%
Year 5	11.52%	8.93%	9.22%	
Year 6	5.76%	8.93%	7.37%	
Year 7	8.93%	6.55%		
Year 8	4.46%	6.55%		
Year 9	6.56%			
Year 10	6.55%			
Year 11	3.28%			

Example. Mary purchased a piece of equipment for $100,000 and used the equipment in her business. The equipment is classified as 5-year property. Mary is entitled to recover the cost of the equipment over time, as follows:

Year	**Calculation**	**Yearly Depreciation**
1	$100,000 x 20%	$20,000
2	$100,000 x 32%	$32,000
3	$100,000 x 19.2%	$19,200
4	$100,000 x 11.52%	$11,520
5	$100,000 x 11.52%	$11,520
6	$100,000 x 5.76%	$5,760
Total Depreciation:		$100,000

Convention. To be entitled to claim depreciation the taxpayer must place the property in service in his business. For the year the taxpayer places the property in service he will not have used it in his business for the entire taxable year. While the taxpayer could compute exactly how many days the asset was used in his business during the initial year and prorate the first-year's depreciation, Congress elected a much simpler method. For the first year, the taxpayer is entitled to claim one-half of the year's depreciation.[72] Note that the chart already takes this into consideration and provides a percentage for one-half of the first year's depreciation.

If the taxpayer sells the property prior to claiming all available depreciation, the same issue arises. During the year of sale, the taxpayer does not use the property in his business the entire taxable year. As with the first year, for the year of sale the taxpayer is entitled to claim one-half of the year's depreciation.[73] The taxpayer must make this calculation.

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[71] Rev. Proc. 87-57, 1987-2 C.B. 687.

[72] Id. Property also can be classified as fifteen- or twenty-year property.
The taxpayer may elect out of using the method represented in the chart (the double-declining method) and recover the cost of the property using the straight-line method, or in equal amounts over the life of the property. See the "Tell Me More" discussion box for more information on the straight-line method of depreciation.

[73] Section 168(d)(1).

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This method of computing a partial year's worth of depreciation is referred to as the convention. Tangible personal property uses a one-half year convention.

Example. Mary purchased a piece of equipment in June for $100,000 and used the equipment in her business. The equipment is classified as 5-year property. In the first year, Mary is entitled to a $20,000 depreciation deduction ($100,000 x 20%). Note that the percentage from the chart has already been adjusted to calculate one-half year's worth of depreciation (1/2 x 40% = 20%).

In Year 4 Mary sells the property. During the year of sale Mary does not use the property in her business for the entire taxable year. Applying the one-half year convention, Mary is entitled to one-half of the depreciation allowed in Year 4, or $100,000 x 11.52% x 1/2 = $5,760.

Because of the half-year convention and only a portion of the first year's depreciation being recovered in the first year, depreciation continues into the year following the asset's actual class life. For example, for property with a three-year class life, it will take the taxpayer at total of four years to recover the cost. For property with a five-year class life, it will take the taxpayer six years to recover the cost. For property with a fifteen-year class life, it will take the taxpayer sixteen years to recover the cost of the property.

Tell Me More

To prevent taxpayers from abusing the one-half year convention by placing all or a majority of assets into service in the later part of the year (and receiving one-half year's worth of depreciation), the Code may provide that the taxpayer use the mid-quarter convention.[74]

If the amount of tangible personal property placed in service during the last three months of the year has an aggregate basis greater than 40 percent of the aggregate basis of all properties placed in service that year, the mid-quarter convention applies in place of the half year convention. Tables that can be used to compute the amount of allowable depreciation using the one-quarter convention can be found in Revenue Procedure 87-57.

Relationship with Adjusted Basis. The basis of property is the cost of the property at the time it was purchased. As the cost is "recovered" by the taxpayer through depreciation, the basis is reduced (adjusted).[75] Depreciation must be taken based on the depreciation method. In other words, it cannot be saved for a later date. This result is accomplished by the basis always being reduced by the allowable amount of depreciation for that year. Similarly, if the taxpayer miscalculates the amount of allowable depreciation and claims too much, the basis is reduced by the amount claimed. In sum, the basis is reduced by the greater of the amount the taxpayer claimed or should have claimed.[76]

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[74] Id.
[75] Section 168(d)(3).
[76] Section 1016(a)(1).

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Once the basis in the property is reduced to zero, the taxpayer has completely recovered the cost of the property and the depreciation deductions have been used to reduce the taxpayer's income over time. Once fully depreciated, no further deductions with respect to that property are allowed.

Formula — Adjusted Basis
Adjusted basis = original cost + capital expenditures – depreciation
Adjusted basis cannot be less than zero.

Example. Mary purchased a piece of equipment for $100,000 and used the equipment in her business. The equipment is classified as 5-year property. Mary is entitled to recover the cost of the equipment over time and must reduce her basis as follows:

Year	**Calculation**	**Depreciation**	**Adjusted Basis**
1	$100,000 x 20%	$ 20,000	$80,000
2	$100,000 x 32%	32,000	48,000
3	$100,000 x 19.2%	19,200	28,800
4	$100,000 x 11.52%	11,520	17,280
5	$100,000 x 11.52%	11,520	5,760
6	$100,000 x 5.76%	5,760	-0-
		$100,000	

Tell Me More

The depreciation methodology that applies to tangible personal property is the modified accelerated cost recovery system (MACRS) and is set forth in Section 168. It incorporates a "double declining" method. Under this method, using the adjusted basis of the property, the taxpayer is permitted to claim twice what he could be entitled to under straight-line. In the year straight-line depreciation would result in a larger depreciation deduction, the taxpayer must switch to the straight-line method. Rather than use the charts provided by the Service, the taxpayer could compute the allowable amount of depreciation.

Example. Mary purchased a piece of equipment for $100,000 and used the equipment in her business. The equipment is classified as 5-year property. Under the straight-line method Mary would be able to recover the cost of the property ratably over 5 years, or 20% each year (20,000 each year). Under the double-declining method, Mary is entitled to recover double that amount, or 40% each year. In the first year, the half-year convention applies. Mary is entitled to recover the cost of the equipment over time as follows:

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Year	Calculation	Depreciation	Adjusted Basis
1	$100,000 x 40% x ½	$20,000	$80,000
2	$80,000 x 40%	32,000	48,000
3	$48,000 x 40%	19,200	28,800
4	$28,800 x 40%	11,520	17,280
-	switch to straight-line -		
5	$17,280 x 2/3	11,520	5,760
6	$5,760	5,760	-0-
Totals:		$100,000	

Note the allowable amount of depreciation is the same as that determined using the depreciation chart.

Straight From the Headlines

The 1980s saw a lot of tax shelter investments being marketed to taxpayers. In general, a tax shelter is a scheme that uses the Code to create artificial deductions for taxpayers.

Perhaps the most pervasive and well known tax shelter of the 80s was that involving Jackie Fine Arts. In this scheme, a taxpayer would agree to purchase an "Art Master," acquiring the rights to exploit the master by selling limited edition graphics. The taxpayer would pay partly in cash and partly with a promissory note. For example, if the purchase price was $136,000, the taxpayer would pay $3,700 on closing and sign promissory notes for the remainder. (The taxpayer rarely made any payments on the notes.) Even though the taxpayer had actually paid only $3,700, depreciation on the "Art Master" was based on the $136,000 purchase price.

Investors who bothered to make limited edition graphics were unable to sell them. Moreover, the artwork was subsequently determined to have no value. The IRS determined the investment was an abusive tax shelter: taxpayers had not invested in the Art Master with an intent to make a profit (but rather to generate artificial and large depreciation deductions). It disallowed the depreciation, leaving the taxpayers owing significant amounts of taxes from the years in which the deductions were claimed. It did allow each investor to claim his out-of-pocket costs as a theft loss. The unraveling of the tax shelters generated a significant amount of litigation ranging from taxpayers arguing (unsuccessfully) before the Tax Court that the depreciation deductions should have been allowed to prosecution of the promotors of the schemes for promoting tax shelters to allegations by the taxpayers against the promoters that the promotors were selling investments in violation of the SEC rules.

Another example is the schemes offered by Walter J. Hoyt. He sold limited partnership interests in partnerships that owned cattle or sheep. A partnership is a "flow-through" entity, meaning that the income, gains, deduction and losses of the partnership flow through to the partner and are reported by the partner on his individual income tax return. For example, if the partnership was entitled to $10,000 of depreciation on cattle and the partner owned 30 percent of the partnership, the partner would claim $3,000 of depreciation on his individual income tax return. If the

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partnership claimed, instead, the cattle were worth $20,000, the 30-percent partner would claim $6,000 in depreciation.

Mr. Hoyt sold interests in over 100 partnerships. In those partnerships, the value of the cattle was inflated, creating larger amounts of depreciation each year that could then be passed through to the partners. In addition, the same 4,000–5,000 cows were "contributed" to multiple partnerships. Finally, when needed, Mr. Hoyt simply created the cows on paper, with the partnerships claiming depreciation on the high-value, non-existent animals. When the scheme finally unraveled, Mr. Hoyt had created 38,000 cows, the cows (both real and imaginary) had generated $103 million worth of illegitimate deductions, and those depreciation deductions were claimed by about 5,000 limited partners.

In 2001 Mr. Hoyt was convicted on one count of conspiracy to commit fraud, 31 counts of mail fraud, three counts of bankruptcy fraud, and 17 counts of money laundering. He was sentenced to 20 years in prison and died in prison in 2007.

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b. Additional First-Year Depreciation

The taxpayer can claim additional depreciation in the year the asset is placed in service. To the extent the taxpayer claims this additional depreciation in the year he places the asset in service, he has less to claim in later years. (The taxpayer can elect to not take the additional first-year depreciation.[77])

Applicable property. To be able to claim the additional first-year depreciation the property:[78]

- Must be depreciated under MACRS;
- Have a recovery period of 20 years or less (basically limiting its availability to tangible personal property); and
- Be placed into service during the taxable year.

Impact of the additional first-year depreciation deduction. For assets purchased after September 27, 2017, additional first-year depreciation is equal to 100 percent of the basis. Accordingly, the taxpayer is entitled to deduct the entire cost of the property in the first year.

Example. In 2018 Phil purchased a drill press for $200,000 and used the equipment in his business. The equipment is classified as 5-year property. In the first year (*i.e.*, 2018), Phil is entitled to claim the full cost of the property, or $200,000. Phil is not entitled to depreciation deductions from the drill press in any other years, and his basis in the press is zero.

[77] Section 168(k)(2)(D)(iii).
[78] Section 168(k)(2)(A)(i).

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c. Bonus Depreciation

In certain situations a taxpayer may elect to claim bonus depreciation.[79] Bonus depreciation does not mean the taxpayer is entitled to depreciation totaling an amount greater than what he paid for the property. Rather, it means that the taxpayer may claim more depreciation in the year he places the asset in service (and, therefore, less in later years).

Bonus depreciation is one area of the Code that has seen many changes over the years. Thus, it is important to make sure you have read the most recent version of Section 179 before giving advice to a client.

Applicable property. If the taxpayer has placed tangible personal property depreciated using MACRS into service in his business during the taxable year, he may elect to claim bonus depreciation.[80] Bonus depreciation is not available for property purchased for an investment activity.

Impact of making election. If the taxpayer elects to claim bonus depreciation, he may claim up to $1,000,000 of depreciation in the year he places the asset in service.[81] The remainder of the cost of the property is recovered under the usual depreciation method (including additional first-year depreciation). This means that in the first year the taxpayer can claim bonus depreciation, additional first-year depreciation, and regular (MACRS) depreciation.

Limitations on amount of bonus depreciation. There are three applicable limitations on the amount of bonus depreciation that can be claimed. The first limitation is that the amount of bonus depreciation claimed cannot exceed the cost of the property.

Example. The taxpayer purchased an oven for $5,000 and elected to claim bonus depreciation. The most bonus depreciation he can claim is $5,000. Note that, after claiming the bonus depreciation, he has recovered all of his basis in the oven (his adjusted basis is zero) and he is not entitled to any additional depreciation.

The second limitation is that the amount of bonus depreciation claimed cannot exceed the taxable income derived from the business (before considering any bonus depreciation).[82]

Example. Taxpayer purchased a piece of equipment for $600,000 and elected to claim bonus depreciation. The taxable income from his business is $20,000. The most bonus depreciation he can claim is $20,000. After claiming $20,000 of bonus depreciation, the remaining $580,000 ($600,000 less $20,000 of bonus depreciation) can be recovered using his regular depreciation method (including additional first-year depreciation).

[79] Section 179(a).
[80] Section 179(d)(1).
[81] Section 179(b)(1).
[82] Section 179(b)(3).

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The third limitation is that, for every dollar over $2,500,000 that the taxpayer spends on tangible personal property, he must reduce the amount of bonus depreciation he can claim.[83]

Example. Taxpayer purchased a total of $2,600,000 of tangible personal property. Because the cost of the purchased tangible personal property exceeds $2,500,000 by $100,000, he must reduce the amount of bonus depreciation by that amount. Thus, the taxpayer can claim $900,000 ($1,000,000 - $100,000) of bonus depreciation.

Examples

Amount Spent on Tangible Personal Property	**Amount Spent over $200,000**	**Amount of Allowable Bonus Depreciation**
$2,700,000	$200,000	$800,000
$3,000,000	500,000	500,000
$3,200,000	700,000	300,000
$3,500,000	1,000,000	-0-

Example. In 2018 Bob purchased a piece of equipment for $1,500,000. He will use the equipment in his business and the equipment has a five year class life. It is the only tangible personal property he purchased that year and his business had taxable income of $1,200,000. He elected bonus depreciation.

None of the three limitations apply and Bob can claim $1,000,000 of bonus depreciation. Bob recovers the remaining $500,000 cost of his property ($1,500,000 cost, less $1,000,000 bonus depreciation) as additional first-year depreciation.

Note that Bob can recover the entire cost of the property through depreciation in the first year through a combination of bonus depreciation and additional first year depreciation.

2. Real Property

Section 168 provides that a taxpayer depreciates real property using the straightline method.[84] Real property is divided into residential and non-residential property based on the use of the property.[85] For example, apartment buildings would be classified as residential property and shopping malls would be characterized as nonresidential property. For residential property, it will take the taxpayer 27.5 years to recover the cost. For nonresidential property, it will take the taxpayer 39 years to recover the cost.[86] The amount of allowable depreciation is determined by multiplying the cost of the property by the applicable percentage, determined by the month the taxpayer placed the building in service, from the depreciation chart.

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[83] Section 179(b)(2).
[84] Section 168(b)(3).
[85] Section 168(b)(3), (c).
[86] Section 168(c).

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The depreciation charts are as follows:

Residential Rental Property (%)

Year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec
1	3.485	3.182	2.879	2.576	2.273	1.97	1.667	1.364	1.061	.758	.455	.152
2–27	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
28	1.87	2.273	2.576	2.879	3.182	3.485	3.636	3.636	3.636	3.636	3.636	3.636
29	0	0	0	0	0	0	.152	.455	.758	1.061	1.364	1.667

Non-Residential Rental Property (%)

Year	Jan	Feb	Mar	Apr	May	June	July	Aug	Sep	Oct	Nov	Dec
1	2.461	2.247	2.033	1.819	1.605	1.391	1.177	.963	.749	.535	.321	.107
2–39	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
40	.107	.321	.535	.749	.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

Example. Nancy purchased a shopping mall in April for $1,000,000. The real property is non-residential real property, and Nancy is entitled to recover the cost of the shopping mall over time as follows:

Year	**Calculation**	**Yearly Depreciation**
1	$1,000,000 x 1.819%	$18,190
2	$1,000,000 x 2.564%	$25,640
3	$1,000,000 x 2.564%	$25,640
38	$1,000,000 x 2.564%	$25,640
39	$1,000,000 x 2.564%	$25,640
40	$1,000,000 x .749%	$7,490
Total Depreciation:		$1,000,000

Convention. To be entitled to claim depreciation, the taxpayer must place the property in service in his business. For the year the taxpayer places the property in service, he will not have used it in his business for the entire taxable year. While the taxpayer could compute exactly how many days the asset was used in his business during the initial year and prorate the first-year's depreciation, Congress elected a simpler route. For the first year, the taxpayer is entitled to claim one-half of the depreciation for the month the building was placed in service and the depreciation for the remaining months.[87] Note that the chart already takes this into consideration and calculates one-half of the month the asset was placed in service and the remaining month's depreciation for the first year.

If the taxpayer sells the property prior to claiming all available depreciation, the same issue arises. During the year of sale, the taxpayer does not use the property in his business the entire taxable year. As with the first year, for the year of sale the taxpayer is entitled to claim depreciation for one-half of the month the asset was sold and all prior months. The taxpayer must make this calculation. This convention for real property is called the one-half month convention.

Example. Nancy purchased a shopping mall in April for $1,000,000. The real property is non-residential real property. In the first year Nancy is entitled to a $18,190 depreciation deduction.

[87] Section 168(d)(2).

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Note that the percentage from the chart has already been adjusted to calculate the depreciation allocable to half of April and all of May through December.

In June of Year 5 Nancy sells the property. During the year of sale Nancy does not use the property in her business for the entire taxable year. Applying the one-half month convention Nancy is entitled to one-half of June and all of January through May, or 5.5/12 x 2.564% x $1,000,000 = $11,772.

Tell Me More

The depreciation methodology that applies to real property is the straight-line method. It allows the cost to be recovered ratably (evenly) over the life of the asset. Rather than use the charts provided by the Service, the taxpayer could compute the allowable amount of depreciation.

Example. Nancy purchased a shopping mall in April for $1,000,000. The building is non-residential real property, and Nancy is entitled to recover the cost of the shopping mall over 39 years, applying the one-half month convention, as follows:

Year	**Calculation**	**Yearly Depreciation***
1	$1,000,000 x 8.5/12 x 1/39	$18,162
2	$1,000,000 x 1/39	$25,641
3	$1,000,000 x 1/39	$25,641
38	$1,000,000 x 1/39	$25,641
39	$1,000,000 x 1/39	$25,641
40	$1,000,000 x 3.5/12 x 1/39	$7,478
Total Depreciation:		$1,000,000

Note that the first year of depreciation is split between year 1 and year 40. The depreciation allocable to January through March and one-half of April are claimed in year one. The remainder of the year, one-half of April and May through December, are claimed in year 40.

* The numbers are slightly different due to rounding.

Relationship with Adjusted Basis. The basis of property is the cost of the property at the time it was purchased. As the cost is "recovered" by the taxpayer through depreciation, the basis is reduced (adjusted).[88] Once the basis in the property is reduced to zero, the taxpayer has completely recovered the cost of the property and the depreciation deductions have been used to reduce the taxpayer's income over time. Once fully depreciated, no further deductions with respect to that property are allowed.

[88] Section 1016(a).

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Example. Nancy purchased a shopping mall in April for $1,000,000. The building is non-residential real property, and Nancy is entitled to recover the cost of the shopping mall over time, reducing her basis, as follows:

Year	Calculation	Yearly Depreciation	Adjusted Basis
1	$1,000,000 x 1.819%	$18,190	$981,810
2	$1,000,000 x 2.564%	$25,640	956,170
3	$1,000,000 x 2.564%	$25,640	930,530
38	$1,000,000 x 2.564%	$25,640	33,130
39	$1,000,000 x 2.564%	$25,640	7,490
40	$1,000,000 x .749%	$7,490	-0-
Total:		$1,000,000	

3. Intangible Property

Section 168 does not address intangible property. Congress eventually filled this gap by enacting Section 197. Section 197 provides that the cost of certain intangible assets is recovered ratably over 15 years (180 months) beginning in the month the intangible asset is placed in service. Because the property is an intangible asset, the deduction is referred to as amortization.

Definition — Intangible Property

Intangible property that is depreciated over 15 years includes:[89]

- Goodwill
- Going-concern value
- Workforce in place
- Customer lists
- Patent
- Copyright
- License
- Covenant not to compete
- Franchise
- Trademark

Example. Ollie purchased a business, including goodwill, in March. He paid $36,000 for the goodwill. Goodwill is intangible property, and Ollie is entitled to recover the cost over 180 months as follows:

Year	Calculation	Yearly Amortization

[89] Section 197(d).

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1	$36,000 x 10 x 1/180	$2,000
2	$36,000 x 12/180	$2,400
3	$36,000 x 12/180	$2,400
15	$36,000 x 12/180	$2,400
16	$36,000 x 2/180	$400
Total Amortization:		$36,000

Relationship with Adjusted Basis. The basis of the intangible asset is the cost of the asset at the time it was purchased. As the cost is "recovered" by the taxpayer through amortization, the basis is reduced (adjusted).[90] Once the basis in the intangible asset is reduced to zero, the taxpayer has been able to completely recover the cost of the asset and the amortization deductions have been used to reduce the taxpayer's income over time. Once fully amortized, no further deductions with respect to that asset are allowed.

Example. Using the same example as from above, Ollie purchased a business, including goodwill, in March. He paid $36,000 for the goodwill. Goodwill is intangible property, and Ollie entitled to recover the cost over 180 months, as follows:

Year	**Calculation**	**Amortization**	**Adjusted Basis**
1	$36,000 x 10 x 1/180	$2,000	$34,000
2	$36,000 x 12/180	2,400	31,600
3	$36,000 x 12/180	2,400	29,200
14	$36,000 x 12/180	2,400	2,800
15	$36,000 x 12/180	2,400	400
16	$36,000 x 2/180	400	-0-
Total Amortization		$36,000	

4. Other Property

If the property is not tangible person property (Section 168), real property (Section 168), or intangible property (Section 197), the cost can be recovered ratably under the straight-line method (Section 167) if the taxpayer can establish:

- That the taxpayer purchased the asset and placed it in service;
- The cost of the property
- That the property wears out over time; and
- The length of time it will take the asset to wear out.

[90] Section 1016(a).

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Tell Me More

Under the straight-line method, the taxpayer recovers the cost of the property ratably over its useful life.

> *Example*. On July 1 the taxpayer paid $3,000 for fire insurance for his business. The insurance extends for three years. Because the useful life of the insurance is three years, the taxpayer recovers the cost ratably over that time.

Year	Calculation	Yearly Amortization
1	$3,000/3 x 1/2	$ 500
2	$3,000/3	1,000
3	$3,000/3	1,000
4	$3,000/3 x1/2	500
Total Amortization:		$3,000

Summary — Depreciation

To qualify for depreciation or amortization, the asset must:

- Be purchased by the taxpayer
- Be used in the taxpayer's business;
- Have a life or benefit of more than one year; and
- Wear out over time.

The determination of how much depreciation is allowed each year depends on whether the asset is:

- Tangible personal property
- Real property
- Intangible property
- Another type of property

Summary — A Difference in Timing

A business or investment expenditure is recovered using one of the following methods:

- If the expenditure has a benefit that impacts only one year, the entire cost is recovered during that year.
- If the expenditure has a benefit that impacts more than one year and the asset wears out over time, the cost (in theory) is recovered over time. However, this result is significantly changed with respect to tangible personal property through the impact of Section 168(k).

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- If the expenditure has a benefit that impacts more than one year and the asset does not wear out over time, the taxpayer's capital investment (*i.e.*, basis) is recovered only upon sale of the property.

Order for computing the first year of depreciation for tangible personal property (recovered through MACRS) when asset is not fully expensed under Section 168(k)

First:	Bonus depreciation (Section179)
Second:	Additional first-year depreciation (having reduced basis by bonus depreciation) (Section 168(k))
Third:	MACRS depreciation (having reduced basis by bonus and first-year depreciation)

If the taxpayer elects bonus depreciation, his depreciation for the first year is the sum of the bonus depreciation, additional first-year depreciation, and the first year of MACRS depreciation.

Taxpayer's Taxable Business Income

Gross income
– Business expenses
– <u>Depreciation and/or amortization</u>
Taxable income

Taxpayer's Taxable Investment Income

Gross investment income
– Investment expenses
– <u>Depreciation from investment property</u>
Taxable investment income

C. Application of Rules

Example 1. Business tangible personal property. Nicole owns and operates a small business. In 2018 she purchased for use in her business a new desk for $40,000. The desk is classified as 7-year property. She made no elections. Under Section 168(k), Nicole can recover the entire cost of the desk in 2018.

Example 2. Business real property. Gregg purchased an apartment building in June, paying $500,000. He made no elections. The real property is residential real property, and Gregg is entitled to recover the cost of the apartment building over time as follows:

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Year	Calculation	Yearly Depreciation
1	$500,000 x 1.97%	$9,850
2	$500,000 x 3.636%	18,180
3	$500,000 x 3.636%	18,180
26	$500,000 x 3.636%	18,180
27	$500,000 x 3.636%	18,180
28	$500,000 x 3.485%	17,425
Total Depreciation:		$500,000

Example 3. Business intangible property. Harry purchased a business in November. As part of the purchase price he paid the seller $25,000 for the going-concerning value of the business.

The going-concern value is an intangible asset, and Harry is entitled to recover the cost over 15 years, or 180 months, as follows:

Year	Calculation	Amortization
1	$25,000 x 2/180	$277
2	$25,000 x 12/180	1,666
3	$25,000 x 12/180	1,666
15	$25,000 x 12/180	1,666
16	$25,000 x 10/180	1,388
Total Amortization:		$25,000

Example 4. Business tangible personal property and bonus depreciation. Arlie owns and operates a soda shop. In 2018 she purchased for use in her business a new piece of equipment (5-year property) for $1,200,000 and elected bonus depreciation. It was the only tangible personal property she purchased that year, and her business had taxable income of $2,000,000.

None of the three limitations apply, and Arlie can claim $1,000,000 of bonus depreciation in the first year, reducing the basis to $200,000 ($1,200,000 cost, less $1,000,000 of bonus depreciation). She can recover $200,000 of the basis through additional first-year depreciation.

Year	Calculation	Depreciation
1	Bonus	$1,000,000
1	Additional first-year	200,000
		$1,200,000

Note that Arlie will claim the total cost of the equipment as depreciation in the first year.

Example 5. Business tangible personal property and bonus depreciation (cost limitation). Betsy owns and operates a bakery. She purchased for use in her business a new piece of equipment (5-year property) for $300,000 and elected bonus depreciation. It was the only tangible personal property she purchased that year, and her business had taxable income of $600,000.

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Because the cost of the property is less than $1,000,000, the most bonus depreciation she can claim is the cost of the property, or $300,000. After claiming bonus depreciation in the first year, Betsy has completely recovered the cost of the equipment.

Example 6. Business tangible personal property and bonus depreciation (income limitation). Chris owns and operates a candy store. In 2018 he purchased for use in his business a new piece of equipment (5-year property) for $1,300,000 and elected bonus depreciation. It was the only tangible personal property he purchased that year, and his business had taxable income of $200,000.

Because the taxable income from his business is less than $1,000,000, the most bonus depreciation he can claim is the amount of taxable income, or $200,000. The bonus depreciation reduces the basis to $1,100,000 ($1,300,000 cost, less $200,000 of bonus depreciation). He can recover the remaining $1,100,000 of the basis through additional first-year depreciation. After claiming bonus depreciation and addition first year depreciation, Chris has completely recovered the cost of the equipment.

Example 7. Business tangible personal property and bonus depreciation (purchase limitation). Danny owns and operates a department store. In 2018 he purchased for use in his business a new piece of equipment (5-year property) for $2,700,000 and elected bonus depreciation. It was the only tangible personal property he purchased that year, and his business had taxable income of $1,200,000.

Because he spent more than $2,500,000 on tangible personal property, the amount of bonus depreciation he can claim is reduced for every dollar he spent on tangible personal property over $2,500,000, or reduced by $200,000. Thus, he can claim $800,000 of bonus depreciation ($1,000,000 less $200,000) in the first year. The bonus depreciation reduces the basis to $1,900,000 ($2,700,000 cost, less $800,000 of bonus depreciation). He can recover the remaining $1,900,000 basis through additional first-year depreciation.

After claiming bonus depreciation and additional first year depreciation in the first year, Danny will completely recover the cost of the equipment.

Example 8. Heather purchased a piece of equipment for $200,000 and used the equipment in her business. She elected out of Section 168(k) additional first year deprecation and did not elect bonus depreciation. The equipment is classified as 5-year property. Heather is entitled to recover the cost of the equipment over time and must reduce her basis as follows:

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Year	**Calculation**	**Depreciation**	**Adjusted Basis**
1	$200,000 x 20%	$ 40,000	$160,000
2	$200,000 x 32%	64,000	96,000
3	$200,000 x 19.2%	38,400	57,600
4	$200,000 x 11.52%	23,040	34,560
5	$200,000 x 11.52%	23,040	22,520
6	$200,000 x 5.76%	11,520	-0-
		$100,000	

Example 9. Investment real property. Gregg purchased an apartment building in June, paying $500,000. The real property is residential real property and Gregg uses it in his investment activity. Gregg is entitled to recover the cost of apartment building over time, as follows:

Year	**Calculation**	**Yearly Depreciation**
1	$500,000 x 1.97%	$ 9,850
2	$500,000 x 3.636%	18,180
3	$500,000 x 3.636%	18,180
26	$500,000 x 3.636%	18,180
27	$500,000 x 3.636%	18,180
28	$500,000 x 3.485%	17,425
Total Depreciation:		$500,000

Example 10. Investment tangible personal property. Kailey has several investments. In 2018 she purchased a $5,000 computer for use in her investment activities. The computer is classified as 5-year property. Kailey is entitled to recover the cost of the computer through additional first-year depreciation.

D. Problems

1. Charlie purchased a new hydraulic lift for use at his car repair shop (which he operates as a sole proprietorship). He paid $1,200,000 and, for tax purposes, the lift has a life of seven years. His business had taxable income (before taking into consideration the depreciation) of $1,000,000 each year. How much depreciation is Charlie entitled to claim during each of the next eight years under the following alternative scenarios?
   a. Charlie makes no elections.
   b. Charlies elects out of additional first year depreciation and elects bonus depreciation.
   c. Charlie elects out of additional first year depreciation and does not elect bonus depreciation.

2. Dennis purchased a new x-ray machine for use in his business. He paid $1,300,000 and, for tax purposes, the x-ray machine has a life of five years. His business had taxable income (before taking into consideration the depreciation) of $1,500,000 each year. How much depreciation is he entitled to claim during each of the next six years under the following alternative scenarios?
   a. Dennis makes no elections.

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b. Dennis elects out of additional first year depreciation and elects bonus depreciation.
c. Dennis elects out of additional first year depreciation and does not elect bonus depreciation.

3. Frank purchased a piece of new equipment for use in his business. The equipment has a life of five years. He elected to claim bonus depreciation. For the year his business had taxable income (before taking into consideration the depreciation) of $700,000. How much bonus depreciation (under Section 179) is he entitled to claim during in the first year if the cost of the equipment is:

a. $500,000
b. $900,000

4. Jack purchased a piece of new equipment for use in his business, and the equipment has a life of five years. He elected to claim bonus depreciation. For the year his business had taxable income (before taking into consideration the depreciation) of $2,500,000. How much bonus depreciation (under Section 197) is he entitled to claim during in the first year if the cost of the property was:

a. $2,500,000
b. $2,800,000
c. $3,700,000

5. George purchased a shopping center in June. He paid $1,000,000 for the building and $500,000 for the land. He made no elections.

a. How much depreciation is he entitled to claim in the first year?
b. How much depreciation is he entitled to claim in the second year?
c. How much depreciation is he entitled to claim in the third year?

6. Hal purchased an apartment building and began renting units in November. He paid $1,000,000 for the building and $500,000 for the land. He made no elections.

a. How much depreciation is he entitled to claim in the first year?
b. How much depreciation is he entitled to claim in the second year?
c. How much depreciation is he entitled to claim in the third year?

7. Inez purchased a coffee shop on July 1. One of the assets she purchased was the customer list. It cost her $20,000. How will she recover the cost of the list?

8. Renee purchased a new computer for use in her investment activities. She paid $3,000 and, for tax purposes, the computer has a life of five years. How much depreciation is Renee entitled to claim during the first year?

E. Analysis and Application

1. Consider a business you might be interested in operating. Identify at least ten capital expenditures (life of more than one year) you would expect to incur in running the business.

a. How many of the items wear out over time?
b. If the asset does not wear out over time, how do you recover the cost of the asset?

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2. Identify seven costs you may have related to an investment activity.
   a. How many of those costs would qualify as an expense?
   b. How many of those costs would qualify as a capital expenditure?
   c. How many of the capital expenditures would be depreciable?

3. Javier owns and operates a high-end hotel in Colorado. Throughout the common areas Javier has displayed a variety of antiques unique to Colorado and its gold mining era. While the majority is maintained in glass display cases, a few are incorporated as functional pieces throughout the lobby.
   a. Can Javier claim depreciation deductions on the antiques kept in the glass display cases?
   b. Can Javier claim depreciation deductions on the antiques used as functional pieces?

   In formulating your analysis and response, you may want to consider:
   - Simon v. Commissioner, 103 T.C. 247 (1994), aff'd, 68 F.3d 41 (2d Cir. 1995)
   - Liddle v. Commissioner, 103 T.C. 285 (1994), aff'd, 65 F.3d 329 (3d Cir. 1995)
   - Rev. Rul. 68-232, 1968-1 C.B. 79

4. Joe purchased a triplex apartment building for $250,000 ($100,000 allocated to the land and $150,000 to the building). Shortly after closing, a dispute arose about whether the fence around the building was on Joe's property or the neighbor's property. After going through mediation, and spending $6,000 in attorney fees, the property line dispute was settled – the fence was properly on Joe's land. Joe also paid his attorney $1,000 to draft a standard lease he could use for all tenants. His first tenants moved into the building in May. Because he wanted all units filled, he spent $300 on advertising, and by the end of the year, all units were occupied. For the year, Joe collected $50,000 in rent and spent $7,000 on various maintenance items. What are the tax results for Joe this year related to the triplex? Why?

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Chapter 27
Bad Debts

Pages 259–265.

The 2017 Tax Cuts and Jobs Act eliminated all deductions subject to the two-percent floor of Section 67. Accordingly, any bad debt that is based on being an employee is no longer deductible.

Very little remains that could be deductible as a business bad debt.

Accordingly, delete this chapter.

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Chapter 33
Net Operating Loss

Pages 309–311.

Replace the chapter with the following.

A. Background

One of the overarching objectives of the Code is to impose tax on a taxpayer's accession to wealth. When the taxpayer operates his own business, his taxable increase in wealth is not his gross income. Rather, it is his gross income less the costs he incurred to generate the income.

Business gross income
– <u>Costs of operating business for the year</u>
Taxable income

In some situations, the allowed deductions may exceed the income for the year, resulting in a net loss.

B. Net Operating Loss

If the taxpayer has a net loss in one taxable year, he is able to utilize that loss in another year. The loss is carried forward until it has been fully utilized.[91]

In general, a net operating loss is the loss from a business to the extent of the excess of the deductions over the gross income.[92] The provision has a number of modifications that must be made when computing the amount of net operating loss.[93] For example, capital losses are not included in the computation,[94] and non-business deductions are allowed only to the extent of non-business income.[95]

Limitation. The amount of the loss that can be deducted is limited to 80 percent of taxable income.[96]

C. Application of Rules

Example. Larry owns and operates a small business. In 2018 his business deductions exceeded his business income by $40,000 (i.e., he had a $40,000 net operating loss).

[91] Section 172(b)(1)(A). Prior to the 2017 Tax Cuts and Jobs Act, the net operating loss could be carried back two years before being carried forward.
[92] Section 172(c).
[93] Section 172(d).
[94] Section 172(d)(2).
[95] Section 172(d)(4).
[96] Section 172(a).

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Assume in 2019 his taxable income (before considering the net operating loss carry forward) from the business will be $45,000. Taxpayer will use $36,000 of the net operating loss (80 percent of $45,000) to reduce his 2019 taxable income to $9,000 ($45,000 taxable income, less $36,000 net operating loss) and carry the remaining $4,000 net operating loss forward.

D. Problem

George owns and operates a small photography studio. His taxable income from the business, before taking into consideration the impact of any net operating loss, is expected to be as follows:

Years	Net income/Loss
2018	<$50,000>
2019	$30,000
2020	$40,000

What will be the tax consequences from George's 2018 net operating loss in 2019 and 2020 if income is as it is expected to be?

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Chapter 34
Capital Assets

Under the 2017 Tax Cuts and Jobs Act, the capital gain tax rates for single taxpayers is:

Rate	Applies to:
0%	Up to $38,600
15%	$38,600 – $425,800
20%	Over $425,800

Page 318–319. Add the following to the list of items excepted from the definition of capital assets.

Patents and secret processes. Patents, inventions, models or designs, and secret formulas or processes, if created by the taxpayer, are excluded from the definition of capital asset.[97]

[97] Section 1221(a)(3). Such items are also excluded from the definition of capital asset if the taxpayer acquired the property from the creator of the property and took a transferred basis in the property.

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Chapter 40
Like Kind Exchange

The like kind exchange rules will no longer apply to tangible personal property. Accordingly, please delete the following:

- **Page 384:** Delete the paragraph under "Examples of Exchanges of Real Estate That Qualify" and before *Use of the property* (*i.e*., the paragraph that begins "When considering tangible personal property . . . .").

- **Page 402:** Delete Analysis and Application question 5.

With respect to real property, the provision applies only to property not held primarily for sale.

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Chapter 42
Kiddie Tax

Pages 415–417

Under the Tax Cuts and Jobs Act, the rates applicable to a child's net unearned income are the rates applicable to trusts and estates (rather than the parent's rate).[98]

[98] Section 1(g)(4)(A).

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Chapter 44
Tax Consequences of Divorce

Pages 427–435

Replace the chapter with the following.

A. Background

Gross income. Gross income includes income (accessions to wealth) derived from any and all sources.[99] It includes every accession to wealth, unless there is an exception, including gains from dealings in property.[100]

Gain realized and recognized. When property has appreciated, the difference between the amount realized and the adjusted basis of the property sold or otherwise disposed of by the taxpayer is the gain realized.[101] This formula permits the taxpayer to recover the amount he paid for the property tax free. This process is sometimes called a return of capital.

  Amount realized
- Adjusted basis
  Gain realized

Unless the code provides otherwise, any gain realized must be recognized, or reported, on the taxpayer's income tax return as an accession to wealth.[102]

Loss realized and recognized. When property had depreciated, the difference between the amount realized and the adjusted basis of the property sold or otherwise disposed of by the taxpayer is the loss realized.[103]

  Amount realized
- Adjusted basis
  <Loss realized>

Unless the taxpayer can provide authority, no loss realized may be recognized, or reported, on the taxpayer's income tax return as a loss.[104]

Personal expenditures. In general, personal expenditures are not deductible. Congress does not consider a personal expense an item that should offset the taxpayer's gross income.[105] In other words, it is not considered part of the cost of earning or generating gross income. Any deduction

[99] Section 61(a).
[100] Section 61(a)(3).
[101] Section 1001(a).
[102] Section 1001(c).
[103] Section 1001(a).
[104] Section 165(c)(1), (2).
[105] Section 262.

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permitted for a personal expense is an exception to this broad-based rule. Accordingly, if the taxpayer wants to claim a deduction on his income tax return for a personal expense, he must establish that Congress specifically provided an exception to this general rule.

B. Tax Consequences of Divorce

The tax consequences of a divorce can be understood by considering three separate aspects. While each of these aspects could have been addressed in other places in this text, because they usually occur together as part of the divorce process, it makes more sense to address them together.

1. Child Support

There are no tax consequences when one spouse[106] pays the other spouse child support. It is not income to the recipient spouse and the payor spouse is not entitled to claim a deduction.[107]

Any payment that constitutes child support cannot qualify as alimony. Moreover, if the payment is clearly associated with a contingency related to a child, it will be treated as child support regardless of the label given to the payment.[108] For example, if a payment is reduced within six months of the child turning 18, 21, or the local age of majority, the payment will be presumed to be child support. The presumption is a rebuttable presumption.

Agreements Executed After 2018. For divorce or separation agreements executed after 2018 (or executed before 2018 but modified after 2018 where the modification expressly provides the new provisions apply), the tax treatment of child support and alimony is the same. Accordingly, for these agreements it will no longer be necessary to distinguish payments made for child support from those that are alimony.

2. Alimony

The tax consequences of alimony depends on when the divorce or separation agreement was entered into.

Agreements Entered Into After 2018. For divorce or separation agreements entered into after 2018 (or executed before 2018 but modified after 2018 where the modification expressly provides the new provisions apply), there are no tax consequences when one spouse pays the other spouse alimony. It is not income to the recipient spouse and the payor spouse is not entitled to claim a deduction.[109]

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[106] Refences in this chapter to "spouse" includes ex-spouses.
[107] Section 71(c).
[108] Temp. Reg. § 1.71-1T(c), Q&A-18.
[109] Section 71(a).

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Agreements Entered Into Before 2019. If the divorce or separation agreement is entered into before 2019, the recipient spouse must include the payment in income and the payor spouse is entitled to claim a deduction.[110] To constitute alimony, the payment must be:[111]

- Cash;
- To or for the benefit of the spouse;
- Not designated as not alimony;
- Not members of the same household if legally separated or divorced;
- No liability after the death of the payee; and
- Not for child support.

The payment must be made in cash. Payments made with services or property do not qualify. If the payment had been made with property, the transaction would be covered by the non-recognition provision for property transferred between spouses.

The payments must be made pursuant to a written agreement. Both parties had to agree to a payment of alimony; one can not unilaterally decide to treat the payments as alimony.

If the spouses were legally separated under a divorce decree or separate maintenance agreement, they cannot be members of the same household. If the parties were not legally separated, the parties can be members of the same household.

The obligation of the payor spouse must terminate upon the death of the recipient spouse. Some state statutes provide that alimony terminates upon the death of the recipient spouse, and those statutes can be used to satisfy that element.

The parties could have elected out of alimony treatment. If they made the election, the recipient spouse does not include the payment in income and the payor spouse is not allowed a deduction for the payment.

If the alimony payment is not sufficient to cover both child support payments and alimony payments, it is allocated first to child support.

3. Transfer of Property

When spouses transfer property between themselves, the transaction is governed by the non-recognition provision of Section 1041. Regardless of whether the property was transferred while they are married or is incident to a divorce, no gain or loss is recognized.[112] The non-recognition treatment is mandatory; the spouses cannot agree to have the provision not apply. The recipient spouse takes the transferor spouse's basis in the property.[113]

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[110] Section 215(a).
[111] Section 71(b). If the parties "front load" the alimony payments, to the extent of "excess alimony payments" the tax consequences are reversed. The payor must include the amounts paid in income and the recipient spouse is allowed a deduction. See section 71(f).
[112] Section 1041(a).
[113] Section 1041(b).

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The property is transferred incident to a divorce if it is transferred within one year after the day the marriage ends or is related to the cessation of the marriage.[114] The regulations provide a presumption that a transfer occurring more than six years after cessation of the marriage is not incident to the divorce. However, the presumption is a rebuttable presumption.[115]

A transfer of property can come within the non-recognition provision when it is paid to a third party on behalf of the payor spouse. The transfer to the third party must be required by the divorce or separation instrument or be made pursuant to the written request of the non-transferring spouse.[116] The property is treated as first being transferred from the transferring spouse to the recipient spouse in a transaction covered by the non-recognition provision. Next, the recipient spouse is treated as transferring the property to the third party in a transaction not covered by the non-recognition provision.

Section 1041. Transfers of Property Between Spouses or Incident to Divorce

(a) General Rule.—No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—
  (1) a spouse; or
  (2) a former spouse, but only if the transfer is incident to the divorce.

(b) Transfer Treated as Gift; Transferee Has Transferor's Basis.—In the case of any transfer of property described in subsection (a)—
  (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift; and
  (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

(c) Incident to Divorce.—For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer—
  (1) occurs within 1 year after the date on which the marriage ceases; or
  (2) is related to the cessation of the marriage

*   *   *

Summary of Rules – Tax Consequences of a Divorce

Child Support: Not included in the income of the recipient spouse and not deductible by the payor spouse.

[114] Section 1041(c).
[115] Temp. Reg. § 1.1041-1T(a), Q&A-7.
[116] Temp. Reg. § 1.1041-1T(a), Q&A-9.

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Alimony: For agreements executed after 2018, not included in the income of the recipient spouse and not deductible by the payor spouse. For agreements executed before 2019, included in the income of the recipient spouse and deductible by the payor spouse.

Transfer of property: No gain or loss is recognized; recipient spouse takes transferor spouse's basis.

C. Application of Rules

Example 1. Sandy and Tom are divorced. Under the divorce decree Tom is required to pay Sandy $5,000 each year in child support. Sandy is not required to include the $5,000 in income and Tom is not entitled to a deduction.

Example 2. Monique and David are divorced. Under the divorce decree, executed July 7, 2015, Monique is required to pay David $10,000 in alimony payments each year until the child turns 18. Because the payments are clearly associated with a contingency related to a child the payment is presumed to be child support irrespective of the fact the parties called the payment alimony. Unless the presumption can be rebutted, David is not required to include the $10,000 in income and Monique is not entitled to a deduction for the payment.

Example 3. Nicole and Max will be divorcing. They expect the divorce decree to be executed in February 2019 and that it will provide that Nicole be required to pay Max $10,000 in alimony payments each year until the child turns 18.

Regardless of whether the payment is truly alimony or actually child support, Max is not required to include the $10,000 in income and Nicole is not entitled to a deduction for the payment.

Example 4. Brett and Meg are divorced. Under the divorce decree (executed in 2017) Brett is required to pay Meg $5,000 each year in alimony. Brett is entitled to a $5,000 deduction and Meg must include $5,000 in her income.

Example 5. James and Linda will be getting divorced. Under the divorce decree (expected to be executed not earlier than March 2019) James will be required to pay Linda $25,000 each year in alimony. James is not entitled to a deduction and Linda does not include the payment in her income.

Example 6. Susan and Jeff are married. Jeff transfers InvestCo stock to Susan. His basis in the stock is $10,000 and it is worth $50,000. Because the property is transferred between spouses, the non-recognition provision applies. Jeff does not recognize any gain on disposition of the stock, and Susan's basis in the stock is $10,000

Example 7. Randy and Julie are divorced. As part of the property settlement Julie transfers InvestCo stock to Randy. Her basis in the stock is $20,000, and it is worth $5,000. Because the property is transferred incident to a divorce, the non-recognition provision applies. Julie does not recognize any loss on disposition of the stock, and Randy's basis in the stock is $20,000.

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D. Problems

1. Kevin and Kim are divorced. Under the divorce decree Kevin is required to pay Kim $5,000 each year in child support.
   a. If the divorce decree is executed in 2018, what are the tax consequences to Kevin and Kim from the payment of child support?
   b. If the divorce decree is executed in 2019, what are the tax consequences to Kevin and Kim from the payment of child support?

2. Doug and Pam are getting divorced. The divorce decree will require Doug to pay Pam $15,000 each year in alimony.
   a. If the divorce decree is executed in 2018, what are the tax consequences to Doug and Pam from the payment of alimony?
   b. If the divorce decree is executed in 2019, what are the tax consequences to Doug and Pam from the payment of alimony?

3. Verne and Britney were divorced in 2017. Would the payment under the following facts be considered alimony?
   a. Verne began making $1,000 monthly payments to Brittney. He mailed them to her each month with a note that she was to treat them as alimony.
   b. Verne and Brittney were talking by phone and agreed that Britney would pay Verne $1,000 per month as alimony.
   c. Verne's attorney sent a letter to Brittney's attorney proposing alimony payments from Verne to Brittney of $1,000 per month. Brittney's attorney sent a letter agreeing to the arrangement.

4. In 2016 Martha and Mike entered into a written agreement that provided Martha would pay Mike $5,000 each year in alimony. This year, because she did not have any cash, she transferred a painting valued at $5,000 to Mike. What are the tax consequences to Martha and Mike?

5. Hillary and Tom have one child, Kitty. In 2015 Hillary and Tom entered into a written agreement providing that Tom would pay Hillary $5,000 each year in alimony and $10,000 each year in child support. All payments will stop when Kitty turns 18.
   a. What are the tax consequences to Hillary and Tom?
   b. What are the tax consequences if the agreement is not entered into until 2019?

6. Doug and Annette are getting divorced. Doug agreed to transfer Blueacre to Annette as long as Annette agreed to treat the transfer as a sale by Doug. Doug's basis in Blueacre was $10,000 and its fair market value was $2,000.
   a. What are the tax consequences to Doug?
   b. What are the tax consequences to Annette?

7. Pursuant to the divorce agreement Amy was required to transfer Blackacre to Harrison, her ex-husband. Amy's basis in Blackacre was $2,000 and its fair market value was $10,000.

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Before Amy could complete the transfer she received a written request from Harrison to transfer the property to Rick. Rick is not related to Amy or Harrison. What are the tax consequences to Amy, Harrison, and Rick?

E. Analysis and Application

1. Kirk and Dayna are getting divorced. They are in negotiations for the amount of alimony and child support payments Dayna will be required to pay Kirk. Dayna believes she will pay Kirk a total of $10,000 each year.
   a. If the divorce decree will be executed during 2018, how would she want the payments to be allocated between child support and alimony? Do you need any additional information to make the decision? If so, what information?
   b. If the divorce decree will not be executed until early in 2019, how would she want the payments to be allocated between child support and alimony?

2. Stacy and Don are getting divorced. They anticipate that the decree will require Don to pay Stacey $10,000 each year in alimony.

   a. What are the tax consequences if the decree is executed in 2018?
   b. What are the tax consequences if the decree is executed in 2019?
   c. If you represent Don, which year (2018 or 2019) would he likely prefer the decree be executed?
   d. If you represent Stacey, which year (2018 or 2019) would she likely prefer the decree be executed?

3. Max and Marlene are getting divorced. They own the following assets and have agreed they each will receive one-half the value of the assets. If you represent Marlene, which assets would you recommend she receive? Why?

Asset	**Adjusted Basis**	**Fair Market Value**
Cash	$10,000	$10,000
Stock	1,000	20,000
Investment Property	18,000	20,000

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4. Diana and Charles are getting divorced. They own the following assets and have agreed they each will receive half the value of the assets. If you represent Diana, which assets would you recommend she receive? Why?

Asset	**Adjusted Basis**	**Fair Market Value**
Car	$10,000	$ 3,000
Boat	50,000	47,000
Cash	50,000	50,000
Stock	50,000	70,000
Investment Property	100,000	120,000
Apartment Building	100,000	200,000

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Chapter 46
Dual-Use Property

Pages 443–447.

The 2017 Tax Cuts and Jobs Act eliminated all deductions subject to the two-percent floor of Section 67. As a deduction for dual-use property would be subject to that limitation, it is no longer permitted.

Delete the chapter.