SECTION F-2009 - A LITTLE MORE EARLY HELP -
SOME TAX PHILOSOPHIES, SOME TAX DOCTRINES,
AND SOME TAX PROCEDURES

Table Of Contents

Table Of Contents . . . . . -1-

Section F-2009 - A Little More Early Help -
Some Tax Philosophies, Some Tax Doctrines,
And Some Tax Procedures . . . . . -7-

The purpose of these tax texts . . . . . -7-

Using these tax texts . . . . . -7-
Viewing Professor Jegen's tax texts and other tax materials . . . . . -7-
Some more comments about Corel WordPerfect software . . . . . -8-
Some more comments about Microsoft Word software . . . . . -8-
Some more comments about Adobe Reader software . . . . . -8-
So use whichever software pleases you . . . . . -9-
If you have some problems . . . . . -9-

Some Tax Philosophies . . . . . -10-

The basic philosophy of the IRC with respect to income and deductions . . . . . -10-
With respect to income . . . . . -10-
With respect to deductions . . . . . -10-
Sounds fair - - - right? . . . . . -10-

Eight Tax Doctrines . . . . . -10-

Eight doctrines in the tax laws . . . . . -10-
However, there are many others in addition to these eight doctrines . . . . . -10-
The 'imputed income" doctrine . . . . . -10-
The "windfall" doctrine . . . . . -10-
The "bargain purchase" doctrine . . . . . -10-
The "every tax year stands alone"doctrine . . . . . -10-
The "tax benefit" doctrine . . . . . -10-
The "claim of right" doctrine . . . . . -10-
The "constructive receipt" doctrine . . . . . -10-
The "assignment of income" doctrine . . . . . -10-

The "imputed income" doctrine . . . . . -10-
Doing things for yourself does not cause you to realize income . . . . . -10-
If a farmer eats some of the ears of corn which the farmer grew, does that result in gross income? . . -10-
Some examples . . . . . -10-
Example . . . . . -10-
Example . . . . . -10-
Some questions . . . . . -10-

The "windfall" doctrine . . . . . -11-
A definition of the term "windfall" . . . . . -11-

Inclusions of windfalls in gross income . . . -11-
Some examples . . . -12-
Example . . . -12-
Example . . . -12-
Example . . . -12-
A windfall cannot be forced on to a person . . . -12-
Some questions . . . -13-

The "bargain purchase" doctrine . . . -13-
A definition of a "bargain purchase" . . . -13-
Is a particular transaction a "bargain purchase" . . . -14-
Another major difference between a windfall and a bargain purchase . . . -14-
Acquiring property at below the fair market value of the property . . . -15-
To be more specific . . . -15-
The reason why the "bargain purchase" doctrine exists . . . -16-
The most interesting thing about all of this . . . -16-
Another problem which arises if the dealer knew the value of the desk . . . -16-
A gift and a sale by the dealer by the dealer to Beverly . . . -16-
Compensation to Beverly by the dealer . . . -17-
Selling property for an amount which is less than the fair market value of the property . . . -17-
Receiving property for the rendering of services . . . -17-
Some examples . . . -18-
Example . . . -18-
Example . . . -18-
Example . . . -18-
Example . . . -19-
Example . . . -19-
Example . . . -19-
Example . . . -19-
Example . . . -19-
Example . . . -19-
Example . . . -20-
Example . . . -20-
Read section 132 and try to answer the following questions . . . -20-

The "every tax year stands alone" doctrine . . . -22-
Adding two plus two and getting five . . . -22-
A case in which the transaction is not just a matter of adding two and two . . . -22-

The "tax benefit" doctrine . . . -22-
Paying an expense in one year and receiving the payment back in another year . . . -22-
The tax benefit doctrine has both an inclusionary and an exclusionary component . . . -22-
Some examples . . . -22-
Example . . . -22-
Example . . . -23-
Read the first sentence of section 104 which "builds in" the tax benefit concept . . . -23-
Which income tax rates apply? . . . -23-
Some examples . . . -23-
Example . . . -23-
Example . . . -23-
Some questions . . . -24-

The "claim of right" doctrine . . . -25-
In a nutshell, the "claim of right doctrine" states as follows . . . -25-

The elements of the claim of right doctrine . . . -25-
Computation of tax where taxpayer restores substantial amount held through a claim of right. . . . -25-
Some examples . . . -26-
Example . . . -26-
Example . . . -26-
The tangled web of medical expenses and the reimbursements thereof and similar tax problems . . . -26-
Some questions . . . -27-

The "constructive receipt" doctrine . . . -29-
Some comments about the cash method of accounting and the constructive receipt doctrine . . . -29-
Some examples . . . -29-
Example . . . -29-
Example . . . -29-
Example . . . -30-
Some questions . . . -30-

The "assignment of income" doctrine . . . -31-
A famous (to tax professors) metaphor of Justice Holmes . . . -31-
The fruit must be taxed to the tree from which it came . . . -31-
Giving away cash instead of giving away income. . . . -32-
A little review and a few more points . . . -32-
Giving away the tree and the income . . . -33-
Assignments of rights to personal service income . . . -33-
Some examples . . . -33-
Example . . . -33-
Example . . . -34-
Example . . . -34-
Example . . . -34-
Example . . . -34-
Example . . . -35-
Example . . . -35-
Example . . . -35-
Example . . . -35-
Some questions . . . -35-

Ten Statutory Exceptions To The Assignment Of Income Doctrine . . . -36-

A major question which you should answer before reading the remainder of this tax text . . . -36-
When does the accrual method of accounting apply? . . . -36-

One section that clearly recognizes the assignment-of-income-doctrine/fruit-and-tree-doctrine is section 73 . -36-
Section 73 provides that income earned by a child is to be income taxed to the child . . . -36-

Ten statutory exceptions to the fruit and tree doctrine . . . -36-
Each of the following ten sections is a statutory exception to the assignment of income doctrine . . . -36-
Partnership agreements . . . -36-
Transfers of receivables to a corporation . . . -36-
Prizes and awards . . . -36-
Community property . . . -36-
Income in respect of a decedent . . . -36-
Estates . . . -36-
Trusts . . . -36-
S corporations and their shareholders . . . -36-
Reorganizations of corporations . . . -36-

Below market interest loans . . . -36-

Partnership agreements . . . -36-
The first statutory exception involves partnerships . . . -36-
Example . . . -36-
The purpose of the partnership sections . . . -36-
Example . . . -37-
Example . . . -37-
Example . . . -37-

Transfers of receivables to a corporation . . . -37-
The second statutory exception involves the transfer of receivables to a corporation . . . -37-
The general rule of this exception . . . -37-
Some examples . . . -38-
Example . . . -38-
Example . . . -38-
Section 351 was cited above as a section which can involve assignment of income problems . . . -38-
Let us start from a little different point . . . -38-
Now, consider a gift transaction . . . -40-
Now, consider a section 1031 transaction . . . -41-
Now, consider a section 109 transaction . . . -41-
Now, consider the receipt of salary . . . -41-

Prizes and awards . . . -42-
The third statutory exception is found in section 74 which involves prizes and awards . . . -42-
Giving away a lottery ticket . . . -42-

Community property . . . -42-
The fourth exception involves community property taxpayers . . . -42-

Income in respect of a decedent . . . -42-
The fifth statutory exception is found in section 691 . . . -42-
Actually, section 691 answers two questions . . . -43-
Some terms . . . -43-
The function of section 691 with respect income . . . -43-
Example . . . -44-
Persons who might be required to include income in respect of a decedent in their gross incomes . . . -45-
Example . . . -45-
The income in respect of a decedent doctrine does not bring about double income taxation . . . -46-
The character of IRD . . . -46-
Who should report IRD? . . . -46-
Is IRD a good or bad for the recipient? . . . -47-
Some comments about a decedent's last taxable year . . . -47-
The basis of property received by an estate as income in respect of a decedent . . . -47-
Taxpayers must be very careful when considering making a transfer of IRD to another person . . . -48-
Some examples . . . -48-
Example . . . -48-
Example . . . -48-
Example . . . -48-
Example . . . -48-
Example . . . -48-
Example . . . -48-
Example . . . -49-
Example . . . -49-

Example . . . -50-
Example . . . -50-
Another major part of section 69l concerns "deductions in respect of a decedent" . . . -50-
Who should deduct DRD? . . . -50-
And, DRD must be deducted on the income tax return of . . . -50-
Is DRD good or bad for the person who pays it? . . . -50-
Some examples . . . -51-
Example . . . -51-
Example . . . -51-
Example . . . -51-
Some questions . . . -51-

Fiduciaries are the sixth and seventh statutory exceptions. . . . -52-
Fiduciaries (of trusts and estates) can be both taxable entities and passthrough entities . . . -52-
Revocable trusts - in general . . . -53-
Irrevocable trusts - in general . . . -54-
The order in which a fiduciary treats its distributions to its beneficiaries . . . -55-
What income of a fiduciary is income taxed to the fiduciary? . . . -55-
Example . . . -56-
A little repetition does not hurt . . . -56-
Example . . . -56-
Generally, all gross income received by a fiduciary is includible in the fiduciary's gross income . . . -57-
The order in which a fiduciary is to treat distributions to beneficiaries as income or principal . . . -57-
A section 663 distribution . . . -57-
Again, what income of a fiduciary is income taxed to the fiduciary? . . . -57-
Example . . . -58-
A section 663 distribution . . . -58-
Some examples . . . -58-
Example . . . -58-
Example . . . -58-
Some comments which are particularly directed to estates . . . -59-
The order in which an estate's distributions are required to be made . . . -60-
What income of an estate is income taxed to the estate? . . . -60-
Example . . . -61-
A section 663 distribution . . . -61-
Fiduciary income tax rates (for both trusts and estates) . . . -61-
Comparisons and contrasts of computations of fiduciary and traditional passthrough entity . . . -61-

S corporations and their shareholders . . . -64-
The eighth statutory exception involves S corporations . . . -64-

Corporate reorganizations . . . -64-
The statutory exception involves corporate reorganizations . . . -64-

Below market interest loans . . . -65-
The tenth statutory exception involves below market interest loans . . . -65-
Section 7872 applies to the following types of below-market loans . . . -65-
Some important comments about gift loans . . . -65-
Some additional comments about the treatment of below interest loans . . . -65-
Some examples . . . -66-
Example . . . -66-
Example . . . -66-

Some Tax Procedures . . . -66-

A little bit of tax procedure . . . . . -66-
The number of days that a taxpayer has to file a petition in the United States Tax Court . . . . . -66-
The name of the court in which the taxpayer may file a petition without paying the disputed tax . . . -66-
The name of the two courts in which a taxpayer may file a complaint for a tax refund . . . . . -66-
The percent of the tax which a taxpayer owes due to a negligence penalty . . . . . -67-
The percent of the tax which a taxpayer owes due to the fraud penalty . . . . . -67-

Section F-2009 - A Little More Early Help -
Some Tax Philosophies, Some Tax Doctrines,
And Some Tax Procedures

Examine The Following Comments Carefully

I. **The purpose of these tax texts**. These tax texts are used primarily for a beginning income tax course of three to four hours and for other two or three-hour courses dealing with: corporation income tax; gratuitous transfer taxes; tax procedure; and/or state and local taxes. For the assumptions which are used in these tax texts, read Section F-2001 of these tax texts.

II. **Using these tax texts**. In order to view, for no charge, Professor Jegen's Federal and State tax texts and other tax materials, whether or not you are a student, a lawyer, or an accountant, you must go to Professor Jegen's Taxsite, the Internet address for which is as follows. Examine this taxsite carefully, before reading any additional part of these tax texts. http://www.iupui.edu/~taxsite

A. Viewing Professor Jegen's tax texts and other tax materials.

1. In order to view all of Professor Jegen's Federal and State tax texts and other tax materials, whether or not you are a student, a lawyer, or an accountant, you must go to Professor Jegen's Taxsite, the Internet address for which is: http://www.iupui.edu/~taxsite
2. There are tax texts, forms, etc. for all viewers, but particularly with respect to students, there are schedules, assignments, and a variety of informative documents about each course which Professor Jegen teaches.
3. After you locate the tax texts (the files) which you wish to read, notice that the name of each file has an extension (ending). A "file extension" is at the end of the basic file name (with a dot in front of it) which has been assigned to the file, generally, by the drafter of the content of the file. There are some extensions with which you probably already familiar, such as the following three.
4. The extension for WordPerfect document is: wpd.
5. The extension for a Word document is: doc or docx.
6. The extension for a Adobe portable document format is: pdf.
7. To repeat. A "file extension" is at the end of the basic file name (with a dot in front of the extension) which extension has been assigned to the file, by me for my files or by someone else for their files.
8. You should be familiar with the following, very common, extensions.
   a. Microsoft Word uses a doc or docx extension. The docx extension is the more recent release of the two.
      (1) You may download a Microsoft Office Compatibility pack to ensure that you can view newer documents with the .docx file extension.
   b. If you use Corel WordPerfect, then you are familiar with the wpd extension.
   c. Adobe Acrobat uses the pdf extension and to read these files, you must go on line and acquire, free of charge, the Adobe Reader program.
      (1) For this purpose, you might want to use the following link: http://www.adobe.com/reader
9. The file of extension of pdf stands for "portable document format" and this type of file is used in competition and as a complement with other types of files, e.g., the doc extension for Microsoft Word and the wpd extension for Word Perfect Documents. One advantage of a pdf file type or commonly referred to as "a pdf file" is that a file which is a pdf file type may be consistently viewed and printed by computer users who normally use other operating systems or software for wordprocessing, e.g., Word, Works, WordPerfect, StarOffice or OpenOffice.
10. Therefore, it does not matter whether or not you normally use Microsoft Word, Microsoft Works, Corel WordPerfect, Sun StarOffice or OpenOffice , you can consistently view and

print files which have a pdf extension by using the Adobe Reader, which is generally referred to as "Adobe".

11. Even though an individual normally uses other software (e.g., Word, Works, WordPerfect, StarOffice or OpenOffice) to edit and view or print files, that individual may use the Adobe Reader for pdf files and this allows the drafter of the documents in a make such pdf files available for viewing by more individuals, without having to make more than one file available for each type of wordprocessor software and/or each type of operating system and further ensures that the document is consistently formatted for viewing and printing. A distinct advantage is clearly provided to the authors of such files, however, a recipient of such file also is provided with the advantage that they can read such file regardless of their word processing software or operating system.

B. Some more comments about Corel WordPerfect software.

1. Two individuals, Bastian and Ashton, decided to create a word processing program for a minicomputer system in 1979 and began selling WordPerfect in 1980. Corel later purchased the rights to the software and began introducing updated versions. For several years, this software was the most popular word processing software until overtaken by Word during the 1990s. Its popularity was mainly due to the fact that it was available for a wide variety of operating systems and it was highly compatible with many systems.
2. Corel WordPerfect is still number two in sales behind Word and some universities also include the cost of the software in fees and permit students to download WordPerfect Office X5. See the IUware online website at http://iuware.iu.edu. As stated above, the most common file extension of WordPerfect files is .wpd. Kendall Callas states the Corel WordPerfect software is still the most popular word processor for lawyers due to PerfectScript, the programming language that, when combined with macros, allows law firms to more readily create their widely varying legal documents than with other leading word processing programs such as Microsoft Word (microcounsel.com).

C. Some more comments about Microsoft Word software.

1. According to contributors to Wikipedia, Microsoft first introduced Word in 1983 under the name Multi-Tool Word. While it was not well received initially and struggled to compete with the well-established WordPerfect, Word slowly, but steadily gained a greater share of the market. The release of Word software with Macintosh-compatible in 1985 gave Word more credibility and increased distribution. Further, Microsoft offers these programs to college students at a greatly reduced cost and some universities allow current students to download them with the cost already included in technology fees. See the IUware online website at http://iuware.iu.edu. This has assured the promulgation of Word to the next generation of professionals.

D. Some more comments about Adobe Reader software.

1. First introduced in 1993 by Adobe, the pdf format has evolved from a proprietary format only being available on Macintosh and requiring a user to purchase software to access such documents to the current state in which the pdf format is near standard format for viewing files and is further an open file format available on all major operating systems. The Adobe software to view the pdf format is available for free from Adobe's site and further since the file format is no longer proprietary there are numerous third party software vendors which provide software to not only view but to create and edit pdf files. In fact you will find features to generate pdf files from most recent major word processing tools.
2. As stated, the Adobe Reader is available to computer users for no charge and a link has been provided on Professor Jegen's taxsite which allows computer users to download the Adobe Reader in order to view and print all pdf files which are located at Professor Jegen's taxsite.

If you are wondering how Adobe makes its money, it is due to Adobe's sales and support of pdf authoring and related software (the software which allows an individual to edit a pdf file) and licensing of their technology to other companies. The site at which computer users can download the Adobe Reader (at no charge) is: http://www.adobe.com/prodindex/acrobat/readstep.html

E. So use whichever software pleases you.

1. Therefore, it does not matter whether or not you normally use Microsoft Word, Microsoft Works, Corel WordPerfect, Sun StarOffice or OpenOffice , you can reliably view and print files which have a pdf extension by using the Adobe Reader. This allows the author of such files to make such one file available for viewing which can be used by a larger group of computer users without having to make more than one file for each type of wordprocessor software and/or each type of operating system.

F. If you have some problems.

1. If you have difficulty opening part or all of some of the files which are on Professor Jegen's taxsite, then you should first download the particular document to your or the law school's hard drive, and then, open the particular file. If you still are unable to open a particular document in whole or in part, then you should speak with one of the individuals who provide student help in the law school computer rooms or contact the University Information Technology Services (UITS) support center at 317-274-4357.

Some Tax Philosophies And Some Tax Doctrines

I. The basic philosophy of the IRC with respect to income and deductions

A. With respect to income.
1. Everything which a taxpayer receives is includible in the taxpayer's gross income unless the IRC specifically provides that the item is excludable from the taxpayer's gross income.

B. With respect to deductions.
1. Everything which a taxpayer pays is not deductible unless the IRC expressly provides that the taxpayer's payment is deductible.

C. Sounds fair - - - right?

Eight Tax Doctrines

I. Eight doctrines in the tax laws.

A. However, there are many others in addition to these eight doctrines.
1. The 'imputed income" doctrine.
2. The "windfall" doctrine.
3. The "bargain purchase" doctrine.
4. The "every tax year stands alone"doctrine.
5. The "tax benefit" doctrine.
6. The "claim of right" doctrine.
7. The "constructive receipt" doctrine.
8. The "assignment of income" doctrine.

I. The "imputed income" doctrine.

A. Doing things for yourself does not cause you to realize income.
1. Building a house for yourself or washing you own automobile might produce income for you, but those things do not produce realized income.

B. If a farmer eats some of the ears of corn which the farmer grew, does that result in gross income?
1. Gross income generally does not include the fair market value of benefits derived by a person from using and consuming the person's own property or services.
2. Therefor, gross income does not include the fair market value of services performed by an individual for the individual nor the fair market value of food grown and consumed by an individual nor the fair rental value of a homeowner who occupies the home.
3. To repeat, you do not "realize" income by doing things for yourself.

C. Some examples.
1. Example. During the current taxable year, Mary was a lawyer and Mary drafted Mary's own last will and testament. Mary normally charged a client $1,500 to draft the client's last will and testament.
a. Mary has no gross income due to such drafting.
2. Example. During the current taxable year, Mary was a lawyer and Mary drafted Mary's assistant's last will and testament. Mary normally charged a client $1,500 to draft the client's last will and testament.
a. Mary's assistant has no gross income due to such drafting. Read section 132.

D. Some questions.
1. Question 1. During the current taxable year, Mary was a lawyer and Mary drafted the last

will and testament of Mary's legal research assistant as a bonus to Mary's legal research assistant. Mary would normally charge a client $1,000 for such drafting. Mary's legal research assistant's ordinary gross income for the current taxable year is as follows.

a. None/Zero
b. $1,000
c. $500
d. No prior stated answer

2. Question 2. Referring to question 1, Mary's ordinary gross income for the current taxable year is as follows.

a. None/Zero
b. $1,000
c. No prior stated answer

3. Question 3. During the current taxable year, Mary was a lawyer and, under an agreement with Beverly, Mary drafted the last will and testament of Beverly, who cleaned Mary's law office almost each day for three months of the current taxable year. With respect to the drafting of a similar last will and testament for a client, Mary normally charged the client $2,000. Beverly's ordinary gross income for the current taxable year is as follows.

a. None/Zero
b. $2,000
c. $1,000
d. No prior stated answer

4. Question 4. Referring to question 3, Mary's ordinary gross income for the current taxable year is as follows.

a. None/Zero
b. $2,000
c. $1,000
d. No prior stated answer

5. Question 5. John is a self-employed real estate broker who charges a 6% commission on each real estate transaction. That is, John charges 6% of the purchase price each time when John fulfills a purchase for one of John's purchasers and 6% of the sales price each time when John fulfills a sale for one of John's sellers. During the current taxable year, John purchased some land to hold for himself as an investment and during the next taxable year John sold the land.

a. Would John have any ordinary commission gross income from such sales and purchases?
b. What if John worked for Smooth Corporation and John was required to give Smooth Corporation 6% of each purchase price and each sales price of land which John arranged for any purpose, including, for John. Then, Smooth Corporation would give John back 50% of the 6% (that is, 3%).
(1) Would John have any ordinary commission gross income from such sales and purchases?

II. <u>The "windfall" doctrine</u>.

A. <u>A definition of the term "windfall"</u>.

1. In general, gross income includes amounts received from windfall, which is generally defined as "an unexpected increase in economic wealth that inures to the taxpayer through little or no effort by the taxpayer".

a. Further, a windfall is generally ordinary gross income to the recipient, because it generally does not result from a sale or exchange of a capital asset.

2. <u>Inclusions of windfalls in gross income</u>.

a. Because all income which a taxpayer realizes, in any form, is gross income unless the income is postponed or excluded, gross income includes windfalls.
b. Gross income includes the fair market value of unsolicited property when the

taxpayer asserts acceptance of and dominion over the property.

B. Some examples.

1. Example. If you find money in the street which you claim as yours, then you have gross income.
2. Example. If you dig for gold and find it and claim the gold as yours, then you have gross income.
3. Example. If you dive into the ocean and find treasure trove which you claim as yours, then you have gross income.

C. A windfall cannot be forced on to a person.

1. The person would have the right to refuse to accept the windfall.
   a. Therefore, an individual does not have gross income from a windfall until the individual accepts ownership or benefits from the windfall or to put it another way, if the individual
      (1) If Beverly states that she does not want the windfall and that the windfall should be given to Peter and that is done, then this will be treated as though Beverly accepted the windfall (in which case Beverly will generally be required to include the windfall in Beverly's gross income, because Beverly had "accepted" the windfall by directing the windfall to be transferred to Peter.
      (2) If Beverly states that she does not want the windfall and that the windfall should be given to the Jewish Community Center and that is done, then this will be treated as though Beverly accepted the windfall (in which case Beverly will generally be required to include the windfall in Beverly's gross income, because Beverly had "accepted" the windfall by directing the windfall to be transferred to the Jewish Community Center. However, Beverly would be entitled to a character contribution deduction through section 170 for the transfer of the windfall to the Jewish Community Center.
2. Paying a $1.00 for a lottery ticket, putting the ticket away and almost forgetting about it, and then being told that you won the lottery in an amount of $1,000,000, is a windfall to you.
   a. However, a sudden unrealized appreciation with respect to your common stock is not a windfall and it is not realized income nor, obviously, gross income.
   b. Further, receiving a $1,000,000 devise from a distant relative who you had only met once, would be a windfall to you, but the $1,000,000 would not be gross income to you because of section 102.
3. If you are digging in your land in order to construct a foundation for your home and you find some coins buried there and, though you have never seen the coins before, you claim the coins as your own, then you have a windfall and you have realized income and you have gross income.
4. If you dive into the ocean and find treasure trove which you claim as yours, then you have a windfall and you have realized income and you have gross income.
5. Because all income which a taxpayer realizes is gross income unless the income is postponed or excluded, a windfall is gross income.
6. Gross income includes the fair market value of unsolicited property when the taxpayer asserts acceptance of and dominion over the property. For example, if a taxpayer finds $1,000 on the street and keeps the money as his or her own money, then the $10,000 is includible in the taxpayer's gross income.
7. Question 7. John won a painting, with a fair market value of $100, as a prize during the current taxable year, and during the next taxable year, John sold the painting for $300. John realizes gross income as a result of the sale in the amount of $200.
   a. If John found the painting on the street, when the painting had a fair market value of $100, then would John recognize gross income in the amount of $100 when John found the painting?

D. Some questions.

1. Question 1. On March 1 of the current taxable year, John went to the Cayman Islands to do scuba diving with a tour group. While visiting a store there, John purchased a coin for $100, which looked like a very old and valuable coin to John. After John brought the coin back to the United States of America (and during the current taxable year), John had the coin appraised by a reputable coin dealer, who was a friend of John, and who stated that the coin had a fair market value of $1,000 on March 4 of the current taxable year. John's gross income for the current taxable year is as follows.
   a. None/Zero
   b. $900
   c. $1,000
   d. $100
   e. No prior stated answer
2. Question 2. Referring to question 1, during December, of the next taxable year, John sold the coin to a collector of coins for $1,500. John's gross income for the next taxable year with respect to the sale of the coin to the coin collector is as follows.
   a. None/Zero
   b. $1,400
   c. $500
   d. $1,500
   e. No prior stated answer
3. Question 3. On March 1, of the current taxable year, John went to the Bahamas to do scuba diving with a tour group. While diving, John found a coin, which John was supposed to turn into the Bahamian Government, but which John hid in John's luggage and brought back to the United States of America. During the current taxable year, John had the coin appraised by a reputable coin dealer, who was a friend of John, and who stated that the coin had a fair market value of $1,000 on March 4 of the current taxable year. John's gross income for the current taxable year is as follows.
   a. None/Zero
   b. $900
   c. $1,000
   d. $100
   e. No prior stated answer
4. Question 4. Referring to question 3, during December of next taxable year, John sold the coin to a collector of coins for $1,500. John's gross income for the next taxable year with respect to the sale of the coin to the coin collector is as follows.
   a. None/Zero
   b. $1,400
   c. $500
   d. $1,500
   e. No prior stated answer
5. Question 5. John won a painting, with a fair market value of $100, as a prize during the current taxable year, and during the next taxable year, John sold the painting for $300. John had gross income of $100, and then, John had a basis for the painting of $100, and then, when John sold the painting, John had gross income of $200.
   a. If John found the painting on the street at a time when the painting had a fair market value of $100, then would John recognize gross income in the amount of $100, and then, John would have a basis for the painting of $100.

III. The "bargain purchase" doctrine.

A. A definition of a "bargain purchase".

1. In general, a bargain purchase is the purchase of property at a price which is below the fair

market value of the property.

B. Is a particular transaction a "bargain purchase".

1. What are these transactions?

a. If a person purchases some property at a price which is below the fair market value of the property, then the difference between what is paid for the property and the fair market value of the property can be one of several things, e.g.:

(1) Compensation to the purchaser in the amount of the difference between the amount which the purchaser pays for the property and the fair market value of the property.

(2) A gift to the purchaser in the amount of the difference between the amount which the purchaser pays for the property and the fair market value of the property.

(3) Support to the purchaser in the amount of the difference between the amount which the purchaser pays for the property and the fair market value of the property.

(4) No affect on the purchaser, because that is truly what a bargain purchase is all about.

(5) However, those results are not the results which attach to bargain purchases.

b. If you enter an antique shop and purchase a desk of George Washington (whether or not either you or the dealer knew that the desk belonged to George Washington), then you have made a bargain purchase and you will not realize gross income until you later dispose of the desk in a taxable transfer at a profit.

(1) Further, until then, your basis for the desk would be the amount which you paid for the desk.

C. Another major difference between a windfall and a bargain purchase.

1. Another major difference between a windfall and a bargain purchase is the character of the income which a taxpayer may ultimately realize and recognize.

2. If you find a watch on the street and you claim the watch as yours, then you have gross income in the amount of the value of the watch and that gross income is ordinary income, because there was no sale or exchange of a capital asset,.and your basis for the watch will be the fair market value of the watch at the time when you find the watch and claim it as yours, and your holding period for the watch will begin at the time when you acquire it.

3. If you explore a mountain and dig for artifacts and find them and claim the artifacts as yours, then you have gross income in the amount of the value of the artifacts and that gross income is ordinary income, because there was no sale or exchange of a capital asset,.and your bases for the artifacts will be the fair market value of the artifacts at the time when you find the artifacts and claim the artifacts as yours, and your holding period for the artifacts will begin at the time when you acquire them.

4. If you dive into the ocean and find treasure trove which you claim as yours, then you have gross income and that gross income in the amount of the value of the treasure trove and that gross income is ordinary income, because there was no sale or exchange of a capital asset,.and your bases for the treasure trove will be the fair market value of the treasure trove at the time when you find the treasure trove and claim the treasure trove as yours, and your holding period for the treasure trove will begin at the time when you acquire it.

5. However, if you purchase a valuable desk at an antique store or at a yard sale for a relatively small amount, then you will not have gross income at that time and your basis for the desk will be the amount that you pay for the desk and assuming that the desk is a capital asset to you (because you are going to hold the desk as a personal assets or as an investment assets) and if you later sell the desk at a significant profit, then two things have occurred which are generally more beneficial to you than a windfall would be to you.

a. First, you did not have to include any income in your gross income until you sold the desk.

b. Second, your gross income will be capital gain, probably long term capital gain.

D. Acquiring property at below the fair market value of the property.

1. If a person acquires property at a price which is below the fair market value of the property, then the difference between what is paid for the property and the fair market value of the property can produce, e.g., one of the following types of receipts to the recipient.
   a. Compensation which is gross income to the recipient. However, read section 61.
   b. A gift which is not gross income to the recipient. Read section 102.
   c. The result of convincing the transferor that the deal was a fair one to the transferor. This generally would not be gross income to the recipient.
   d. A simple purchase of the property from an antique dealer. This generally would not be gross income to the recipient.
2. Compensation causes the realization of gross income, but gifts and bargain purchases do not cause the realization of income.
3. If you find money in the street which you claim as yours, then you have ordinary gross income. You do not have capital gain, because there is no sale or exchange of a capital asset.
4. If you dive into the ocean and find treasure trove which you claim as yours, then you have ordinary gross income equal to the value of the treasure which you claim as yours (because there is no sale or exchange of a capital asset) and your basis for the treasure is the value of the treasure and your holding period for the treasure begins at the time when you find it and claim it as yours.
5. If you find a desk which belonged to George Washington, abandoned in a road side junk yard, and claim the desk as yours and take it with you, then you will have ordinary gross income at the time when you find the desk and claim the desk as being yours and your basis for the desk will be the value of the desk when you find it and claim it as yours and you will have a holding period for the desk which begins at the time when you find the desk and claim it as yours. Even if you do not know the value of the desk when you find it, but a year later, you are told by an expert that the desk has (and had when you found it) a value of $50,000, you still have gross income when you find the desk and claim it as yours.
6. However, if you enter an antique shop and purchase a desk of George Washington's (which you know belonged to George Washington but the dealer did not), then you have made a bargain purchase and you will not realize gross income until you dispose of the desk in a taxable transfer at a profit. This would be true even though neither you nor the dealer knew that the desk belonged to George Washington when you purchased it. In such a case, you would have a basis for the desk of what you paid for it and you would have a holding period which began at the time when you purchased the desk.
   a. And, if you purchase the desk (to use in your home as a personal asset or if you purchase the desk as an investment) in a bargain purchase, then when you dispose of the desk in a taxable transfer at a gain, you will realize capital gain from a sale or exchange of a capital asset.

E. To be more specific.

1. If Beverly enters an antique shop and purchases a desk for $5,000 (which she did or did not know belonged to George Washington and the dealer did not know that the desk belonged to George Washington) and because the desk did belong to George Washington, the desk had a value of $50,000, then Beverly made a bargain purchase and Beverly will not realize gross income until Beverly disposes of the desk in a taxable transfer at a profit.
   a. Until then, Beverly's basis for the desk is the amount which Beverly paid for the desk ($5,000) and not the value of the desk at the time when Beverly acquired the desk.
   b. Further, if, a few months or years later, Beverly has the desk appraised by an expert who determines that the desk belonged to George Washington and that the desk has a value of $50,000, Beverly still does not have gross income. The appraisal is not a disposition of the desk and the appraisal does not cause income to be realized.

F. The reason why the "bargain purchase" doctrine exists.

1. The reason why the government and the courts recognize the bargain purchase doctrine is because whenever there is wholesale income tax evasion, which is very difficulty for the government to stop, the IRS and courts just make up an exception to the rule that "everything that you receive is gross income unless a section states that it is not."

   a. Probably, most, if not all, of the individuals who frequent antique shops and shows do not know anything about the bargain purchase doctrine and it is doubtful, if there were no such doctrine, that these individual would begin reporting gross income whenever they made a purchase which was really a bargain. They would have 100's of reasons for not reporting the gross income. The primary one would have to be that the item which they purchased (or worse yet, exchanged) did not have the value, which the IRS would maintain that the item had, at the time of the purchase or exchange.

   b. Further, it is doubtful that the IRS could track down (and win a case in court) even 1% of the individuals who make bargain purchases each year.

   c. Therefore, was better to change the "gross income" rule into the "bargain purchase" rule.

G. The most interesting thing about all of this.

1. The most interesting part of the all of this is, as stated above, if a individual finds a baseball in the street, then the individual will have ordinary income (because there is no sale or exchange of a capital asset) and the individual will have a basis for the baseball which is equal to the value of the baseball when the individual finds it

   a. For example, if Peter finds a baseball in the street and the baseball has a value of $100, then Peter has ordinary gross income of $100, and then, Peter has a basis for the baseball of $100 and Peter's holding period for the baseball begins at the time when Peter acquires the baseball and claims it as his own personal (or investment) property and if Peter later sells the baseball for $150, then Peter will have capital gain of $50.

   b. On the other hand, if Peter states (and thereby committing fraud) that Peter purchased the baseball from a child $1, then Peter "will not have any ordinary income and he will not have any income due to the purchase". Just kidding. And when Peter sells the baseball for $150, he has $149 of ordinary income. Just kidding again.

H. Another problem which arises if the dealer knew the value of the desk.

1. Referring to the discussion above in which Beverly purchased the desk from an antique shop, there is another problem which arises if the antique dealer knew that the desk once belonged to George Washington.

   a. That is, if the dealer, who sold the desk to Beverly, knew that the desk had a value of $50,000 when the dealer sold the desk to Beverly, then other factors enter into the decision of whether or not Beverly realized gross income when Beverly purchased the desk.

2. A gift and a sale by the dealer by the dealer to Beverly. For example, the dealer could be making a gift to Beverly (who is the dealer's friend or child) in which case the dealer might have both gross income (from the sale of the of a portion of the desk) and owe some gift tax (from the gift of a portion of the desk).

   a. For example, if the dealer had purchased the desk for $1,000, then the dealer would have both gross income and a gift as part of the same transaction (the conveyance of the desk to Beverly and the receipt of Beverly's cash) transferred the desk to Beverly for $5,000 at the time when the desk had a value of $50,000.

      (1) In such a case, Beverly might have no gross income to the extent of the gift and have gross income

3. Compensation to Beverly by the dealer. Alternatively, the dealer might be compensating Beverly for services which Beverly rendered as an employee of the antique dealer. However, read section 132.
4. If Beverly purchased the desk either to use in her home or as an investment, then the desk would be a capital asset to Beverly and her holding period for the desk would begin at the time when she acquired the desk.
    a. If Beverly later sold the desk, then she would have long term capital gain or loss. In such a case, any loss would not be deductible if she had been holding the desk as a personal asset.
    b. If she had been holding the desk as an investment and she sold the desk at a loss, then she could deduct the loss as a capital loss.
    c. However, if you purchase the baseball as a personal asset or if you purchase the baseball as an investment in a bargain purchase, then, when you dispose of the baseball in a taxable transfer, you will realize capital gain from such sale or exchange and your income tax rate will probably be lower than your ordinary income tax rate.
        (1) If you report the value of the baseball as gross income to you, e.g., $1,000, and later, you sell the baseball for $600, then you will have a nondeductible loss due to section 165(c).

I. Selling property for an amount which is less than the fair market value of the property
1. If a seller of property sells the property for the fair market value of the property, then the seller may offset the seller's entire adjusted basis for the property against the amount realized in order to determine the gain or loss realized to the seller.
2. If a seller of property sells the property for less than the fair market value of the property, then the seller is making both a sale and, e.g., a gift or a charitable contribution. Read section 1011(b).
3. If a charitable contribution deduction is available for a bargain sale of property to a charitable organization, the transferor's adjusted basis for the property must be allocated between the charitable contribution and the sale portions of the transaction in accordance with the fair market value of each element of the transaction. Read section 1011(b).
    a. Thus, the taxpayer has more recognized gain (or less recognized loss) from the transaction.

J. Receiving property for the rendering of services.
1. If you purchase paint and a brush for $100 and you draw and paint a picture and you normally charge $500 for your services, then your basis for the picture is $100 and not $600. You may not increase your basis for property by including the value of your services when you build the property.
    a. However, if the Happiness Corp. builds an automobile for $5,000, $4,000 of which is labor charges, then Happiness' basis for the automobile is $5,000, because Happiness paid $4,000 for the services rendered. Happiness did not render the services itself.
2. On the other hand, if you receive property as compensation for your services (or in some other taxable transaction), then your basis for the property is equal to the fair market value of your services.
    a. The reason why a recipient of property, in that situation, has a fair market value basis for the property is because the recipient must included the fair market value of the property (of his or her services) in the recipient's gross income.
        (1) To state that the recipient has a basis for the property is less than the fair market value (which the recipient should reported as gross income) would mean that the recipient would be income taxed twice on some of the income - - - once when the property was received as compensation - - - and again when the recipient sold the property, e.g., for the same fair market value of

the property (of the services).

(2) Of course, if the fair market value of the property goes up after the recipient receives the property, and then, the recipient sells the property for the new fair market value, then the recipient would realize gain from the sale - - - measured by the difference between the basis of the property and the sale price of the property.

3. The same concept is applicable to, e.g., distributions of property by a corporation to a shareholder of the corporation. Usually, the applicable rule for determining the basis of property which is received by any person is that the basis of the property is the fair market value unless a section provides otherwise. For example.

a. The donee of a gift (through section 102) would have a basis for the property given which is equal to the fair market value of the property, except for the provisions of section 1015.

b. The basis of a tax-postponing stock dividend distribution to a shareholder through section 305 would be the fair market value of the stock distributed but for section 307.

c. The basis of a football found in the street and taken possession of by the finder is the fair market value of the football, because there is not section which provides another basis of the football to the finder and new possessor.

d. The distribution of property by a corporation to a shareholder, through section 301(c), as a dividend or as return of capital or as capital gain is the fair market value of the property received by the shareholder. In this case, section 301(d) states it all. Specifically, section 301(d) states that the "basis of property received in a distribution to which subsection (a) applies shall be the fair market value of such property."

(1) There is no need for section 301(d) to state this, **because there is no other section in the IRC would states that the basis of such property is not the fair market value of the property**.

e. Similarly, section 334(a) states that the receipt of a property distribution by a shareholder due to a complete liquidation by a corporation provides the shareholder with (generally) capital gain or loss, and in any event, the basis of the property to the shareholder is the fair market value of the property at the time of the receipt of the shareholder. Again, section 334(a) is helpful, but it is not necessary.

K. Some examples.

1. Example. John owns some land which has a fair market value of $10,000 and an adjusted basis of $2,000 and John sells the land to Peter for $10,000. John realizes and recognizes gain of $8,000 and Peter's basis for the land is $10,000. Peter's holding period for the land begins on the date of the sale (on the date on which the property is transferred to Peter).

2. Example. John owns some land which has a fair market value of $10,000 and an adjusted basis of $2,000 and John gives the land to Peter. John does not realize any gain or loss and Peter acquires John's adjusted basis for the land of $2,000. Peter's holding period for the land includes John's holding period for the land.

3. Example. John owns some land which has a fair market value of $10,000 and an adjusted basis of $2,000 and John sells the land to Peter for $6,000. The $2,000 of adjusted basis which John has for the land is allocated 60% to the sale portion of the transaction and 40% to the gift element of the transaction. The 60% is determined by determining that $6,000 (the amount of the sales proceeds) is 60% of the value of the land. The 40% is determined by determining that $4,000 is 40% of the value of the land. Therefore, 60% of the land adjusted basis of $2,000 is $1,200, and thus, John's gain from the sale is $4,800 (6,000 - 1,200) and Peter's basis for the land is $6,800 (6,000 of cash paid by Peter and 800 with

respect to the gift portion of the land).

4. Example. John owns some land which has a fair market value of $10,000 and an adjusted basis of $2,000 and John sells the land to the Religious Corp. for $6,000. The $2,000 of adjusted basis which John has for the land is allocated 60% to the sale portion of the transaction and 40% to the charitable contribution element of the transaction. The 60% is determined by determining that $6,000 (the amount of the sales proceeds) is 60% of the value of the land. The 40% is determined by determining that $4,000 is 40% of the value of the land. Therefore, 60% of the land adjusted basis of $2,000 is $1,200, and thus, John's gain from the sale is $4,800 (6,000 - 1,200) and John's charitable contribution is $4,000.

5. Example. If Beverly works for Peter and earns $10,000 and Peter pays Beverly by giving Beverly some common stock with a value of $10,000, then Beverly has ordinary gross income of $10,000 and a basis for the property of $10,000 so that if Beverly sells the common stock for $10,000, then Beverly will not realize any gain. It would be grossly unfair to state that Beverly had no basis for the common stock, and therefore, Beverly again had gross income of $10,000.

6. Example. If Beverly receives land from Mary (which land has a value of $100,000) in an arm's length exchange in which Beverly transfers a painting to Mary, with a fair market value of $98,000 and which has an adjusted basis to Beverly of $60,000 and which Beverly held as an investment for several years, and the $2,000 difference in values is attributable to services which Beverly rendered to Mary in a different transaction, then Beverly would realize gain of $40,000 - - - measured by the difference between the fair market value of the land received ($100,000) and the adjusted basis of the painting transferred ($60,000) by Beverly. The character of that gain would be $38,000 of long term capital gain and $2,000 of ordinary income. Then, Beverly's basis for the land received by Beverly would be $100,000.

7. Example. Referring to the previously example, if Mary gave Beverly land with a value of $98,000 and a boat with a value of $2,000, then Beverly still would have ordinary gain of $2,000 and Beverly would still have long term capital gain of $38,000 and Beverly would have a basis for the boat of $2,000 and Beverly's holding period for the boat would begin when Beverly received the boat.

8. Example. Referring to the previous examples, if Mary gave Beverly some land with a value of $90,000 and a truck with a value of $10,000 (and no payment was made by Mary for the services of Beverly), then Beverly would still have long term capital gain of $40,000 and Beverly would have a basis for the land of $90,000 and a basis for the truck of $10,000.

9. Example. Paul worked for TTT Corporation, which manufactured furniture and which allowed Paul to purchase CCC Corporation common stock, with a fair market value of $10,000, for $6,000 and which TTT Corporation held as an investment, and the sale was made because Paul worked so well for TTT Corporation. In general, Paul has ordinary gross income of $4,000 and Paul's adjusted basis for the common stock is $10,000 (the $6,000 which Paul paid for the common stock plus the $4,000 which Paul received as compensation and which Paul is required to include in Paul's gross income). Thus, if Paul sells the common stock for $10,000, Paul will not realize any more gross income. If Paul sells the common stock for $11,000, then Paul will realize $1,000 of capital gain gross income.
   a. To state that Paul has an adjusted basis of property of only $6,000 (the amount of cash which Paul transferred in order to purchase the common stock) would mean that if Paul sold the common stock for $10,000, then Paul would recognize another $4,000 of gross income.
   b. That is, Paul would recognize the $4,000 of gross income twice - - - once when Paul

received the common stock (as compensation), and again, when Paul sold the common stock - - - a total of $8,000 ($4,000 plus $4,000). This would be ridiculous.

c. Therefore, Paul's adjusted basis for the common stock, after Paul received the common stock, is the $6,000 of cash paid by Paul plus the $4,000 of gross income which Paul realized when the common stock was transferred to Paul.

10. Example. The computation of a bargain sale of property to a charitable organization.

Fair market value of property given/sold	$ 15,000
Sales price of property given/sold	10,000
Adjusted basis of property given/sold	3,000

10,000/15,000 = 2/3
2/3 x 3,000 = 2,000

Fair market value of property given/sold	$ 15,000
Minus sales price of property given/sold	10,000
Gift to charitable organization	$ 5,000

Sales price of property given/sold	$ 10,000
Minus allocate portion of adjusted basis of property given/sold	2,000
Gain from property given/sold	$ 8,000

11. Example. Another example of a sale of property to a charitable organization.

Mary sold some land to the YMCA for $100,000, with no sales commissions. The land had a fair market value of $400,000 and Mary's adjusted basis for the land was $60,000.

Sales price	$ 100,000
Minus adjusted basis ($100,000/$400,000 = 25%; 25% time $60,000)	15,000
Gain from sale	$ 85,000

Fair market value of property	$ 400,000
Minus sales price	100,000
Charitable contribution	$ 300,000

L. Read section 132 and try to answer the following questions. With great respect to you, it is doubtful that you will provide correct answers to all of the questions until you have a better understanding about section 132. So read section 132 once or twice.

1. Question 1. During the current taxable year, John's employer, Jolly Corporation, which manufactured and sold computers to the general public, allowed John to purchase one of Jolly Corporation's office desks (which had a fair market value of $10,000) for $6,000, because John had worked so hard for Jolly Corporation during a prior tax year. Jolly Corporation had an adjusted basis of $4,000 for the desk. John received the desk (with no restrictions attached) on November 1, of the current taxable year. John's ordinary gross income for the current taxable year with respect to the transfer of the desk to John is as follows.

a. None/Zero
b. $4,000
c. $10,000
d. $6,000
e. No prior stated answer

2. Question 2. Referring to question 1, Jolly Corporation's ordinary gross income for the current taxable year with respect to the transfer of the desk to John is as follows.
   a. None
   b. $4,000
   c. $10,000
   d. $6,000
   e. No prior stated answer

3. Question 3. Referring to question 1, Jolly Corporation's ordinary income tax deduction for the current taxable year with respect to the transfer of the automobile to John is as follows.
   a. None
   b. $4,000
   c. $10,000
   d. $6,000
   e. No prior stated answer

4. Question 4. Referring to question 1, on March 5, of next taxable year, John sold the desk to Beverly for cash of $9,000. John's short term capital gain for the next taxable year with respect to the sale of the automobile to Beverly is as follows.
   a. None
   b. $4,000
   c. $9,000
   d. $3,000
   e. No prior stated answer

5. Question 5. During the current taxable year, John's employer, RollyPolly Corporation, which regularly sold automobiles to customers, allowed John to purchase one of RollyPolly Corporation's automobiles (which RollyPolly Corporation held in inventory and which automobile had an adjusted basis of property of $2,000 to RollyPolly Corporation and which automobile had a fair market value of $20,000) for $15,000, because John had worked so hard for RollyPolly Corporation during a prior taxable year. John received the automobile (with no restrictions attached) on November 1, of the current taxable year. John's ordinary gross income for the current taxable year with respect to the transfer of the automobile to John is as follows.
   a. None
   b. $5,000
   c. $10,000
   d. $6,000
   e. No prior stated answer

6. Question 6. Referring to question 5, RollyPolly Corporation's ordinary gross income for the current taxable year with respect to the transfer of the automobile to John is as follows.
   a. None
   b. $5,000
   c. $18,000
   d. $13,000
   e. No prior stated answer

7. Question 7. Referring to question 5, RollyPolly Corporation's ordinary income tax deduction for the current taxable year with respect to the transfer of the automobile to John is as follows.
   a. None
   b. $5,000
   c. $18,000

d. $13,000
e. No prior stated answer

8. Question 8. Referring to question 5, John drove the automobile for two years as John's personal automobile, and then, John sold the automobile to Beverly for $19,000. John's capital gain gross income or capital loss deduction from the sale of the automobile to Beverly is as follows.
   a. None
   b. $1,000
   c. $5,000
   d. $6,000
   e. No prior stated answer

IV. The "every tax year stands alone" doctrine.

A. Adding two plus two and getting five.
1. If, in a prior taxable year, a taxpayer adds two plus two and inserts five on the taxpayer's income tax return, then the taxpayer should correct that error by amending that income tax return or the IRS should will probably determine that the error has been made, but in any case, that error should be corrected with respect to that prior taxable year, by changing the income tax computation of and for that prior taxable year.
   a. If the applicable statute of limitations has run, then the taxpayer or the IRS, as the case may be, is out of luck.
   b. The entire transaction (adding two plus two) occurred in that prior taxable year and the discovery of that error is not another transaction in a later taxable year.

B. A case in which the transaction is not just a matter of adding two and two.
1. If a taxpayer takes an income tax deduction which fully benefits the taxpayer in that taxable year and if, during a later taxable year, the taxpayer receives a reimbursement for all or some of the expense, then the taxpayer should include the reimbursement in the taxpayer's gross income for the taxable year in which the taxpayer receives the reimbursement.
   a. Each taxable year stands alone and these two transfers occurred in separate taxable years.
2. Similarly, if a taxpayer reports a receipt as gross income in a prior taxable year and if, during the current taxable year, the taxpayer is required to repay all or some of the receipt, then the taxpayer is entitled to an income tax deduction for the current taxable year for all or some of the repayment.
   a. Each taxable year stands alone and these two transfers occurred in separate taxable years.

V. The "tax benefit" doctrine.

A. Paying an expense in one year and receiving the payment back in another year.
1. If a taxpayer takes an income tax deduction in a prior taxable year, and then, during the current taxable year, the taxpayer receives a reimbursement or a recovery of the deducted amount, then, because the taxpayer enjoyed a tax benefit from the prior year income tax deduction, the recovery is includible in the taxpayer's gross income. Read section 111.

B. The tax benefit doctrine has both an inclusionary and an exclusionary component.
1. That is, the recovery is includible in the taxpayer's gross income to the extent that the prior taxable year's income tax deduction provided a tax benefit.
2. Some examples.
   a. Example. During the current taxable year, John loaned Paul $10,000 in a transaction which was a business transaction to both John and Paul. During the next

taxable year, Paul's $10,000 debt to John became worthless and John deducted $10,000 on John's income tax return as a bad debt income tax deduction for that taxable year.

(1) The income tax deduction is a tax benefit to John.

b. Example. Referring to the previous example, several taxable years later, Paul repaid John $3,000 as a partial payment on Paul's $10,000 debt.

(1) Even though the $3,000 paid to John was a partial return of a loan John had previously made, and therefore, was a return of John's capital, the $3,000 is, nevertheless, includible in John's gross income because John had enjoyed an income tax benefit by taking an income tax deduction for the debt a prior taxable year.

C. Read the first sentence of section 104 which "builds in" the tax benefit concept.

1. "Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include - - -"

2. This introduction may be difficult for you to understand, but it is only stating that gross income does not include, e.g., money which you receive for injuries which you incurred.

a. However, the first part of the sentence is stating that if you paid medical expenses due to such injuries and those payments were deductible, for income tax purposes by you, then reimbursement of those expenses will be gross income to you.

3. So if you had medical expenses, but none of them were deductible, e.g., due to the 7.5% limitation, then reimbursements of those nondeductible expenses would not be gross income.

4. If you had medical expenses of $10,000 and you could deduct, for income tax purposes, $4,000 of them, then the question of how much of any reimbursement is deduction.

a. For example, if you receive reimbursements of $3,000, then you would not have any gross income, because it is assumed that the $3,000 reimbursement was first attributable to the medical expenses which you did NOT deduction.

b. If you received $5,000 of reimbursements, then you would have gross income of $1,000 ($5,000 - $4,000).

D. Which income tax rates apply?

1. The amount includible in gross income in the taxable year of the recovery is income taxed at the current rates for that taxable year, regardless of the amount of tax benefit which the taxpayer received from the income tax deduction in a prior taxable year.

2. If all or a portion of the recovered item resulted in no tax savings in the prior taxable year when the taxpayer took an income tax deduction for the item, then the recovery is excludable from gross income to that extent. Read section 111.

E. Some examples.

1. Example. In a prior taxable year, Paul had total itemized income tax deductions of $4,000, of which $100 was for state income taxes withheld during the prior taxable year. If the standard deduction were $3,900 for that prior taxable year, then only $100 ($4,000 minus $3,900) of the income tax deduction for state income taxes produced any tax benefit. Therefore, if Paul receives a refund during the current taxable year of $500 of such state income taxes of such prior taxable year, then only $100 of the refund would be includible in Paul's gross income.

2. Example. During the current taxable year, John determined that Beverly owed John a fee of $2,000, because John, a lawyer, researched a chain of title of real property which Beverly was purchasing (and did purchase) as Beverly's home. Therefore, John sent to Beverly a bill for $2,000, but Beverly stated that the bill was too high and that Beverly did not owe the $2,000 fee and that Beverly did not intend to pay the $2,000 fee. However, later, during the current taxable year, Beverly paid John the $2,000 and promptly sued John for the return of the money. The lawsuit will continue for two or three years.

a. Under the claim of right doctrine, when John receives the money even though John may be required to repay it in a later taxable year, John must include the $2,000 in John's gross income for the current taxable year.
b. The fee paid to John is a personal expense to Beverly, and therefore, Beverly may not take an income tax deduction for the expense.
c. If John were required to repay $200 of the fee to Beverly three years later. The income tax result to John for the taxable year in which John makes the repayment is that John is entitled to an income tax deduction for the returned fee.
d. The income tax result to Beverly, under the tax benefit doctrine, for the current taxable year due to the repayment is that nothing is includible in Beverly's gross income, because, Beverly was not entitled to an income tax deduction for the fee in the taxable year in which Beverly paid the fee.

F. Some questions.

1. Question 1. During the current taxable year, John determined that Beverly owed John a fee of $1,000, because John, a lawyer, researched a chain of title of real property which Beverly was purchasing (and did purchase) as Beverly's home. Therefore, John sent to Beverly a bill for $1,000, but Beverly stated that the bill was too high and that Beverly did not owe the $1,000 fee and that Beverly did not intend to pay the $1,000 fee. However, later, during the current taxable year, Beverly paid John the $1,000 and promptly sued John for the return of the money. The lawsuit was settled during the next taxable year and John paid Beverly $200. John's gross income for the current taxable year with respect to the fee is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
2. Question 2. Referring to question 1, Beverly's income tax deduction for the current taxable year is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
3. Question 3. Referring to question 1, John's income tax deduction for next taxable year when John repays $200 of the fee is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
4. Question 4. Referring to question 1, Beverly's gross income for next taxable year when John repays $200 of the fee is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
5. Question 5. During the current taxable year, John determined that Beverly owed John a fee of $2,000, because John, a lawyer, had handled a breach of contract case, for Beverly, which case involved the breach of a home purchase agreement by Beverly. Therefore, John sent to Beverly a bill for $2,000, but Beverly stated that the bill was too high and that Beverly did not owe the $2,000 fee and that Beverly did not intend to pay the $2,000 fee. However, later, during the current taxable year, Beverly paid John the $2,000 and promptly sued John

for the return of the money. The lawsuit was settled during the next taxable year and John repaid Beverly $500. John's gross income for the current taxable year with respect to the fee is as follows.

a. None/Zero
b. $2,000
c. $500
d. Need more information
e. No prior stated answer

6. Question 6. Referring to question 5, Beverly's income tax deduction for the current taxable year with respect to the fee is as follows.

a. None/Zero
b. $2,000
c. $500
d. $1,500
e. No prior stated answer

7. Question 7. Referring to question 5, John's income tax deduction for next taxable year when John repays part of the fee is as follows.

a. None/Zero
b. $2,000
c. $500
d. $1,500
e. No prior stated answer

8. Question 8. Referring to question 5, Beverly's gross income for next taxable year when John repays part of the fee is as follows.

a. None/Zero
b. $2,000
c. $500
d. $1,500
e. No prior stated answer

VI. The "claim of right" doctrine.

A. In a nutshell, the "claim of right doctrine" states as follows.

1. Income which is received by a taxpayer without restriction - - - income which the taxpayer has dominion and control over - - - must be includible in the cash method taxpayer's gross income in the taxable year received, even if there is a possibility that the income may have to be repaid at a later time.

B. The elements of the claim of right doctrine.

1. The elements of the claim of right doctrine are that first, the taxpayer actually receives the funds, and second, the taxpayer does not concede that there is any other valid claim to the funds, even though in fact others may dispute the taxpayer's right to the funds.
2. If a taxpayer receives funds through a claim of right and without restriction as to the disposition of the funds, then the taxpayer has received gross income, even though there may be claims that the taxpayer is not entitled to retain the money.
3. Money received under a favorable trial court judgement is includible in gross income, despite the possibility that the judgement might be reversed on appeal.
4. The claim of right doctrine does not apply when a taxpayer borrows money, because the taxpayer recognizes the taxpayer's obligation to repay the funds borrowed.

C. Computation of tax where taxpayer restores substantial amount held through a claim of right.

1. Read section 1341.
2. As a general rule, income which is received by a taxpayer without restriction - - - income which the taxpayer has dominion and control over - - - must be includible in the cash method

taxpayer's gross income in the taxable year received, even if there is a possibility that the income may have to be repaid at a later time.

3. Then, section 1341 states that if a taxpayer is entitled to an ordinary income tax deduction in excess of $3,000 for restoring an item previously includible in gross income (because it appeared that the taxpayer had an unrestricted right to such item), then the income tax for the taxable year of repayment may be computed by:
   a. Deducting the amount of the repayment from gross income; or,
   b. Computing the income tax for the taxable year of the repayment without regard to the ordinary income tax deduction, and then, reducing the income tax for the taxable year of the repayment by the tax paid in the earlier taxable year on the item includible in gross income. Read section 1341(a).

D. Some examples.

1. Example. In a prior taxable year, Paul had total itemized income tax deductions of $4,000, of which $100 was for state income taxes withheld during the prior taxable year. If the standard deduction were $3,900 for that prior taxable year, then only $100 ($4,000 minus $3,900) of the income tax deduction for state income taxes produced any tax benefit. Therefore, if Paul receives a refund during the current taxable year of $500 of such state income taxes of such prior taxable year, then only $100 of the refund would be includible in Paul's gross income.
2. Example. During the current taxable year, John determined that Beverly owed John a fee of $2,000, because John, a lawyer, researched a chain of title of real property which Beverly was purchasing (and did purchase) as Beverly's home. Therefore, John sent to Beverly a bill for $2,000, but Beverly stated that the bill was too high and that Beverly did not owe the $2,000 fee and that Beverly did not intend to pay the $2,000 fee. However, later, during the current taxable year, Beverly paid John the $2,000 and promptly sued John for the return of the money. The lawsuit will continue for two or three years.
   a. Under the claim of right doctrine, when John receives the money even though John may be required to repay it in a later taxable year, John must include the $2,000 in John's gross income for the current taxable year.
   b. The fee paid to John is a personal expense to Beverly, and therefore, Beverly may not take an income tax deduction for the expense.
   c. If John were required to repay $200 of the fee to Beverly three years later, then the income tax result to John for the taxable year in which John makes the repayment is that John is entitled to an income tax deduction for the returned fee.
   d. The income tax result to Beverly, under the tax benefit doctrine, for the current taxable year due to the repayment is that nothing is includible in Beverly's gross income, because, Beverly was not entitled to an income tax deduction for the fee in the taxable year in which Beverly paid the fee.

E. The tangled web of medical expenses and the reimbursements thereof and similar tax problems.

1. Medical expenses are only deductible if they are paid. Thus, accrual method taxpayers may not deduct accrued medical expenses - - - the expenses must be paid in order to be deducted. Read section 213(a).
   a. This is also so for payments of alimony. Read section 215(a).
   b. This is also so for contributions to individual retirement accounts. Read section 219(a) which actually uses the word "contributions" instead of the word "paid".
2. Medical expenses must be reduced by insurance proceeds (which are attributable to those medical expenses) in order to determine the amount of medical expenses which is deductible for a particular year.
3. After the amount of paid medical expenses minus the applicable insurance proceeds is determined, the taxpayer must determine the amount which is 7.5% of the taxpayer's adjusted gross income for the taxable year involved.
   a. Then, the paid net medical expenses for that particular year must be deducted, below

the line, only to the extent that such net paid expenses exceeds 7.6% of adjusted gross income.

4. Now, read words which begin section 104(a) - - - Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 for any prior year, gross income does not include amounts received, etc.
   a. The above wording is bound to confuse students (and everyone else), but it is very important wording.
   b. The words state that except in the case of amounts received for a prior year's medical expenses which the taxpayer deducted, gross income does not include amounts received during the current year for medical reimbursements, etc.
   c. However, if the amounts received are reimbursements, etc. for medical expenses which an individual paid and deducted during a prior taxable year, then such amounts received may be gross income for the current taxable year.
   d. The IRS publications make it clear that a reimbursement for medical expenses paid in a prior taxable year will first be attributable to the portion of the medical expenses which **were not deductible**, e.g., because of the 7.5% floor which such medical expenses had to exceed in order to obtain a medical expense deduction which could only consist of such excess.
      (1) Thus, if an individual had medical expenses in a prior taxable year of $12,000 and the individual's adjusted gross income were $100,000 and the individual was reimbursed $2,000 for such medical expenses so that the individual deducted $2,500 of the $10,000 as medical expenses (12,000 - 2,000 = 10,000 and 7.5% of 100,000 = 7,500 and 10,000 - 7,500 = 2,500).
         (a) Then, assume that the individual was reimbursed another $2,000 for such prior year's medical expenses. The IRS would allow the $2,000 reimbursement to be applied against the $7,500 of medical expenses which were not deducted in the prior taxable year. Therefore, the individual would not have any gross income in the current taxable year due to such $2,000 reimbursement in the current taxable year.
         (b) However, the amount of the reimburse were $8,000 in the current taxable year, then the individual would have gross income in the current taxable year in the amount of $500 (8,000 - 7,500).
      (2) Therefore, in a nutshell, the individual is income taxed in the current taxable year only for the amount which the individual actually received a deduction.
         (a) And, any amount received by the individual during the current taxable year would first be offset against the portion of the medical expenses which were not deductible by the individual, and therefore, the reimbursement of such nondeductible expenses would not be gross income to the individual.
         (b) An individual will only have gross income to the extent that the individual received **a reimbursement of expenses which were deducted in a prior taxable year**. Also, read section 111.

F. <u>Some questions</u>.

1. Question 1. During the current taxable year, John determined that Beverly owed John a fee of $1,000, because John, a lawyer, researched a chain of title of real property which Beverly was purchasing (and did purchase) as Beverly's home. Therefore, John sent to Beverly a bill for $1,000, but Beverly stated that the bill was too high and that Beverly did not owe the $1,000 fee and that Beverly did not intend to pay the $1,000 fee. However, later, during the current taxable year, Beverly paid John the $1,000 and promptly sued John for the return of the money. The lawsuit was settled during the next taxable year and John paid Beverly $200. John's gross income for the current taxable year with respect to the fee is as follows.

a. None/Zero
b. $1,000
c. $800
d. $200
e. No prior stated answer

2. Question 2. Referring to question 1, Beverly's income tax deduction for the current taxable year is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
3. Question 3. Referring to question 1, John's income tax deduction for next taxable year when John repays $200 of the fee is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
4. Question 4. Referring to question 1, Beverly's gross income for next taxable year when John repays $200 of the fee is as follows.
   a. None/Zero
   b. $1,000
   c. $800
   d. $200
   e. No prior stated answer
5. Question 5. During the current taxable year, John determined that Beverly owed John a fee of $2,000, because John, a lawyer, had handled a breach of contract case, for Beverly, which case involved the breach of a home purchase agreement by Beverly. Therefore, John sent to Beverly a bill for $2,000, but Beverly stated that the bill was too high and that Beverly did not owe the $2,000 fee and that Beverly did not intend to pay the $2,000 fee. However, later, during the current taxable year, Beverly paid John the $2,000 and promptly sued John for the return of the money. The lawsuit was settled during the next taxable year and John repaid Beverly $500. John's gross income for the current taxable year with respect to the fee is as follows.
   a. None/Zero
   b. $2,000
   c. $500
   d. Need more information
   e. No prior stated answer
6. Question 6. Referring to question 5, Beverly's income tax deduction for the current taxable year with respect to the fee is as follows.
   a. None/Zero
   b. $2,000
   c. $500
   d. $1,500
   e. No prior stated answer
7. Question 7. Referring to question 5, John's income tax deduction for next taxable year when John repays part of the fee is as follows.
   a. None/Zero
   b. $2,000
   c. $500
   d. $1,500
   e. No prior stated answer

8. Question 8. Referring to question 5, Beverly's gross income for next taxable year when John repays part of the fee is as follows.
   a. None/Zero
   b. $2,000
   c. $500
   d. $1,500
   e. No prior stated answer

VII. The "constructive receipt" doctrine. Most individual taxpayers report gross income by using the cash method of accounting rather than using the accrual method of accounting. However, a taxpayer may have to use the accrual method of accounting, e.g., with respect to the taxpayer's sole proprietorship, if the taxpayer holds property as inventory in the taxpayer's business.

A. Some comments about the cash method of accounting and the constructive receipt doctrine.
   1. Accordingly, a cash method taxpayer must include compensation income in gross income when the funds are actually received or credited to the taxpayer or set aside and made available to the taxpayer.
   2. Advance payments are immediately includible in gross income even if the advance is made in a prior taxable year.
   3. Under the constructive receipt doctrine, if a cash method taxpayer has an unqualified vested right to income, the taxpayer may not defer income taxation by refusing to take the income. The taxpayer will be deemed to have constructively received income that is made available to the taxpayer, even if the taxpayer does not actually receive the income. Read Reg. §1.451-2.
   4. The IRS states "under the doctrine of constructive receipt, a taxpayer may not deliberately turn the taxpayer's back upon income and thereby select the taxable year for which the taxpayer will report it." Read Rev. Rul. 60-31, 1960-1 C.B. 174, 178.
   5. A taxpayer has constructively received income when the funds are set aside and made available to the taxpayer. In general, in determining whether or not a taxpayer has constructively received income, determine whether or not the funds have been set aside and made available to the taxpayer.
   6. If a taxpayer agrees to the deferral of payment before the taxpayer has earned the right to the payment, the taxpayer will not recognize gross income until the date on which the deferred payments are to be made.

B. Some examples.
   1. Example . John wrote a book during a prior taxable year and during October, of the prior taxable year, John took the book to a publisher who agreed to publish the book. John had the choice of receive a book royalty of $500,000 immediately or receive $120,000 per year for the next five taxable years. John chose to take the $120,000 per year for five taxable years and, under this agreement, John received $120,000 during the prior taxable year.
      a. John does not have an unqualified vested right to receive immediate payment. The money is not set aside for John, therefore, John has not constructively received the $500,000. John does not have to recognize the full $500,000 in a prior taxable year. John will only have to recognize the $120,000 in the prior taxable year and will recognize $120,000 in the subsequent four taxable years as well. Therefore, the answer is $120,000 ordinary income.
   2. Example. During January, of the current taxable year, John was told that the current federal representatives and senators and president intended to raise the income tax rates for the current taxable year (and thereafter). Therefore, John asked the publisher to amend the agreement (which the publisher did) so that John would receive the remaining payments of $480,000 over the next ten taxable years (during the current taxable year and nine more taxable years), at the rate of $48,000 per taxable year. John received the current taxable year's payment of $48,000 during the current taxable year.

a. Even though John amends the payment plan, John will still have to recognize the $120,000 in the current taxable year. The $120,000 was set aside for John and is available to John and John has constructively received the $120,000. John will not be able to escape recognition of the $120,000 in the current taxable year by deferring the payment. Therefore, the answer is $120,000 ordinary income.

3. Example. John, a lawyer, agreed, in writing, to represent Beverly in a lawsuit which Beverly wanted to bring against Poison Corporation. The written agreement stated that John was to receive, from Beverly, 30% of any recovery if the case did not go to trial and 40% of any recovery if the case went to trial. In both cases, the payment to John was to be made at the time when the settlement agreement with Poison was executed by John, Beverly, and Poison and the payments were made by Poison. On March 10 of the current taxable year, Beverly and John agreed to tell Poison that Beverly would accept $100,000 and that John was to be paid $10,000 a taxable year for three taxable years, by Poison, instead of $30,000 all in one taxable year being paid by Beverly, because John and Beverly believed that Poison would not pay both Beverly and John if John wanted $30,000 all in one year. However, after some negotiation, Poison agreed that Beverly would be paid only $100,000 and the date for signing the settlement agreement was set as March 15 of the current taxable year. So, on March 15 of the current taxable year, Beverly received $100,000 and despite the prior written agreement between Beverly and John, Beverly and John agreed to pay John $10,000 per taxable year for three taxable years, which Beverly did, because John wanted to reduce his income tax liability for the taxable year in which Poison made the payment to Beverly. John constructively received the entire $30,000 at the time of the settlement. John sought to have the payment deferred after John had earned the right to the $30,000 of ordinary income.

C. Some questions.

1. Question 1. John wrote a book a prior taxable year and during October, of the prior taxable year, John took the book to a publisher who agreed to publish the book. John had the choice of receiving a book royalty of $500,000 immediately or receiving $120,000 per taxable year for the prior taxable year and for each of the next four taxable years. John chose to take the $120,000 per taxable year for the five taxable years and, under this agreement, John received $120,000 during a prior taxable year. John's gross income for the prior taxable year with respect to the publishing agreement is as follows.
   a. None/Zero
   b. $500,000 ordinary income
   c. $500,000 capital gain
   d. $120,000 ordinary income
   e. No prior stated answer
2. Question 2. During December, of the current taxable year, John's employer told John that John's employer intended to pay a bonus to John of $1,000, which John could have either during December of the current taxable year or during January of next taxable year, at John's election. John elected to receive the bonus during January of next taxable year, which John did. John's gross income for the current taxable year with respect to the bonus is as follows.
   a. None/Zero
   b. $1,000 ordinary income
   c. $1,000 short term capital gain
   d. $1,000 long term capital gain
   e. No prior stated answer
3. Question 3. John was a world class ice skater who was offered a contract to perform with the blazing skaters for one taxable year. Under the purposed contract, John had one of two choices: receive $2,000 per week for 52 weeks, starting with the date of signing; or, receive $50,000 upon the signing of the contract and $75,000 at the end of the 52 weeks. John signed the contract on March 1st of the current taxable year, chose to take the first option of payments, and received all the funds throughout the current taxable year and the next taxable

year. John's gross income for the current taxable year with respect to the contract and the payments thereunder is as follows.

a. None/Zero
b. $104,000
c. $50,000
d. $88,000
e. No prior stated answer

4. Question 4. John, a lawyer, agreed to represent Beverly in a lawsuit which Beverly wanted to bring against Poison Corporation. The written agreement stated that John was to receive, from Beverly, 30% of any recovery if the case did not go to trial and 40% of any recovery if the case went to trial. In each case, the payment to John was to be made at the time when the settlement agreement with Poison Corporation was to be executed by John, Beverly, and Poison Corporation. On March 10 of the current taxable year, Beverly and John agreed to tell Poison Corporation that Beverly would accept $100,000 and that John was to be paid $10,000 a taxable year for three taxable years, by Poison Corporation, instead of $30,000 all in one taxable year from Beverly, because John and Beverly believed that Poison Corporation would pay both Beverly and John if John took $10,000 per taxable year for three taxable years. However, after some negotiation, Poison Corporation agreed that Beverly would be paid only $100,000 and the date for the signing the settlement agreement was set as March 15 of the current taxable year. Poison Corporation also agreed to do this, and so, on March 15 of the current taxable year, Beverly received $100,000, and then, Beverly agreed with John to pay John $10,000 per taxable year for three taxable years, which Beverly did. John's gross income for the current taxable year is as follows.

a. None/Zero
b. $30,000 ordinary income
c. $10,000 capital gain
d. $10,000 ordinary income
e. No prior stated answer

5. Question 5. John, a lawyer, agreed to represent Beverly in a lawsuit which Beverly wanted to bring against Poison Corporation. John commenced the lawsuit during the current taxable year and the law suit ended during the current taxable year with a verdict in favor of Beverly. Under John's contract with Beverly, John was to receive 40% of Beverly's recovery, which recovery was $10,000, and therefore, John was entitled to receive $4,000 from the suit, from Beverly. However, John asked Beverly to pay the amount during January of next taxable year, which Beverly did. John's gross income for the current taxable year is as follows.

a. None/Zero
b. $4,000
c. $10,000
d. Need more information
e. No prior stated answer

VIII. <u>The "assignment of income" doctrine</u>.

A. <u>A famous (to tax professors) metaphor of Justice Holmes</u>.

1. A famous metaphor of Justice Holmes is often referred to, in one form or another, as the "fruit and tree" doctrine and the "fruit and tree" doctrine is often worded, in one form or another, as "The fruit is to be income taxed to the tree from whence the fruit came".

B. <u>The fruit must be taxed to the tree from which it came</u>.

1. The person who earns the gross income and who is entitled to receive the gross income must include the gross income in such earner's gross income even if the earner is not the recipient of the gross income.
2. The earner of the gross income may not assign the income to another person so that the latter person becomes the person who must include the income in gross income.

3. In general, a donor may not give away accrued income, regardless if the taxpayer uses the cash method of account or the accrue method of accounting.
4. In general, a donor can give away cash or other property, but a donor may not, for income tax purposes, give away the donor's accrued income.
5. The "fruit and tree" metaphor was use by Justice Holmes, in the case of Lucas v. Earl, 281 U.S. 111 (1930) in which Justice Holmes put forth the fruit and tree metaphor.

C. Giving away cash instead of giving away income..
1. An individual who has accrued income may not give away that income whether the taxpayer uses the cash method or accrual method of accounting.
2. Except for certain IRC exceptions, an individual who has earned income may not give away the"income" to another person. The individual can give away the cash or the right to the cash or other property or the right to other property, but the individual may not give away "income".
3. This is obviously true for an accrual method taxpayer, because an accrual method taxpayer has already accrued the income as part of his or her own gross income.
   a. Accrued income sticks to a taxpayer like flypaper to your hand. But even if a taxpayer uses the cash method of accounting, if the taxpayer has a right to income, then the taxpayer may not give the income away.
      (1) Again, the taxpayer may give away the cash or the right to the cash or other property or the right to other property, but the individual may not give away "income". Making a gift of the cash or the right to the cash or property or the right to the property does not shift the income with the gift. The donor-earner is still income taxed on the income and the donor has probably made a gift too.
4. Therefore, if a cash method taxpayer has a right to a fee that the taxpayer earned and the taxpayer tell his or her child to go to the person who owes the fee and get the fee and keep the fee, which the child does, then the taxpayer is still income taxed on the fee, through the fruit and tree doctrine/assignment of income doctrine, and the taxpayer has made a gift to his or her child in the amount of the fee, which gift is excluded from the child's gross income through section 102.
5. And, speaking of children, read section 73 which codifies the assignment of income doctrine by stating that a child (and not the child's parents) is income taxed on income which is earned by the child.

D. A little review and a few more points.
1. The person who earns the gross income and who is entitled to receive the gross income must include the gross income in such earner's gross income even if the earner is not the recipient of the gross income.
   a. The earner of the gross income may not assign the income to another person so that the latter person becomes the person who must include the income in gross income.
2. In general, a donor may not give away accrued income.
   a. In general, a donor can give away cash or other property, but, in general, a donor may not, for income tax purposes, give away the donor's accrued income.
3. From the case of Lucas v. Earl, 281 U.S. 111 (1930), came a fairly well-known metaphor of Justice Holmes, which is referred to as the "fruit and tree doctrine", specifically, that: the fruit (the income) must be income taxed to the tree (the earner of the income) from whence the fruit (the income) came.
4. If a cash method taxpayer transfers, e.g., to the cash method taxpayer's child, income producing property after some of the income (with respect to the property) has accrued, then the accrued income is includible in such cash method taxpayer's gross income when the accrued income is received (by either the cash method taxpayer or the child).
5. Income from property is generally income taxed to the owner of the property.
   a. If the owner of income producing property (e.g., rental property) gives away the

right to collect some cash (e.g., from a renter) with respect to the rental property, which cash will be paid to the owner in the future and which cash would be gross income to the owner if the owner collected the cash and if the owner retains the underlying property, then the donor-owner must include such future receipts of cash in the donor-owner's gross income at the time when the donee collects the cash.

E. Giving away the tree and the income.

1. If the donor gives away the income producing property, then the income from the property (which income is generated or accrues after the gift of the income producing property) is includible in the donee's gross income.
   a. In this case, the giving away of the tree means that the donee now has the tree, and therefore, all future income from the trust is taxable to the owner of the tree.
   b. However, income earned prior to the date of transfer, such as accrued interest or accrued rents, is still includible in the donor's gross income. Read section 102.
   c. Because the donee of property may acquire the donor's adjusted basis of property through section 1015, any appreciation in the fair market value of the property is normally income taxed to the donee when the donee sells or exchanges the property and has realized and recognized gain, if, in fact, the donee does realize and recognize gain when the donee sells or exchanges the property.
2. To state again, if a taxpayer gives appreciated property to another person and the latter person sells the appreciated property, then, as a general rule, the gain is includible in the seller's gross income.
   a. This is not an example of accrued income, because appreciation does not accrue to the owner of property. The owner of property does not have a right to the current appreciation.
   b. If interest income accrues with respect to a debt which is owed to a taxpayer, then the taxpayer has a right to the interest income and the assignment of income doctrine will be applicable to an attempt by the taxpayer to shift the accrued income to another person.
3. However, for income tax purposes, a taxpayer may not give away accrued income.

F. Assignments of rights to personal service income.

1. Although assignments of earned income are generally ineffective for income tax purposes, an individual can perform services gratuitously in connection with income producing activities of another taxpayer without having any of the income imputed to the taxpayer.
2. However, if a taxpayer performs services for a payment being made by a third party to another person, then the payment is includible in the taxpayer's gross income.
   a. Further, if the third person's payment is to a charitable organization, then the taxpayer (who performs the services) would have both gross income and an ordinary income tax deduction (for the charitable contribution). Read section 170.
   b. However, if the charitable organization is a promoter and the taxpayer merely donates the taxpayer's services, then the proceeds are not includible in the taxpayer's gross income.
3. Income received for personal services performed by a child is includible in the child's gross income, even if the parent is entitled to the earnings of the child under state law and receives the earnings of the child. Read section 73.
4. Therefore, section 73 does nothing more than codify the fruit and tree doctrine.
5. If a cash method taxpayer transfers, e.g., to the cash method taxpayer's child, income producing property after some of the income (with respect to the property) has accrued, then the accrued income is includible in such cash method taxpayer's gross income when the accrued income is received (by either the cash method taxpayer or the child).

G. Some examples.

1. Example. If John gives Peter a condominium with a fair market value of $100,000 and an

adjusted basis of property to John of $20,000, then Peter will have an adjusted basis of property for the condominium of $20,000 (a carryover basis) and if Peter immediately sells the condominium for $100,000, then Peter will realize capital gain income of $80,000 and John will not realize any income.

a. The appreciation has not ripened into gain which has been "accrued" to a cash method taxpayer.

2. Example. If Mary gives to Paul an apartment building, then the fair market value of the building is not includible in Paul's gross income. If, at the time of the gift, some of the tenants of the building owe back rent, and the back rent is paid to Paul after the building is given to Paul, then the back rent is includible in Mary's gross income Mary may not give to Paul accrued income. Under the assignment of income doctrine, Mary may give to Paul cash or other property, but Mary may not give to Paul Mary's income (the fruit), i.e., income which has accrued to Mary. When the future rent is paid by the tenants to Paul, the future rents are includible in Paul's gross income, because Paul then owns the building (the tree) when that gross income accrues.

3. Example. Referring to the prior example, Mary gave to Paul 50% of the building and 50% of the back rents and all of the future rents. In this case, Mary would include all of the back rents in Mary's gross income, when the rents are collected, and Mary would include 50% of the future gross rents in Mary's gross income. Paul would not include any of the back rents in Paul's gross income and not include the building in Paul's gross income, but would include 50% of the future rents in Paul's gross income. However, Paul must include only 50% of the future rents in Paul's gross income.

4. Example. John transferred some rental property (some land and an apartment building), with a fair market value of $50,000, to Peter as a gift. Also, prior to the transfer of the rental property, rents of $1,000 accrued to John and John told Peter that Peter can have these accrued rents and that Peter can have all of the future rents. During the current taxable year, Peter receives the rental property of $50,000, the accrued rents of $1,000, and later rents of $3,000 (for the current taxable year).

a. With respect to the transfer of the rental property, Peter has no gross income, because the transfer is a gift. Read section 102.

b. With respect to the transfer of the $1,000 of rent money which accrued prior to the transfer of the rental property to Peter, Peter has no gross income, because the transfer of the rent money is a gift to Peter. Read section 102.

(1) However, John must include the $1,000 of rent money in John's gross income, even though Peter collects such $1,000 of rent money.

c. With respect to the transfer of the $3,000 of rents which accrued after the transfer of the rental property to Peter, Peter has gross income of $3,000, because Peter owned the tree, the rental property, at the time when the $3,000 of rents accrued. Read section 102.

d. Income from property is generally income taxed to the owner of the property.

e. If the owner of income producing property gives away the right to collect cash, with respect to the property, which cash will be paid to the owner in the future, and which cash would be gross income to the owner if the owner collects the cash, and if the owner retains the underlying property, then the donor-owner must include such future receipts of cash in the donor-owner's gross income.

f. A taxpayer who uses the cash method of accounting should include such cash in the donor-owner's gross income as the donee collects such cash.

5. Example. John earned a fee of $1,000 and told Peter to collect the money and keep the money. John can tell Peter that Peter can collect the money and keep the money. But John may not, for income tax purposes, transfer the income tax attributes of the income collected from John to Peter.

a. Thus, John would be making a gift of the right to the money to Peter and John may owe a gift tax because of this, but Peter would not be required to include the income in Peter's gross income due to section 102.

b. Instead, John must include the fee in John's gross income when Peter collects the fee.

c. John gave away the cash, but John did not give away the income. The income will be income taxed to John because John earned the income.

6. Example. If Mary earns a salary and tells Peter to pick up the check from Mary's employer and to spend the money as Peter wishes, then Mary (the "earner") has gross income in the amount of the check under either the constructive receipt doctrine or the assignment of income doctrine.

a. The constructive receipt doctrine might apply because the money (the check) was set aside and available to the Mary when she told Peter that Peter could have the check.

b. The assignment of income would apply because the income had accrued to Mary at the time when Mary gave the income to Peter.

c. Mary has given a gift of the money to Peter and that is excluded from Peter's gross income by section 102.

7. Example. If Mary loans money to Beverly and interest accrues on the debt and Mary gives the note to, with the accrued interest on it, to Peter to collect, then the gift of the note and accrued interest are excluded from Peter's gross income when the note principal and interest is collected by Peter. Mary cannot give away "income" to Peter. Mary can give the right to cash to Peter, but not the right to income. So Mary is income taxed on the income when Peter collects the cash.

8. Example. John gives Peter some rental property with a fair market value of $50,000, to Peter as a gift. Also, prior to the transfer of the rental property, rents of $1,000 accrued to John and John told Peter that Peter can have these accrued rents and that Peter can have all of the future rents. During the current taxable year, Peter receives the rental property of $50,000, the accrued rents of $1,000, and later rents of $3,000 (for the current taxable year).

a. With respect to the transfer of the rental property, Peter has no gross income, because the transfer is a gift. Read section 102.

b. With respect to the transfer of the $1,000 of rent money which accrued prior to the transfer of the rental property to Peter, Peter has no gross income, because the transfer of the rent money is a gift to Peter. Read section 102.

c. However, John must include the $1,000 of rent money in John's gross income, even though Peter collects such $1,000 of rent money.

d. With respect to the transfer of the $3,000 of rents which accrued after the transfer of the rental property to Peter, Peter has gross income of $3,000, because Peter owned the tree, the rental property, at the time when the $3,000 of rents accrued. Read section 102.

9. Example. John established a trust which granted Peter the income for life and the remainder to Sue. Several years later, Peter gave Beverly the next two years of income, which Beverly received. Peter is income taxed on the income which Beverly receives, when Beverly receives the income, because Peter did not part with any of Peter's tree (which is the stream of income which John gave to Peter for life). It is said that Peter gave to Beverly a "horizontal slice" of Peter's tree.

a. If Peter had given Sue a vertical slice of Peter's tree (the stream of income to which Peter was entitled), e.g., two percent of all of the trust income to which Peter was entitled for Peter's life, a vertical slice of the right to income, then Peter has given away part of Peter's tree to Beverly and Beverly will be income taxed on that amount of income as the income is distributed to Beverly.

H. Some questions.

1. Question 1. Beverly's employer fired Beverly because she attended a Roman Catholic Church. Beverly sued her employer and received an award which was paid, by the employer, as follows: $700,000 to Beverly; and, $300,000 to Beverly's lawyer.

a. What is the amount of Beverly's gross income?

b. What is the character of Beverly's gross income?
c. May Beverly deduct the amount paid to Beverly's lawyer?
d. If Beverly may deduct the lawyer fees, is the deduction above or below the line?

Ten Statutory Exceptions To The Assignment Of Income Doctrine.

I. A major question which you should answer before reading the remainder of this tax text.

A. When does the accrual method of accounting apply?
1. That is, does the assignment of income doctrine only apply when income has actually accrued (been earned by or is absolutely to be received by or legally belongs to) a person who uses the cash method of accounting?

II. One section that clearly recognizes the assignment-of-income-doctrine/fruit-and-tree-doctrine is section 73.

A. Section 73 provides that income earned by a child is to be income taxed to the child.
1. That is, no matter what State law provides, the child is taxable on the child's earnings and such earnings are not income taxed to the child's parents.

III. Ten statutory exceptions to the fruit and tree doctrine.

A. Each of the following ten sections is a statutory exception to the assignment of income doctrine.
1. Partnership agreements. Read section 701 et seq.
2. Transfers of receivables to a corporation. Read section 351, section 358, section 1032, and section 362.
3. Prizes and awards. Read section 74.
4. Community property. Read section 1(a).
5. Income in respect of a decedent. Read section 691(a).
6. Estates. Read section 641, section 651, and section 652, and section 661 and section 662.
7. Trusts. Read section 641, section 651 and section 652, and section 661 and section 662.
8. S corporations and their shareholders. Read section 1371 et seq.
9. Reorganizations of corporations. Read section 368 et seq.
10. Below market interest loans. Read section 7872.

IV. Partnership agreements.

A. The first statutory exception involves partnerships.
1. Read section 701 and section 702 which concern partnership agreements.
2. These sections apply to situations in which, e.g., two individuals agree to operate a partnership and to split the net income from the partnership in some agreed to percentage.
3. Example. Mary and Beverly made a partnership agreement to share their partnership profits, 50-50, but Mary became ill, so Beverly had to do almost all of the work for the first year and Beverly earned almost all of the fees for the first year. Nevertheless, the partnership agreement will stand up against the assignment of income doctrine, because of the statutory provisions.
a. For that matter, is not the shifting of income by all of the passthrough entities an exception to the fruit and tree doctrine?

B. The purpose of the partnership sections.
1. The income tax partnership provisions of section 701 et seq allow persons to make a proper partnership agreement which allow the persons, within reason, to allocate the income and expenses of the partnership among the partners in certain ways.
a. Of course, the partnership allocation does not have to be a 50-50 one. Whatever the potential partners believe is fair with respect to their partnership contributions of

property and services is general satisfactory under the tax law. For example, the allocation could be 70% to the older, more experienced individual who contributes $100,000 to the partnership and 30% to the younger individual who contributed no property to the partnership, but who is to do a considerable amount of work for the partnership.

C. Some Examples.

1. Example. Partners could, e.g., agree to split the net profit of a partnership between two partners, 50% for each partner, and this agreement will provide each partner with 50% of the partnership's net profit, even though, as it turns out, one of the partners becomes ill and is unable to work and the other partner generates all of the net profit of the partnership for a particular year. The assignment of income doctrine will not, as a general rule, apply to such a case.
2. Example. A parent organizes a partnership and gives 50% of the capital interest in the partnership to the working parent and 50% of the capital to the working parent's minor, nonworking child and 50% of the annual net profit of the partnership to the working parent and 50% of the annual net profit of the partnership to the minor, nonworking child. The working parent would include 50% of the partnership's annual net profit in the working parent's gross income and 50% of the partnership's annual net profit in the minor, nonworking child's gross income even though the parent did all of the work.
   a. The basis of the child's partnership interest would be treated as a gift basis from the parent.
   b. However, the child's share of gross income would be passive income to the child and such gross income would be subject to the kiddie income tax.
   c. If the partnership passed any losses through to the child, then the losses would be subject to the passive loss rules of the IRC. Of course, the child's passive losses could be offset against (and to the extent of) the child's passive income from the partnership.
   d. The shift of the 50% of the net profits to the child would be supported by the child's 50% interest in the partnership's capital.
3. Example. Mary and Paul enter into a partnership agreement which binds Mary and Paul to work full time for Snappy Partnership and to split the partnership's income and expenses equally. If, during the current taxable year, Mary earns, for Snappy Partnership, $100,000 and Paul earns, for Snappy Partnership, $20,000, Snappy Partnership will have total gross income of $120,000, and pursuant to the partnership agreement, $60,000 is includible in Mary's gross income and $60,000 is includible in Paul's gross income. The effect is to transfer a part of Mary's earnings to Paul, or rather, to allow the partnership agreement to determine how the partnership's gross income is to be allocated among the partners.

V. Transfers of receivables to a corporation

A. The second statutory exception involves the transfer of receivables to a corporation.

1. Read section 351, section 358, section 1032, and section 362.
2. A third statutory exception to the assignment of income doctrine concerns section 351 which concerns the income tax consequences to a person who forms a corporation and transfers assets to the corporation in exchange for the corporation's common stock.

B. The general rule of this exception.

1. If a cash method sole proprietor organizes a corporation and transfers the sole proprietor's business assets to a corporation under the provisions of section 351, then, as a general rule, no gain or loss is recognized to the cash method taxpayer when the cash method taxpayer transfers the receivables to the corporation, because section 351 makes a clear exception to the recognition of income from such a transfer of receivables.
2. However, a question is raised, through the assignment of income doctrine, when the

corporation collects the receivables. The question is whether the cash method taxpayer or the corporation should include the gross income from the receivables in the cash method taxpayer's gross income or in the corporation's gross income. The general answer is that: if the cash method taxpayer does not clearly manifest an intention to shift the cash method taxpayer's potential gross income to the corporation for the sole purpose of having the corporation recognize the gain, then the assignment of income doctrine probably will not apply.

3. Thus, if a cash method taxpayer transfers to the corporation a representative portion of assets of the cash method taxpayer's prior sole proprietorship, then this fact indicates that the cash method taxpayer does not have manifested intention to shift the cash method taxpayer's gross income from the cash method taxpayer to the corporation. Read section 446 through section 482.

C. Some examples.

1. Example. Super Corporation is organized by Beverly and Beverly transfers many business assets, including, an account receivable to Super Corporation in exchange for all of Super Corporation's common stock. The receivable has an adjusted basis to Beverly of $1,000 and a face amount of $10,000. Super Corporation's adjusted basis of property for the receivable is $1,000 and when Super Corporation collects the receivable, the $9,000 of ordinary income ($10,000 minus $1,000) is includible in Super Corporation's gross income (and not in Beverly's gross income). Read section 351, section 1032, and section 362.

2. Example. John has been operating a sole proprietorship for many years and for several reasons, he now wishes to transfer his sole proprietorship assets to a corporation which John will form. Among the assets will be some accounts receivable. If John transfers the accounts receivable to the corporation, along with John's other sole proprietorship assets, in exchange for common stock of the corporation, so that John owns, thereafter, at least 80% of the outstanding voting stock of the corporation, then John will not recognize any gain or loss due to the transaction, including when John transfers the accounts receivable to the corporation. Further, when the corporation collects the accounts receivable, the corporation, and not John will recognize the gross income from the collection.

   a. This too is an exception to the fruit and tree doctrine.

D. Section 351 was cited above as a section which can involve assignment of income problems.

1. In addition, section 351 can be used to illustrate:

   a. The difference between a section which postpones the recognition of gain or loss and a section which excludes gross income (or denies a deduction).

   b. How postponing of the recognition of gain or loss by an adjustment of the basis of property, can cause the holding period of property to be extended by the tacking of one property's holding period on to the holding period of another property; and,

   c. How such tacking on of the holding period of one property can bring about a lower income tax rate upon a disposition of the property which had its holding period increased.

   d. A stated tax philosophy above is that everything which a taxpayer receives is includible in the taxpayer's gross income unless the IRC specifically provides that the item is excludable from the taxpayer's gross income. Therefore, one should ask, when a person transfers property to a corporation and receives back stock from the corporation, why does not the person have gross income from the receipt of the stock? And, the answer to this is simple. Section 351 postpones the recognition of the recipient's gain or loss.

E. Let us start from a little different point.

1. The highest income tax rate for noncorporate taxpayers with respect to ordinary income (except for dividends) is 35%. The highest income tax rate for dividends (which is also ordinary income) and net capital gain is 15%, so the difference between the highest ordinary

income tax rate of 35% and the highest capital gain and dividend tax rate of 15% is 10%.

a. So if you have $100,000 of ordinary taxable income, the tax would be $35,000 unless some or all of the $100,000 of ordinary income consisted of dividends, in which case the dividends would be income taxed at a maximum income tax rate of 15%.

b. But if all of the ordinary taxable income consisted of dividends, then the income tax would only be $15,000.

c. And, if the taxable income consisted of $200,000 of ordinary income (none of which was dividend income), then the 35% income tax rate would yield $70,000 of income taxes and the 15% rate would yield only $30,000. Read section 1(a)-(d) and section 1(h).

2. In order to obtain the 15% income tax rate on net capital gains, you must have long term capital gains, i.e., you must hold the asset for more than one year. There are other requirements, but just concentrate of the "long term" concept at this time.

3. Now, read section 1223. Holding period of property. For purposes of this subtitle -

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges after March 1, 1954, the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph -

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

4. The result of the above section 1223 paragraphs is that if you carryover basis of one property to another property, then you can also carryover the holding period of the first property to the second property.

5. Consider a section 351 incorporation of a corporation followed by a transfer, e.g., of land to the corporation by, e.g., a sole shareholder of the corporation.

a. If the shareholder/transferor's owned land for two years and the shareholder/transferor had an adjusted basis for the land and the shareholder/transferor transferred to the corporation in a section 351 transaction at a time when the land had an adjusted basis to the shareholder/transferor of $50,000, then the corporation would have that adjusted basis of $50,000 for the land (due to section 362).

(1) And if the value of the land were $60,000, then neither the shareholder/transferor nor the corporation would recognize any portion of the $10,000 of realized gain (due to section 351 and section 1032, respectively).

(2) And, the shareholder/transferor's adjusted basis of the shareholder/transferor's stock (which the shareholder/transferor received from the corporation) would be the same as the shareholder/transferor's land, specifically, $50,000 (due to section 358) and the corporation would also have the shareholder/transferor's adjusted basis for the land of $50,000 (due to section 362).

(3) Then, due to section 1223(1), the shareholder/transferor can "tack" the

shareholder/transferor's holding period of the land on to the shareholder/transferor's ownership of the stock which the shareholder/transferor received from the corporation in return for the transfer of the land to the corporation by the shareholder/transferor. So -0- holding period of the stock by the shareholder/transferor plus the two years which the shareholder/transferor held the land equals an automatic holding period of two years as the shareholder/transferor's holding of the stock. .

(a) Therefore, the stock would automatically have a holding period for the shareholder/transferor of two years. Carryover basis and carryover holding period. Read section 1223(1).

(4) Further, due to section 1223(2), the corporation can "tack" the shareholder/transferor's holding period of the land (two years) on to the corporation's holding period of the land (-0- + two years) equals two years.

(5) Therefore, if the shareholder/transferor owned the land for two years prior to exchanged, then the land would automatically have a holding period for the land of two years to the corporation (-0- + two years).

6. If, in the above example concerning a postponement through the adjustment of the bases of the property involved, the applicable sections were exclusions sections instead of postponing sections, then the results would be startlingly different.

   a. For example, in the first example (the section 351 example), there would be no postponing of the recognition of gain to the shareholder/transferor. That is, the transaction would be treated as a taxable exchange which would result in the recognition gain to the shareholder/transferor and the transferor to the corporation. carryover of basis of the shareholder/transferor's land to either the shareholder/transferor's stock nor would the corporation have a basis of for the land which was the same as the basis that the shareholder/transferor had for the basis for the land. Section 1032 would still be applicable to the corporation so no gain or loss would be recognized. However, section 1223 would not apply in order to tack the shareholder/transferor's holding period of the property on to either the shareholder/transferor's stock or to the property transferred to the corporation.

7. One good thing about all of the above carryover of basis provisions is that there is also a carryover of holding periods so that it will be easier to meet the "more than one-year holding period" when the property is sold.

F. <u>Now, consider a gift transaction</u>.

1. John makes a gift to of land to Peter. Read section 102 and section 1015 and remember the (shorter) statement "Carryover basis, carryover holding period".
2. Whenever Peter carries over the adjusted basis of John's gift, then Peter will carryover John's holding period for the gifted property. Read section 1223(2).
   a. For example, if John gave Peter some land with an adjusted basis to John of $50,000 and a value of $60,000, then John would not have any realized or recognized gain and Peter would not have any realized or recognized gain and Peter would have John's adjusted basis for the land.
3. Therefore, if Peter sold the land for $60,000 two days after the gift, then Peter would realize and recognize gain of $10,000 and John would not realize or recognize any gain.
   a. In so doing, this would not be an assignment of income problem, because the appreciation which arose when John owned the property had not accrued to John prior to the transfer of the land to Peter. If it were clear that John would have been entitled to that appreciation if John had not given the property to Peter, then assignment of income issue could arise.
   b. Therefore, section 102 is not an exclusion section. It is a postponing section which is misplaced in the IRC and all of the postponement is, as usual, carried out by another provision in the IRC, e.g., section 1015.
4. Further, without section 102, a sound argument could be made that John realized and

recognized gain when John transferred the land to Peter. Further, a sound argument could be made that Peter realized and recognized income when Peter received the land, and therefore, Peter's basis for the land was equal to the fair market value of the land.

G. Now, consider a section 1031 transaction.

1. Mary transfers land to Beverly, which land had an adjusted basis to Mary of $20,000 and a value of $100,000, and which land Mary used, e.g., in Mary's business or as an investment asset. In return for Mary's land, Beverly transferred land to Mary, which land had an adjusted basis to Beverly of $140,000 and a value of $100,000. Beverly used the land, e.g., in Beverly's business or as an investment asset.
2. Mary intends to use the land which Mary received, e.g., in Mary's business or as an investment asset.
   a. Because Mary meets the section 1031 provisions, Mary will not recognize any realized gain and Mary will have an adjusted basis for the new land of $20,000 and because of section 1223(1), Mary's holding period for the new land will include Mary's holding period of Mary's old land.
3. Beverly intends to use the land which Beverly received, e.g., in Beverly's business or as an investment asset.
   a. Because Beverly meets the section 1031 provisions, Beverly will not recognize any realized loss and Beverly will have an adjusted basis for the new land of $140,000 and because of section 1223(1), Beverly's holding period for the new land will include Beverly's holding period of Beverly's old land.

H. Now, consider a section 109 transaction.

1. Do you remember the hypothetical in which Peter rented some land from Paul at a fair rent and Peter built a building on the land, which building would belong to Paul at the end of the lease?
2. Second 109 provided that Paul did not recognize any gain when Peter left the land and building and section 1019 stated (and still states) that Paul had a zero basis for the building.
   a. Thus, there was no carryover of basis to Paul through section 1223.
   b. In fact, the building received a new basis to Paul, specifically, the building had a zero basis to Paul.
   c. Therefore, Paul is NOT able to tack on any of his holding period for Paul's old land on to the building and Paul's holding period for the building would begin at the date when Peter turned over the building to Paul.
   d. For example, if the value of the land (without the building on it) were $50,000 and Paul had an adjusted basis for the land of $40,000 and the building had a value of $100,000 and an adjusted basis of $80,000 to Peter when Peter left the building on the land, then Paul would not recognize any gain and the basis of the building to Paul would be zero.
      (1) Therefore, the realized gain to Paul would not be recognized.
      (2) Further, Peter's adjusted basis for the building would not be Paul's adjusted basis. Instead, Paul would have an adjusted basis for the building of zero. Therefore, there would not be a carryover of basis nor a carryover of holding period to Paul with respect to the building.

I. Now, consider the receipt of salary.

1. Mary works for Chair Corporation and during the current taxable year, Mary is entitled to a salary of $5,000 per month. At the end of December of the current taxable year, Chair pays Mary $5,000 of cash for the month of December. Mary is income taxed on the $5,000 of cash and Mary's basis for the cash is $5,000 and the cash has a basis to Mary of $5,000 and Mary's holding period for the cash begins when Mary receives the check.
   a. This all may sound like nonsense to you, but the hypothetical illustrates that when there is no section which postpones the recognition of gain when property is

received, then the basis of the property received is the value of the property received.

b. However, there is no section which postpones the recognition of the cash as gain to Mary and if there is no section which postpones such recognition of income, then such income is not postponed.

c. Further, it would be absurd to provide that the cash has a basis to Mary of less than $5,000 so that Mary would be income taxed when Mary received groceries in return for the payment of some cash.

d. If Chair paid Mary's December salary by having Chair transferred some newly manufactured furniture to Mary (instead of the cash) which furniture has a value of $5,000, then Mary is income taxed on the value of the furniture ($5,000) and Mary has a basis for the furniture of $5,000 and Mary's holding period for the furniture begins on the day when the furniture is delivered to Mary. There is no section which postpones the recognition of gain to Mary.

VI. Prizes and awards.

A. The third statutory exception is found in section 74 which involves prizes and awards.

1. In general, prizes and awards are includible in the recipient's gross income. Read section 74(a).

2. However, gross income does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if the recipient was selected without any action by the recipient to enter the contest or proceeding, the recipient is not required to render substantial future services as a condition of receiving the prize or award, and the recipient designates a taxexempt charitable organization or governmental unit to receive the prize or award. Read section 74(b).

3. Therefore, if the requirements of section 74(b) are met, then the income tax result of a prize or an award can be shifted from the "recipient" to another person.

B. Giving away a lottery ticket.

1. John purchased a Hoosier Lottery ticket.

a. Before the winner was selected, John gave the ticket to Peter. Thereafter, the wining ticket is announced and the winning ticket was the one which John gave to Peter. Therefore, Peter cashed in the ticket and was given $1,000,000.

b. Alternatively, John kept the ticket until the winning ticket was announced and the winning ticket was the one which John held, and thereafter, Peter cashed in the ticket and was given $1,000,000.

c. Who is income taxed with respect to the $1,000,000?

VII. Community property.

A. The fourth exception involves community property taxpayers.

1. Read section 1(a).

2. To the extent that income which is earned by a married taxpayer becomes community property, the income is to be split equally between both spouses.

3. Similarly, married individuals in common law states can split their incomes between the spouses by filing joint income tax return. Read section 1(a).

VIII. Income in respect of a decedent.

A. The fifth statutory exception is found in section 691.

1. The first statutory exception to the fruit and tree doctrine involves the transfer of the rights to income from a decedent to the decedent's estate.

2. If a cash method taxpayer has a right to a fee that the taxpayer earns prior to the taxpayer's

death, and before the taxpayer collects the fee, the taxpayer dies, then, after the taxpayer dies, the taxpayer's estate will generally collect the fee. So, the taxpayer earned the fee and another person (the taxpayer's estate) collects the fee.

a. This is clearly an assignment of income problem. The rule is that: he or she who earns the income is to be income taxed on the income.

b. However, section 691 states that, in such a case, the estate (or whomever else receives the income) should report the income. So this is a statutory exception to the assignment of income doctrine.

B. Actually, section 691 answers two questions.

1. Who is going to be income taxed on income which has accrued to a cash method taxpayer who dies?

a. The answer is: The person who is legally entitled to the income and who actually receives the income.

2. And, who is going to deduct a deduction which has accrued to a cash method taxpayer who dies?

a. The answer this is: The person who is legally obligated to pay the amount owed and who actually pays the amount owed.

C. Some terms.

1. "Income in respect of a decedent" or "section 691 income" or "IRD" is income which has accrued to a taxpayer before the taxpayer's death, but which is not includible in the taxpayer's gross income, due to the taxpayer's method of accounting.

a. The taxpayer is using the cash method of accounting as the taxpayer's method of accounting, and therefore, the taxpayer only includes income which the taxpayer has actually received or income which comes within the scope of the constructive receipt doctrine.

2. Obviously, the accruing of the gross income (which is necessary in order to have "income in respect of the decedent") is something less than the accruing which constitutes constructive receipt of income.

a. That is, if the constructive receipt doctrine applies to a particular item of income which has accrued prior to the decedent's death, then that item must be includible in the decedent's final (or a prior) income tax return (IRS Form 1040) and not be includible in an income tax return (IRS Form 1041) of the fiduciary of the decedent's estate.

b. One of the purposes of IRD was to prevent the bunching of gross income in the decedent's final income tax return (IRS Form 1040) and to ensure that gross income reported on the decedent's final income tax return (IRS Form 1040) is reported under the same accounting practice which the decedent used during the decedent's life.

c. However, section 691 has turned into a disaster for the beneficiaries of a decedent's estate, because the income tax rates of a fiduciary apply such low levels of the fiduciary's taxable income.

3. "Deductions in respect of a decedent" or "section 691 deductions" or "DRD" are deductions which have accrued to a taxpayer before the taxpayer's death, but which is not deductible in the taxpayer's deductions due to the taxpayer's method of accounting.

a. The taxpayer is using the cash method of accounting as the taxpayer's method of accounting, and therefore, the taxpayer only deducts deductions which the taxpayer has actually paid. There is no constructive deduction concept in the tax law.

D. The function of section 691 with respect income.

1. Section 691 requires such income to be included in the gross income of the person who succeeds to the right to the income when the "money" is received by the successor taxpayer.

2. Section 691 generally applies to a cash method taxpayer, because a cash method taxpayer does not report income until the money or property is actually or constructively received by

the cash method taxpayer.

a. Therefore, in such a case, there is a taxpayer who has earned income, but who does not have to include the income, yet, in the taxpayer's gross income, because the taxpayer has not actually or constructively received the income, and then, the taxpayer dies.

b. In such case, section 691 states that the taxpayer who dies does not have to include the income in such taxpayer's gross income.

(1) Instead, the income is to be included in the gross income of a taxpayer who succeeds to the right to the income when such successor actually receives the income.

c. Thus, this is a case in which one taxpayer has a right to income, but another taxpayer includes the income in the latter taxpayer's gross income. And, this treatment flies in the face of the assignment of income doctrine (the fruit and tree doctrine) which requires the taxpayer who earns the income to include the income in the earning taxpayer's gross income.

d. In a section 691 case, the earner of the gross income does not report the gross income and a person who is not the earner of the gross income does report the gross income.

3. IRD includes, e.g., the following types of gross income.

a. All accrued gross income of a decedent who used the cash method of accounting during the decedent's life.

b. Gross income accrued solely by reason of the decedent's death in the case of a decedent who used the accrual method of accounting during the decedent's life.

c. Income to which the decedent had a contingent claim at the time of the decedent's death.

d. Deferred salary payments which are payable to the decedent's estate.

e. Uncollected interest on United States savings bonds.

f. Proceeds from a completed sale of farm produce.

g. A decedent's final paycheck.

h. Unreported gain on installment notes received for the sale of property.

4. In general, the assignment of income doctrine (the fruit and tree doctrine) requires a taxpayer to include, in the taxpayer's gross income, income which has accrued to the taxpayer.

a. This, of course, should be done if the taxpayer used the accrual method of accounting.

b. But if the taxpayer used the cash method of accounting, then generally the taxpayer would not include receipts into gross income until the receipts are actually or constructively received by the taxpayer.

c. Thus, at the death of a cash method of accounting taxpayer who has accrued items of gross income or deductions, the question arises as to whether or not the decedent should report these accrued items in the decedent's final income tax return because the decedent had accrued the items or whether or not the decedent's estate should report the items, because the decedent, who used the cash method of accounting, had not received or paid the items, but such items were received or paid by the decedent's estate.

(1) The answer is, through section 691, that such receivables should be reported by the person who succeeds to the right to the receivables and who collects the receivables.

d. Thus, IRD might be reportable by a decedent's estate or by a beneficiary of the decedent's estate, if a beneficiary of the decedent's estate succeeds to the IRD (before the IRD is collected by the decedent's estate).

5. Example. John earns a fee of $5,000 from Paul and Paul sent an email to John which states that the check can be picked up at Paul's office. Because Peter is leaving for college on that day, John asks Peter to go to Paul's office and pickup the check and keep it in order to pay for some of Peter's college expenses. Peter get's the check and deposits in Peter's college

bank account.

a. The assignment of income doctrine requires John to include the $5,000 in John's gross income for the year in which Peter picked up the check, and in addition, John has made a gift of $5,000 to Peter.

E. Persons who might be required to include income in respect of a decedent in their gross incomes.

1. There are three taxpayers who might be successors in interest and who may be required to include income in respect of a decedent in their gross incomes. Read section 691(a)(1).
   a. One is the decedent's estate, if the right to receive the amount of income in respect of a decedent is acquired by the estate from the decedent. Read section 691(a)(1)(a).
   b. The second is the person who, by reason of the decedent's death, acquires the right to the amount of income in respect of a decedent, if the amount is not acquired by the decedent's estate from the decedent. Read section 691(a)(1)(b).
   c. The third is the person who acquires the right to receive the amount of income in respect of a decedent by bequest, devise, or inheritance, if the amount is received after a distribution of that right by the decedent's estate. Read section 691(a)(1)(c).
2. A successor in interest who transfers a right to receive income in respect of a decedent must include in gross income an amount equal to the fair market value of the right at the time of the transfer plus the amount, if any, by which any consideration received for the right exceeds the fair market value.
3. This rule does not apply to the transfer at death to the decedent's estate or to a transfer to a person pursuant to that person' right to receive the amount of income in respect of a decedent by reason of the decedent's death or by bequest, devise, or inheritance from the decedent. Read section 691(a)(2).
   a. Thus, this is a case in which one taxpayer has a right to income, but another taxpayer includes the income in the latter taxpayer's gross income. And, this flies in the face of the assignment of income doctrine (the fruit and tree doctrine) which requires the taxpayer who earns the income to include the income in the earning taxpayer's gross income.
4. In a section 691 case, the earner of the gross income does not report the gross income and a person who is not the earner of the gross income does report the gross income.
5. Section 691 does not put a cash method taxpayer on the accrual method of accounting at the death of the taxpayer, which, if done, would require the cash method taxpayer to report the accrued, but not received, gross income.
   a. Instead, section 691 requires another person, generally, the estate of the decedent taxpayer, to report the accrued income when the recipient receives the cash or other property which represents the payment of the gross income.
6. Example. Paul dies while working for VeryNice Corporation and a week later, VeryNice Corporation prepares Paul's final paycheck and delivers that final paycheck to the executor of Paul's estate.
   a. In such a case, the gross income which accrued to Paul prior to Paul's death is not includible in Paul's gross income, but instead, the gross income is includible in Paul's estate's (the fiduciary's) gross income. Read section 691.
7. Income in respect to a decedent consists of items of gross income which accrue to an individual prior to the individual's death but which are not received by the individual prior to the individual's death, and which would have been gross income to the decedent had the decedent received the income items before the decedent died.
   a. However, because the income items are not received by the decedent prior to the decedent's death, and because such income items are received by other persons who did not earn or otherwise have a right to such income items, a dilemma arises.
8. Normally, a cash method taxpayer must report gross income earned by the cash method taxpayer when the cash method taxpayer actually or constructively receives the gross income.
   a. However, when a cash method taxpayer earns gross income prior to death, and then

dies, and the gross income is received by another person after the decedent's death, then the situation exists in which one person earns the gross income, but another person receives the gross income, and the solution to this problem is generally that the person who earns the gross income must report the gross income, even if the person who earns the gross income is not the recipient of the gross income.

b. This latter concept is generally referred to as the assignment of income doctrine or the fruit and tree doctrine.

9. Income earned by a decedent before death, but not properly includible in the decedent's gross income under the decedent's method of accounting, is includible in the gross income of the person who has the right to such gross income and who collects the gross income, e.g., the decedent's estate or a beneficiary of the decedent's estate. Read section 691(a).

a. For this reason, the income in respect of a decedent doctrine does not apply to an accrual method taxpayer, because an accrual method taxpayer must report any accrued income during the accrual method taxpayer's life and the income in respect of a decedent doctrine does not apply to income which is reportable by a taxpayer prior to the taxpayer's death.

(1) Therefore, if a cash method taxpayer actually or constructively receives income prior to the taxpayer's death, then the income in respect of a decedent doctrine is not applicable to such a situation.

10. The taxable year of an individual ends on the date of the individual's death, and because most individuals use the cash method of accounting, items of income earned before the date of death, but not received until after death, are not properly reportable in the decedent's final income tax return. Such items constitute income in respect of a decedent and are includible in the person' gross income who has a right to the gross income and who receive the gross income.

F. <u>The income in respect of a decedent doctrine does not bring about double income taxation</u>.

1. In no case will the income in respect of a decedent doctrine cause income to be income taxed twice to the taxpayer who was to receive it. Nor will that doctrine require both the decedent and the decedent's estate to be income taxed on the same income.

2. Income can be income taxed to either the decedent or to the decedent's estate.

a. However, income can be income taxed once to the decedent for income tax purposes and once to the decedent's estate, as property, with the federal estate tax return (which is an estate tax transfer return, form 706, and not an income tax return, either form 1040 or form 1041).

G. <u>The character of IRD</u>.

1. The character of the IRD is the same in the hands of an estate as the character of the gross income would have been to the decedent, had the decedent been required to report the income in the decedent's gross income.

2. For example, if a decedent is owed a salary from the decedent's employer at the decedent's death and if the salary is collected by the decedent's estate as IRD, then such gross income would be ordinary gross income to the estate because the salary would have been ordinary gross income to the decedent had the decedent received the salary during the decedent's life.

a. If the gross income would have been capital gain to the decedent, then the IRD is capital gain to the recipient (generally, the decedent's estate) of the IRD.

H. <u>Who should report IRD?</u>

1. Specifically, with respect to items of IRD which are received by a fiduciary or a beneficiary of a decedent's estate, section 69l provides that the person who acquires the right to the gross income and who receives the gross income must report the gross income.

2. Therefore, IRD must be includible in the gross income of:

a. The decedent's estate, if the estate receives the gross income; or,

b. A beneficiary of the estate, if the right to the gross income is passed directly to the

beneficiary and the beneficiary receives the gross income; or,

c. Any person to whom the estate properly distributes the right to receive the gross income.

3. The general rule concerning the reporting of section 69l gross income, by the recipient, is that such gross income is reported when the recipient receives payment of the gross income - - - even if the recipient is uses the accrual method of accounting. Therefore, if an accrual method of accounting taxpayer receives IRD, the accrual method of accounting taxpayer will report the IRD during the taxable period when received, and not, e.g., in a prior taxable period when the IRD might be said to have accrued to the accrual method of accounting taxpayer.

I. Is IRD a good or bad for the recipient?

1. Contrary to popular belief, section 69l income is good for the recipient, once it is determined that the item involved is income - - - as opposed to, e.g., a return of capital.
2. This is because there are two major advantages of section 69l income.
   a. First, the character of the income is the same to the recipient as the income would have been to the decedent.
   b. Second, there is a special income tax deduction which is allowable to recipients of IRD, specifically, a recipient of the IRD is entitled to an income tax deduction for the amount of estate tax which is attributable to the inclusion of the IRD in the decedent's gross estate for estate tax purposes. Read section 691(c).
3. Income which a decedent had a right to receive is includible in the decedent's gross estate and is subject to estate tax, if the estate tax is, in fact, imposed on the decedent's estate.
   a. This IRD is also subject to income tax when the receivable is collected by the estate or beneficiary, and this may result in a form of double taxation - - - taxation once by the income tax and taxation once by the estate tax.
      (1) Obviously, if one of these taxes is not imposed with respect to the IRD, then no income tax deduction is allowable for all or some of the estate tax.
   b. An individual or estate may qualify to claim the income tax deduction if the IRD was includible in the gross income of the estate or individual.
   c. The deduction is attributable to the estate tax paid by the decedent's estate upon the estate's receipt of the IRD.

J. Some comments about a decedent's last taxable year.

1. The taxable year of an individual ends on the date of the individual's death, and because most individuals use the cash method of accounting, items of income earned before the date of death, but not received until after death, are not properly reportable in the decedent's final income tax return.
   a. Such items constitute income in respect of a decedent and are includible in the person' gross income who has a right to the gross income and who receive the gross income.
2. An estate may have to include the following types of income in the estate's gross income: the decedent's final paycheck; interest; rental income; and, unreported gain on installment notes received for the sale of property. The character of the income, such as capital gain or ordinary income, carries through to the recipient.

K. The basis of property received by an estate as income in respect of a decedent.

1. Unlike most property acquired from a decedent, items of income in respect of a decedent do not acquire a new (or any) basis at death. Read section 1012(c).
   a. Thus, such items are subject to both income tax returns (IRS Form 1041) and estate tax returns (IRS Form 706).
   b. However, the recipient is entitled to an income tax deduction for the portion of the decedent's federal estate tax which is attributable to the income of the income in respect of a decedent in the decedent's federal gross estate. Read section 691(c).

c. As a corollary to the rules concerning income in respect of a decedent, an income tax deduction is allowable for the payment of business expenses, interest, or taxes incurred by a decedent but not properly income tax deducted on the decedent's final income tax return because the decedent used the cash method of accounting and the decedent did not pay the expense prior to the decedent's death. Such income tax deductions are allowable to the estate when paid. Read section 691(b).

L. Taxpayers must be very careful when considering making a transfer of IRD to another person.

1. If the right to receive the IRD is transferred, by gift or by sale or by other means, then the transferor will immediately recognize gain and the transferor must include in the transferor's income the greater of:
   a. The amount received for the right; or
   b. The fair market value of the right transferred.
2. Thus, if a gift is made of such right, then the donor must include in the donor's gross income the fair market value of the right at the time of the gift, and, a sale of a right to IRD will require the sales proceeds to be first applied against the income portion of the right.
3. An exception to this general rule applies to a distribution of IRD by a decedent's estate to the decedent's beneficiaries, e.g., to the residuary beneficiaries of the estate or to a beneficiary by operation of law.

M. Some examples.

1. Example. On February 1, of the current taxable year, Paul sold Paul's personal sailboat for $3,000, payable on March 1 of the current taxable year. Paul's adjusted basis for the sailboat was $2,000. Paul died on February 15, before receiving payment.
   a. The gain to be reported as income in respect of the decedent is the $1,000, which is the difference between Paul's adjusted basis in the property and the sale proceeds.
2. Example. Shortly before a taxpayer died, the taxpayer was entitled to a large salary payment. The amount was to be paid in five annual installments. The decedent received one installment before the decedent died; the estate collected two installments; and the estate distributed the right to receive the remaining two installments to the beneficiary of the estate.

   a. One of the payments is includible in the taxpayer's final income tax return (IRS Form 1040). The estate must include in the estate's gross income the two installments the estate received and the beneficiary must include in the beneficiary's gross income each of the two installments as the beneficiary receives the payments.
3. Example. John owned and operated an apple orchard, used the cash method of accounting, sold and delivered 1,000 bushels of apples to a canning factory for $2,000, but did not receive payment before John's death. When John's estate was settled, payment had not been made and the estate transferred the right to the payment to Mary. When Mary collects the $2,000, Mary must include that amount in Mary's gross income.
4. Example. Referring to the example above, John died while using the accrual method of accounting. The amount accrued from the sale of the apples is includible in John's final gross income.
   a. Neither John's estate nor Mary is required to include the $2,000 in gross income.
5. Example. A taxpayer inherited the right to receive renewal commissions on life insurance sold by the taxpayer's parent before the parent's death. The taxpayer inherited the right from the taxpayer's parent, who acquired the right by devise from the parent's spouse. None of these commissions were includible in the spouse's final income tax return (IRS Form 1040). The commissions received by the parent were includible in the parent's gross income. The commissions received by the taxpayer are not includible in the parent's gross income, even on the parent's final income tax return (IRS Form 1040). The taxpayer must include the commissions in the taxpayer's income tax return.
6. Example. At the time when Mary died, Mary was owed a fee of $1,000, by Paul, for work which Mary did for Paul, and the fee was collected by the executor of the estate during the

current taxable year.

a. The income tax result to the estate for the current taxable year due to the estate's collection of the fee is as follows. Under the cash method of accounting, income is not includible in gross income until the person receives the income. Here, Mary did not receive the income before Mary died. The estate collected the fee, and therefore, the estate should report the fee as gross income. Therefore, the answer is $1,000 ordinary income. Read section 691.

b. If Mary used the accrual method of accounting, then the income tax result to the estate for the current taxable year due to the estate's collection of the fee is as follows. Under the accrual method of accounting, a taxpayer incurs tax liability as soon as the income is realized. Here, the income is realized when earned even though the income was not paid to Mary. Mary, not the estate, should include the income in Mary's gross income. Therefore, the answer is none. Read section 691.

7. Example. On January 1 of the current taxable year, Nice Corporation declared a dividend which was payable to shareholders who owned Nice Corporation shares on February 1 of the current taxable year. The dividend was payable on April 1 of the current taxable year. Mary died on March 1 of the current taxable year, and the executor of the estate received the dividend of $1,000 on April 1 of the current taxable year.

a. The income tax result to the estate for the current taxable year due to the estate's collection of the dividend is as follows.

January 1	February 1	March 1	April 1
Dividend declared	X-date	Record Date	Dividend Payable

The dividend is not payable until April and because Mary dies in March, Mary does not realize the dividend income. The estate will recognize the dividend income. Therefore, the answer is $1,000 ordinary income.

b. If Mary used the accrual method of accounting, then the income tax result to Mary with respect to the year in which Mary died is as follows. Under the accrual method of accounting, Mary will realize the dividend income on the date of record. The record date of the stock was February 1 and Mary died on March 1. Therefore, Mary would have $1,000 of ordinary income.

c. If the decedent sells property using the installment method of accounting and a taxpayer collects an installment obligation which the taxpayer acquired from the decedent, then the taxpayer must use the same gross profit percentage which the decedent used in order to determine the part of each collection which represents profit.

8. Example. A decedent's estate is entitled to collect an installment obligation with a face value of $100,000, an estate tax value of $80,000 and a basis in the hands of the decedent of $60,000.

a. The $40,000 difference between the face value of the obligation and the decedent's basis of $60,000 is IRD.

b. If the estate collects the $100,000 obligation in installments of $10,000, $6,000 of each installment would be considered the basis of the installment. Therefore, each $10,000 installment would give rise to $4,000 of IRD.

c. The estate tax value of an installment obligation has no bearing on the amount of IRD arising from the installment obligation and the recipient of an installment obligation owed to the decedent, may use the same gross profit percentage as that used by the decedent in order to report the gain arising from the obligation.

d. A transfer of a right to income occurs if the decedent sells property using the installment method of accounting and the installment obligation is transferred to the buyer or is cancelled either at death or by the estate or person receiving the obligation from the decedent.

(1) An obligation that becomes unenforceable is treated as being cancelled.

(2) If the decedent and obligor were related persons, the fair market value of the obligation cannot be less than its face value.

9. Example. During the current taxable year, Beverly, who was a lawyer, and who used the cash method of accounting, died. When Beverly died, Beverly was owed a legal fee from Peter in the amount of $10,000 and Peter paid the $10,000 to Beverly's estate. Beverly's estate, and not Beverly, must report the $10,000 as ordinary gross income.

10. Example. During the current taxable year, Paul owed real property taxes to Marion County, Indiana in the amount of $4,000. Paul's estate paid the real property taxes. Paul's estate (Paul's fiduciary) may deduct the $4,000. Paul may not.

N. Another major part of section 691 concerns "deductions in respect of a decedent".

1. Deductions in respect of a decedent are deductions which are attributable to expenses which accrued to a decedent prior to the decedent's death, but which were not deductible by the decedent, in the decedent's final income tax return (IRS Form 1040), because of the decedent's method of accounting.
   a. In general, deductions in respect of a decedent arise in cases where the decedent used the cash method of accounting.
2. Deductions in respect of a decedent are taken by the taxpayer who owes the liability attributable to the deduction, and who pays such liability.
   a. Generally, the fiduciary pays the liabilities of a decedent.
   b. However, the liability of a decedent could also be paid by a surviving joint tenant, with whom the decedent held property as a joint tenant with rights of survivorship.
3. Only the following types of income tax deductions are treated as deductions in respect of a decedent.
   a. Interest (section 163).
   b. State and local taxes, e.g., state and local income taxes and real property taxes (section 164).
   c. Business expenses (section 162).
   d. Expenses for the production of income (section 212).
   e. Depletion - - - to the extent that the income which is subject to depletion is received by the taxpayer (section 691(b)(2)).
      (1) Depreciation is not a deduction in respect of a decedent.
      (2) Instead, depreciation is allocated to the decedent and the estate based upon the basis of the depreciable property and the time that the property is held by each.
4. That is, section 691 also applies to cash method taxpayers who die owing, e.g., business expenses or deductible interest or state and local taxes.
   a. Thus, section 691 is applicable to cash method of accounting taxpayers who die with a right to income or who die owing certain expenses.

O. Who should deduct DRD?

1. On the other hand, with respect to items of DRD which are owed by a fiduciary or a beneficiary of a decedent's estate, section 691 provides that the person who becomes liable to pay the DRD and who pays the DRD may deduct the DRD on that person's income tax return.

P. And, DRD must be deducted on the income tax return of:

1. The decedent's estate, if the estate pays the DRD; or,
2. A beneficiary of the estate, if the liability is passed directly to the beneficiary and the beneficiary pays the liability; or,
3. Any other person to whom the estate properly passes the liability and who pays the liability.

Q. Is DRD good or bad for the person who pays it?

1. A DRD is definitely beneficial because such deductions provide the estate with double

deductions - - - one for income tax purposes and one for estate tax purpose - - - and there is no penalty for this benefit.

R. Some examples.

1. Example. At the time when Mary died, Mary owed Marion County, Indiana real property taxes, with respect to Mary's residence, of $1,000, and the real property taxes were paid by the executor of the estate during the current taxable year.
   a. The income tax result to the estate for the current taxable year due to the estate's payment of the real property taxes is as follows. Because the estate paid the income tax and the cash method of accounting is being utilized, the estate is entitled to an income tax deduction for the payment of the real property taxes. Therefore, the answer is $1,000 ordinary deduction.
   b. If Mary used the accrual method of accounting. The income tax result to Mary for the current taxable year with respect to the year in which Mary died is as follows. With the accrual method of accounting, the tax liability accrues to Mary who was alive when the taxes were incurred. The estate's later payment of the real property taxes does not affect Mary. Therefore, the answer is $1,000 ordinary deduction, from adjusted gross income.
2. Example. During the current taxable year, Beverly, who was a lawyer, and who used the cash method of accounting, died. When Beverly died, Beverly was owed a legal fee from Peter in the amount of $10,000 and Peter paid the $10,000 to Beverly's estate. Beverly's estate, and not Beverly, must report the $10,000 as ordinary gross income.
3. Example. During the current taxable year, Paul owed real property taxes to Marion County, Indiana in the amount of $4,000. Paul's estate paid the real property taxes. Paul's estate (Paul's fiduciary) may deduct the $4,000. Paul may not.

S. Some questions.

1. Question 1. At the time when Mary died, Mary was owed a fee of $2,000, by John, for work which Mary did for John, and the fee was collected by the executor during the current taxable year. The estate's ordinary gross income for the current taxable year with respect to the fee is as follows.
   a. None/Zero
   b. $2,000
   c. Need more information
   d. No prior stated answer
2. Question 2. Referring to Question 1, Mary used the accrual method of accounting. Mary's ordinary gross income for the current taxable year with respect to the fee is as follows.
   a. None/Zero
   b. $2,000
   c. Need more information
   d. No prior stated answer
3. Question 3. At the time when Mary died, Mary was owed a fee of $2,000, by John, for work which Mary did for John, and the fee was collected by the executor during the current taxable year. The estate's ordinary gross income for the current taxable year with respect to the fee is as follows.
   (1) None/Zero
   (2) $2,000
   (3) Need more information
   (4) No prior stated answer
4. Question 4. Referring to question 3, Mary used the accrual method of accounting. Mary's ordinary gross income for the current taxable year with respect to the fee is as follows.
   (1) None/Zero
   (2) $2,000
   (3) Need more information

(4) No prior stated answer

IX. Fiduciaries are the sixth and seventh statutory exceptions.

A. Fiduciaries (of trusts and estates) can be both taxable entities and passthrough entities.

1. Five very important points.

a. There are five very important points about fiduciaries, beneficiaries, and the individuals who establish such relationships which you must understand at the beginning of my comments about fiduciaries.

b. First. If an individual establishes and funds a trust, but the individual keeps too much control over the trust provisions (as determined through the grantor trust rules of sections 671 et seq), then the individual who establishes and funds the trust will be income taxed on the trust's gross income and be able to use all or some of the trust's deductions and credits.

(1) The trust may be legal for state law purposes and the provisions of the trust may be carried out for legal purposes, but for income tax purposes, the individual who funded the trust will be considered to own the assets of the trust, and therefore, the individual will be entitled to the income from the assets of the trust, and therefore, that individual will be income taxed on the trust's gross income and be able to use all or some of the trust's deductions and credits.

(2) For example, if John establishes and funds a revocable trust which provides that the annual net income is to be distributed to Peter and, at Peter's death, the remainder is to be distributed to Sue, then the grantor trust provisions of section 671 et seq provide that John is considered to own the trust's assets, and therefore, John is to be income taxed on the income generated by the trust assets, and John may deduct all or some of the trust's deductions and use all or some of the trust's income tax credits.

(a) Presumably, the trustee of the trust will follow the terms of the trust agreement and, if the trust is funded, then the trustee will (or should) follow such terms and distribute the net income of the trust to Sue. Nevertheless, John will be income taxed on the trust's gross income and John will be considered to have made a gift to Sue of the gross income which the trustee distributes to Sue. come.

c. Second. The result would be the same if John had established an irrevocable trust and that John had kept the power to change the beneficiaries of the trust at any time.

(1) Thus, establishing an irrevocable trust might not change the gift, estate, or income tax results which would come from the establishment of a revocable trust, though it might change the legal aspects of a revocable trust.

d. Third. If John establishes an irrevocable trust which is not subject to any of the provisions of the grantor trust provisions of section 671 et seq, then section 641 provides that the fiduciary of the trust is to be income taxed in the same manner as an individual would be income taxed, with certain exceptions as are provided in, e.g., section 642, section 651, section 652, section 661, and section 662.

(1) The most extraordinary exception is that an irrevocable trust (which is not subject to the provisions of section 671 et seq) may take income tax deductions for distributions to beneficiaries and that such trust is then income taxed on the amount of ordinary income and capital gains which such trust does not distribute to the beneficiaries.

(2) Also, while in general, an irrevocable trust (which is not subject to the provisions of section 671 et seq) is to compute its taxable income in the same manner as an individual does (read section 641), section 641 provides that the income tax rates which are applicable to fiduciaries (both trusts and estates) are the separate income tax rates of section 1(e).

(3) Also, there is a minor difference in that section 642(b) provides that an irrevocable trust which is required to distribute all of its income current is entitled to an annual income tax exemption of $300 each year and other trusts are granted an annual income tax exemption of $100 each year.

e. Fourth. If John dies, then John's estate comes into being and the administrator of the estate is either an administrator of an intestate estate or the executor of John's estate through John's last will and testament.

(1) The income tax rules which are applicable to trusts and estates are almost identical, with some very significant exceptions, one of which is that, obviously, the grantor trust rules of section 671 et seq do not apply, because the grantor is dead.

(2) Also, as stated above, section 641 requires estates to be income taxed in the same manner as individuals, with the exceptions which are provided, e.g., in section 642, section 651, section 652, section 661, and section 662.

(3) Also, as stated above, the most extraordinary difference between trusts and estates (fiduciaries) and individuals is that irrevocable trusts (which are not subject to the provisions of section 671 et seq) and estates may take income tax deductions for distributions to beneficiaries and that the irrevocable trusts and estates are then income taxed on the amount of ordinary income and capital gains which the trust or estate does not distribute to the beneficiaries.

(4) Also, while in general, an irrevocable trust (which is not subject to the provisions of section 671 et seq) is to compute its taxable income in the same manner as an individual does (read section 641), section 641 provides that the income tax rates which are applicable to fiduciaries (both trusts and estates) are the separate income tax rates of section 1(e).

(5) Also, there is a minor difference between irrevocable trusts (which are not subject to the provisions of section 671 et seq) in that section 642(b) provides that an irrevocable trust which is required to distribute all of its income current is entitled to an annual income tax exemption of $300 each year and other trusts are granted an annual income tax exemption of $100 each year and that estates are granted an annual income tax exemption of $600.

f. Fifth. The managers of trusts are trustees and they are often referred to as fiduciaries and they are the ones who are liable (in that capacity and not in their personal capacities) for things that go wrong while managing the trusts. Nevertheless, we generally refer to trusts and estates as those they are the managers of themselves. For example, we state that a trust or an estate is income taxed this way or that way or that a trust can do this but not that. Technically, we generally should be referring to the fiduciary (the trustee or the executor) instead of referring to the trust or the estate.

2. Read section 671 et seq, section 641, section 1(e), section 642, section 643, section 651, section 652, section 102, section 661, and section 663.

B. <u>Revocable trusts - in general</u>.

1. If an individual establishes a revocable trust agreement, then the individual must include all of the trust's gross income in the individual's gross income and the individual will benefit from all of the trust's income tax deductions and credits. Read section 671 et seq.

a. The reason for this is because the individual retained too much control over the trust principal, and therefore, the individual is considered to own the trust principal and if an individual is considered to own principal, then the individual is considered to be income taxable on the gross income which the principal generates.

2. In this situation, the trust (the fiduciary thereof) does not have any separate gross income and deductions. Instead, the individual who has the power to revoke the trust agreement is

considered to be entitled to all of the trust's income, deductions, and credits. Read section 672 et seq.

C. Irrevocable trusts - in general.

1. Normally, irrevocable trusts are income taxed in the same manner as individuals. Read section 641(b).
   a. However, an irrevocable trust is both a conduit and a taxable entity, unless, e.g., the grantor of the trust keeps to much control over the trust, e.g., the power to change the beneficiaries, even though that individual does not have the power to revoke the terms of the trust agreement. This latter result is caused by the provisions of section 671 et seq.
   b. Therefore, if an irrevocable trust distributes funds to a beneficiary, then the trust is to deduct the distribution from the trust's current income and the recipient beneficiary of the trust is to include the distribution in the recipient beneficiary's gross income to the extent that the distribution is attributable to the trust's current income.
      (1) In such a case, the trust is income taxed on the current income which the trust did not distribute and the recipient beneficiary is income taxed on the income which the beneficiary received from the trust.
2. Read the following sections.
   a. Section 641 states that such trusts are, in general, to compute their taxable incomes in the same manner as individuals do.
   b. Section 651 and section 661 provide such trusts with distribution deductions with respect to the distributions which such trusts make from their current income to their beneficiaries.
   c. Section 652 and section 662 provide that the recipient beneficiaries of such trusts are to include such distributions in the beneficiaries' gross incomes to the extent that such distributions are attributable to the current gross income of such trusts.
   d. If such trusts distribute more than the current income of such trusts to such beneficiaries, then the distributes are attributable to the principal of the trusts (or to the accumulated income of such trusts, which is treated as principal of such trusts) and the recipient beneficiaries are not be income taxed on these latter distributions.
   e. Section 1(e) provides the separate income tax rates which are attributable to the taxable incomes of fiduciaries (both trusts and estates).
3. If an individual establishes an irrevocable trust, but the individual retains too much control over the trust property which would be subject to the provisions of section 671 et seq), then the individual must include all of the trust's gross income in the individual's gross income, but the individual will benefit from all of the trust's income tax deductions and income tax credits. Read section 671 et seq.
4. As stated above, if an individual establishes a revocable trust, then the individual must include all of the trust's gross income in the individual's gross income and the individual will benefit from all of the trust's income tax deductions and credits. Read section 671 et seq.
   a. The reason for this is because the individual retained too much control over the trust principal, and therefore, the individual is considered to own the trust property/principal and if an individual is considered to own property/principal, then the individual is considered to be income taxable on the gross income which the property/principal generates.
5. If an individual establishes an irrevocable trust, but the individual retains too much control over the trust property, then the individual must include all of the trust's gross income in the individual's gross income, but the individual will benefit from all of the trust's income tax deductions and income tax credits. The power to revoke a trust is the most powerful power that an individual might hold. However, holding one or more of other types of powers can have the same income tax result to the holder, the trust, and the beneficiaries thereof, e.g., holding the power to change the beneficiaries of the trust. Read section 671 et seq.

6. As a general rule, all gross income received by an irrevocable trust is includible in the trust's gross income.
7. In the case of an irrevocable trust, if the trust's gross income is required to be distributed to a beneficiary, then the trust will include such gross income in the trust's gross income, and then, the trust may take an income tax deduction (against the trust's gross income) for the gross income which is distributed to such beneficiary.
8. Normally, capital gains and losses are treated as gains and losses of a trust's principal and are not passed through to the beneficiaries to be income taxed to the beneficiaries. Instead, a trust's capital gains are generally considered to be gross income to be income taxed to the trust after offsetting, e.g., capital losses.

D. <u>The order in which a fiduciary treats its distributions to its beneficiaries</u>.
1. The order in which a trust (which is not subject to the provisions of section 671 et seq) is to treat its distributions to its beneficiaries.
2. In general, except for distributions which are referred to as "section 663 distributions", a fiduciary's distributions are first attributable to the fiduciary's current income and such distributions are deductible as ordinary deductions to the fiduciary currently and such distributions are includible in the beneficiary's gross income as ordinary gross income.
   a. Thereafter, all distributions are attributable to principal of the fiduciary, which consists of initial principal, appreciation thereon, and accumulated income (which is treated as principal, because such amounts have already been income taxed to the fiduciary).
   b. The capital gains and losses of a fiduciary are generally considered to be attributable to the principal of a fiduciary and kept by the fiduciary, until the fiduciary distributes the fiduciary principal to the remainder person.
      (1) Of course, a fiduciary could have the power to distribute all or some of the fiduciary's principal to all or some of the beneficiaries during the taxable years which precede the final taxable year of the fiduciary.
   c. Therefore, such gross income will not be income taxed twice, as in the case of dividends disbursed by a C corporation.
   d. If a fiduciary distributes to beneficiaries an amount which is more than the fiduciary's ordinary net book income, then the beneficiary will, as a general rule, receive such additional amount from the fiduciary's principal or from the fiduciary's accumulated income - - - which is also treated as the fiduciary's principal, because the accumulated income has already been income taxed to the fiduciary prior to the accumulation, by the fiduciary, of such income.
      (1) Any principal which is distributed by a fiduciary to a beneficiary is not deductible by the fiduciary and it is not income taxed to the recipient beneficiary.

E. <u>What income of a fiduciary is income taxed to the fiduciary?</u>
1. A fiduciary will generally be income taxed on all ordinary income which the fiduciary does not distribute to the beneficiaries of the fiduciary, and in addition, the fiduciary will also be income taxed on the net of the fiduciary's capital gains and losses.
   a. The net capital gain and the ordinary income on which a fiduciary is income taxed will then become principal (technically, accumulated income, which is treated the same as principal).
   b. That is, if such principal or accumulated income is later distributed to the fiduciary's beneficiaries, such recipient beneficiaries will not be income taxed on any of such distribution, because such distribution has already been income taxed to the fiduciary.
   c. And, as previously stated, a fiduciary may not deduct distributions of principal to beneficiaries.
2. The reason why accumulated income should be referred to as "accumulated income" is not

a tax reason. Instead, the reason is to have a clear record of how much income has been accumulated in the event that the fiduciary were required to distribute all or some of the accumulated income to a beneficiary at some point during the administration of the fiduciary.

3. Example. An irrevocable trust has gross income of $20,000 for the current taxable year. Also, the trust has expenses of $2,000 and the trustee, through a discretionary power, distributes $4,000 of the trust's net book income to John, a beneficiary. The trust's taxable income for the current taxable year is as follows.

Taxable interest income	$ 20,000
Minus: expenses	2,000
Minus: personal exemption	100
Taxable income prior to the distribution deduction	17,900
Distribution	4,000
Taxable income	$ 13,900

   a. John must include the distribution of $4,000 from the trust in John's gross income.
   b. If the trust had distributed $30,000 to the trust's beneficiaries, then the trust's distribution deduction would have been $18,000 and John would have been income taxed on $18,000 of ordinary interest income and the remaining amount of the $30,000 distribution, specifically, the amount of $12,000 (30,000 - 18,000) would not be income taxed to John, because the distribution would have come from the principal of the trust.

F. A little repetition does not hurt.

1. Read section 671 et seq.
2. Trusts and estates are both taxable entities and conduits.
3. If an individual establishes a revocable trust, then the individual must include all of the trust's gross income in the individual's gross income and the individual will benefit from all of the trust's income tax deductions and credits. Read section 671 et seq.
   a. The reason for this is because the individual retained too much control over the trust principal, and therefore, the individual is considered to own the trust principal and if an individual is considered to own principal, then the individual is considered to be income taxable on the gross income which the principal generates.
4. If an individual establishes an irrevocable trust, but the individual retains too much control over the trust property, then the individual must include all of the trust's gross income in the individual's gross income, but the individual will benefit from all of the trust's income tax deductions and income tax credits. Read section 671 et seq.
5. Example. John transferred $100,000 to an irrevocable trust with the net income to be distributed to Sue for life, remainder to Peter. During the current taxable year the trust had gross income (interest) of $10,000 and also the trust principal appreciated in fair market value by $10,000. The trust's gross income for the current taxable year is includible in Sue's gross income, even if the trust's gross income is not distributed to Sue during the current taxable year, because Sue is entitled to the gross income. Read section 652(a). The appreciation is not includible in either the trust's or Sue's gross income, because the appreciation has not ripened into income.
   a. When Sue dies, Peter is to receive all of the principal which remains in the trust. However, the principal will not be includible in Peter's gross income because the principal is a gift to Peter. The actual receipt, by Peter, of the funds which constitute the gift are merely delayed. Read section 102(a).
   b. The mechanics of income taxing Sue on the trust's gross income is to have the trust include the gross income in the trust's gross income, and then, to allow the trust an income tax deduction for the income which is distributed to Sue, and then, to require Sue to include the trust's gross income in Sue's gross income.
   c. Therefore, such gross income will not be income taxed twice, as in the case of dividends distributed by a C corporation to the C corporation's shareholders.

G. Generally, all gross income received by a fiduciary is includible in the fiduciary's gross income.

1. As a general rule, all gross income received by a trust (which is not subject to the provisions of section 671) is includible in the trust's gross income.
2. In the case of an irrevocable trust and an estate, if the fiduciary's gross income is required to be distributed to a beneficiary, then the fiduciary will include such gross income in the fiduciary's gross income, and then, the fiduciary may take an income tax deduction (against the fiduciary's gross income) for the gross income which is distributed to such beneficiary.
3. Normally, capital gains and losses are treated as gains and losses of a fiduciary and not be passed through to the beneficiaries to be income taxed to the beneficiaries. Instead, the net capital gain will be income taxed to the fiduciary.

H. The order in which a fiduciary is to treat distributions to beneficiaries as income or principal

1. The order in which a trust (which is not subject to the provisions of section 671 et seq) is to treat its distributions to its beneficiaries is as follows.
2. In general, except for distributions which are referred to as "section 663 distributions", a fiduciary's distributions are first attributable to the fiduciary's current income and such distributions are deductible as ordinary deductions to the fiduciary currently and such distributions are includible in the beneficiary's gross income as ordinary gross income.
   a. Thereafter, all distributions are attributable to principal, which consists of initial principal, appreciation thereon, and accumulated income (which is treated as principal, because such amounts have already been income taxed to the fiduciary).
   b. The capital gains and losses of a fiduciary are generally attributable to the principal of a fiduciary.
   c. Therefore, such gross income will not be income taxed twice, as in the case of dividends disbursed by a C corporation.
   d. If a fiduciary distributes to beneficiaries an amount which is more than the fiduciary's ordinary net book income, then the beneficiary will, as a general rule, receive such additional amount from the fiduciary's principal (or from the fiduciary's accumulated income - - - which is also treated as the fiduciary's principal) and such additional amount will not be income taxed to the beneficiary recipients.

I. A section 663 distribution.

1. In a nutshell, section 663 provides that if an individual is devised through a will or granted through a fiduciary agreement a specific amount of money or property, then when the money or property is received by the beneficiary, the estate or trust, as the case may be, is not entitled to an income tax deduction for such amount and the recipient beneficiary is not required to include that amount in the recipient beneficiary's gross.
   a. Instead, for these two purposes, the distribution is consider to be attributable to a distribution of principal, which is not deductible by the fiduciary and not includible in the recipient beneficiary's gross income.

J. Again, what income of a fiduciary is income taxed to the fiduciary?

1. A fiduciary will generally be income taxed on all ordinary income which the fiduciary does not distribute to the beneficiaries of the fiduciary, and in addition, the fiduciary will also be income taxed on the net of the fiduciary's capital gains and losses.
   a. The net capital gain and the ordinary income on which a fiduciary is income taxed will then become principal (technically, accumulated income, which is treated the same as principal).
   b. That is, if such principal or accumulated income is later distributed to the fiduciary's beneficiaries, such recipient beneficiaries will not be income taxed on any of such distribution, because such distribution has already been income taxed to the fiduciary.
2. The reason why accumulated income should be referred to as "accumulated income" is not

a tax reason. Instead, the reason is to have a clear record of how much income has been accumulated in the event that the fiduciary were required to distribute all or some of the accumulated income to a beneficiary at some point during the administration of the trust.

3. Example. An irrevocable trust has gross income of $20,000 for the current taxable year. Also, the trust has expenses of $2,000 and the trustee, due to a mandatory power, distributes $4,000 of the trust's net book income to John, a beneficiary of the trust. The trust's taxable income for the current taxable year is as follows.

Taxable interest income	$ 20,000
Minus: expenses	2,000
Minus: personal exemption	300
Taxable income prior to the distribution deduction	17,700
Distribution	4,000
Taxable income	$ 13,700

   a. John must include the distribution of $4,000 from the trust in John's gross income.
   b. If the trust had distributed $30,000 to the trust's beneficiaries, then the trust's distribution deduction would have been $18,000 and John would have been income taxed on $18,000 of ordinary interest income and the remaining amount of the $30,000 distribution, specifically, the amount of $12,000 (30,000 - 18,000) would not be income taxed to John, because the distribution would have come from the principal of the trust.

K. A section 663 distribution.

1. In a nutshell, section 663 provides that if an individual is devised through a will or granted through a trust agreement a specific amount of money or property, then when the money or property is received by the beneficiary, the trust or estate, as the case may be, is not entitled to an income tax deduction for such amount and the recipient beneficiary is not required to include that amount in the recipient beneficiary's gross.
   a. Instead, for these two purposes, the distribution is consider to be attributable to a distribution of principal, which is not deductible by the fiduciary and not includible in the recipient beneficiary's gross income.

L. Some examples.

1. Example. John transferred $100,000 to an irrevocable trust with the net income to be distributed to Sue for life, remainder to Peter. During the current taxable year the trust had gross income (interest) of $10,000 and also the trust principal appreciated in fair market value by $10,000. The trust's gross income for the current taxable year is includible in Sue's gross income, even if the trust's gross income is not distributed to Sue during the current taxable year, because Sue is entitled to the gross income. Read section 652(a). The appreciation is not includible in either the trust's or Sue's gross income, because the appreciation has not ripened into income.
   a. When Sue dies, Peter is to receive all of the principal which remains in the trust. However, the principal will not be includible in Peter's gross income because the principal is a gift to Peter. The actual receipt, by Peter, of the funds which constitute the gift are merely delayed. Read section 102(a).
   b. The mechanics of income taxing Sue on the trust's gross income is to have the trust include the gross income in the trust's gross income, and then, to allow the trust an income tax deduction for the income which is distributed to Sue, and then, to require Sue to include the trust's gross income in Sue's gross income.
   c. Therefore, such gross income will not be income taxed twice, as in the case of dividends distributed by a C corporation to the C corporation's shareholders.
2. Example. John transferred $100,000 to an irrevocable trust with the net income to be distributed to Sue for life, remainder to Peter. During the current taxable year the trust had gross income (interest) of $10,000 and also the trust principal appreciated in fair market value by $10,000. The trust's gross income for the current taxable year is includible in Sue's

gross income, even if the trust's gross income is not distributed to Sue during the current taxable year, because Sue is entitled to the gross income. Read section 652(a). The appreciation is not includible in either the trust's or Sue's gross income, because the appreciation has not ripened into income.

a. When Sue dies, Peter is to receive all of the principal which remains in the trust. However, the principal will not be includible in Peter's gross income because the principal is a gift to Peter. The actual receipt, by Peter, of the funds which constitute the gift are merely delayed. Read section 102(a).

b. The mechanics of income taxing Sue on the trust's gross income is to have the trust include the gross income in the trust's gross income, and then, to allow the trust an income tax deduction for the income which is distributed to Sue, and then, to require Sue to include the trust's gross income in Sue's gross income.

c. Therefore, such gross income will not be income taxed twice, as in the case of dividends distributed by a C corporation to the C corporation's shareholders.

d. In general, the "first dollar" distributed by a trust to a beneficiary is attributable to the current income of the trust and the "second dollar" which is distributed by the trust to a beneficiary is from the accumulated income (which is treated as principal, because the accumulated income has been previously income taxed to the trust) and other principal of the trust.

M. <u>Some comments which are particularly directed to estates</u>.

1. If an individual dies, then individual's estate (the fiduciary of the individual's estate) must include all of the estate's gross income in the estate's income tax computation and not in the decedent's gross income and the estate will benefit from all of the estate's income tax deductions and credits.

   a. Section 671 et seq does not apply to estates because the grantor is dead.

   b. Further, the decedent's final income tax return will include the gross income and deductions and credits which were available to the decedent, while the decedent was alive, using the applicable method of accounting of the decedent.

2. Clearly, an estate is not easily compared with a revocable trust or any other trust which is subject to the provisions of section 671 et seq.

3. Equally clear is that an estate is subject to almost all of the income tax provisions which are applicable to irrevocable trusts.

4. Normally, estates are income taxed in the same manner as individuals. Read section 641(b).

   a. However, an estate is both a conduit and a taxable entity.

   b. Therefore, if an estate distributes funds to a beneficiary, then the estate is to deduct the distribution from the estate's current income and the recipient beneficiary of the estate is to include the distribution in the recipient beneficiary's gross income to the extent that the distribution is attributable to the estate's current income.

   c. In such a case, the estate is income taxed on the current income which the estate did not distribute and the recipient beneficiary is income taxed on the income which the recipient beneficiary received from the estate.

5. Read the following sections.

   a. Section 641 states that estates are, in general, to compute their taxable incomes in the same manner as individuals do.

   b. Section 661 provides estate's with distribution deductions for distributions which estates make to their beneficiaries.

   c. Section 662 provides that the beneficiaries of estates are to include such distributions in the beneficiaries' gross incomes to the extent that such distributions are attributable to the current gross income of the estates.

      (1) If an estate distributes more than the current income of the estate to a beneficiary of the estate, then the distribution is attributable to the principal of the estate (or to the accumulated income of the estate, which is treated as principal of the estate) and the beneficiaries will not be income taxed on

these latter distributions.

d. Section 1(e) provides the separate income tax rates which are attributable to the taxable incomes of fiduciaries (both trusts and estates).

6. As a general rule, all gross income received by an estate is includible in the estate's gross income.

7. If an estate's gross income is required to be distributed to a beneficiary, then the estate will include such gross income in the estate's gross income, and then, the estate may take an income tax deduction (against the estate's gross income) for the gross income which is distributed to such beneficiary.

8. Normally, capital gains and losses are treated as gains and losses of an estate's principal and are not passed through to the beneficiaries to be income taxed to the beneficiaries. Instead, a estate's capital gains are generally considered to be gross income to be income taxed to the estate after offsetting, e.g., capital losses.

N. <u>The order in which an estate's distributions are required to be made</u>.

1. In general, except for distributions which are referred to as "section 663 distributions", an estate's distributions are first attributable to the estate's current income and such distributions are deductible as ordinary deductions by the estate currently and such distributions are includible in the beneficiary's gross income as ordinary gross income.

a. Thereafter, all distributions are attributable to principal of the estate, which consists of initial principal, appreciation thereon, and accumulated income (which is treated as principal, because such additional amounts have already been income taxed to the trust).

b. The capital gains and losses of an estate are generally attributable to the principal of an estate and kept by the estate, until the estate distributes the estate principal to the remainder person.

(1) Of course, an estate could have the power to distribute all or some of the estate's principal to all or some of the beneficiaries during the taxable years which precede the final taxable year of the estate.

c. Therefore, such gross income will not be income taxed twice, as in the case of dividends disbursed by a C corporation.

d. If an estate distributes to beneficiaries an amount which is more than the estate's ordinary net book income, then the beneficiary will, as a general rule, receive such additional amount from the estate's principal or from the estate's accumulated income - - - which is also treated as the estate's principal, because the accumulated income has already been income taxed to the estate prior to the accumulation, by the estate, of such income.

(1) Any principal which is distributed by an estate (or a trust) to a beneficiary is not deductible by the estate and that distribution is not income taxed to the recipient beneficiary.

O. <u>What income of an estate is income taxed to the estate?</u>

1. An estate will generally be income taxed on all ordinary income which the estate does not distribute to the beneficiaries of the estate, and in addition, the estate will also be income taxed on the net of the estate's capital gains and losses.

a. The net capital gain and the ordinary income on which an estate is income taxed will then become principal (technically, accumulated income, which is treated the same as principal).

b. That is, if such principal or accumulated income is later distributed to the estate's beneficiaries, such recipient beneficiaries will not be income taxed on any of such distribution, because such distribution has already been income taxed to the trust.

c. And, as previously stated, a fiduciary may not deduct distributions of principal to beneficiaries.

2. The reason why accumulated income should be referred to as "accumulated income" is not

a tax reason. Instead, the reason is to have a clear record of how much income has been accumulated in the event that the estate were required to distribute all or some of the accumulated income to a beneficiary at some point during the administration of the estate.

3. Example. An estate has gross income of $20,000 for the current taxable year. Also, the estate has expenses of $2,000 and that the estate distributes $4,000 of the estate's net book income to John, a beneficiary. The estate's taxable income for the current taxable year is as follows.

Taxable interest income	$ 20,000
Minus: expenses	2,000
Minus: personal exemption	600
Taxable income prior to the distribution deduction	17,400
Distribution	4,000
Taxable income	$ 13,400

a. John must include the distribution of $4,000 from the estate in John's gross income.

b. If the estate had distributed $30,000 to the estate's beneficiaries, then the estate's distribution deduction would have been $18,000 and John would have been income taxed on $18,000 of ordinary interest income and the remaining amount of the $30,000 distribution, specifically, the amount of $12,000 (30,000 - 18,000) would not be income taxed to John, because the distribution would have come from the principal of the estate.

P. A section 663 distribution.

1. In a nutshell, section 663 provides that if an individual is devised by a land will and testament or granted by a trust agreement a specific amount of money or property, then when the money or property is received by the beneficiary, the trust or estate, as the case may be, is not entitled to an income tax deduction for such amount and the recipient beneficiary is not required to include that amount in the recipient beneficiary's gross.

a. Instead, for these two purposes, the distribution is consider to be attributable to a distribution of principal, which is not deductible by the fiduciary and not includible in the recipient beneficiary's gross income.

Q. Fiduciary income tax rates (for both trusts and estates).

1. Fiduciaries are subject to income taxation and the income tax rates of section 1(e) of: 10%; 15%; 25%; 28%; 33%; and, 35%.

2. The alternative minimum tax of section 55 also can apply to fiduciaries with income tax rates of 26% and 28%.

3. In general, if a fiduciary distributes any current income to a beneficiary of a trust or an estate, then the beneficiary is income taxed on such distributed current income and the fiduciary may deduct the income (so distributed) and the fiduciary is income taxed on the current income which the fiduciary keeps.

4. Thus, in this sense, a fiduciary is a passthrough entity. However, in the case of a fiduciary, the passthrough aspect means that, in general, the fiduciary must distribute cash or property which is attributable to current income to a beneficiary in order for the beneficiary to be income taxed on the fiduciary's current income.

a. In the case of other passthrough entities, the "owners" of the businesses are income taxed on the current net income of the entity (and may deduct the net losses of the entity) even though the entity does not make any distribution to such owners.

b. A "pure" passthrough entity (e.g., general partnerships, limited partnerships, limited liability companies, and S corporations) will generally be income taxed on the gross income (after offsetting the proper deductions) which the passthrough entity receives and that is so whether or not the passthrough entity makes any distributions to the owners of the entities.

R. Comparisons and contrasts of computations of fiduciary and traditional passthrough entity.

1. All passthrough entities must computed what could be called "DNI", which is nothing more than the current income of the entity for each year minus the expenses which are attributable to such current income.
   a. In the case of, e.g.,partnerships, limited liability companies, and S corporations, each year, they each must make a table which is similar to the table that is used by fiduciaries of trusts and estates for the purpose of determining the fiduciary's distributable net income.
   b. Such a table lists the types of current net income that the passthrough entity has, and then, allocates the entity's expenses to the proper type of current income.
   c. Then, the net amount of each column is inserted on the applicable K-1 and distributed to the partners (of a partnership) and the members (of an llc) and the shareholders (of an S corporation).
   d. That is, all of the current net income of the traditional passthrough entities is passed through to such owners whether or not all or any of such current net income is, in fact, distributed to all or any of such owners.
   e. And, such current net income passes through to such owners in the same character of each type of income that such income is characterized to the fiduciary.
2. With respect to current net losses, such losses passthrough to such owners of partnerships, llcs, and S corporation, but as you will see, the deductions which such owners of such passthrough entities might deduct for such current net losses are limited by two or three of the following limitations.
3. That is, the owner may deduct such net loss only to the extent of the lower of:
   a. The amount of the net loss;
   b. The owner's adjusted basis for the owner's ownership interest in the entity;
   c. And, if the net loss is a passive loss to the owner, then to the extent of the amount of any passive gain which the owner has.
4. If there is any net loss remaining after applying the above three limitations, such net losses may carryover to be deducted in future taxable years, again, through the same limitations. Further, if a particular category of passthrough income results in a net loss (of that category), then that negative amount is passed through to such owners as a negative amount and it is deductible, as a general rule, in arriving at an individual recipient's adjusted gross income. For example, if a current net category is passed through to an owner as a negative amount (e.g., gross rent of $10,000 minus expenses attributable to rent of $12,000, which provides a loss of net rent of $2,000), then such current net rent loss is generally deductible by an individual recipient in arriving at such individual's adjusted gross income).
5. Further, if one type of net current income consists of tax exempt income (e.g., income which is excluded from the recipient's gross income, e.g., interest on state or local bonds is excluded from gross income by section 103, then that excluded income passes through to the beneficiary as excluded income.
6. In the case of a fiduciary (of a trust or an estate), capital gains and capital losses are generally defined as being principal and they are generally retained by the entity (the fiduciary) and are income taxed to the entity, whereas ordinary income, .e.g., dividends, interest, rents, etc., are listed on the "table" and from them are subtracted the applicable expenses and the resulting net amount of each column of current income is passed through to the beneficiary (or beneficiaries) depending on the amount of cash (or the value of other property) which is distributed to the beneficiary (or beneficiaries).
7. Thus, in the case of the traditional passthrough entities (e.g., partnerships, llcs, and s corporations), all of the net current income is passed through for income tax purposes from the entity to the partner, member, and shareholder, as the case may be, whether or not all or any of that net current income is treated as being distributed to such a partner, member, or shareholder. However, in the case of fiduciaries, the beneficiary (or beneficiaries) is only income taxed on the net current income which is attributable to a distribution of money or property to the beneficiary (or beneficiaries) and the net current income (and generally the net capital gains) which are retained by the fiduciary are income taxed to the fiduciary. As

stated above, if one or more categories of current net income which is included in DNI and which passes through to a beneficiary (or beneficiaries) consist of net excluded income, e.g., state and local bond interest which is excluded by section 102, then that excluded current net income which is included in DNI is excluded from the recipient's (or recipients') gross income.

8. For the purposes of the income tax course which I teach, there are only three types of trust examples, which involve some more detailed computations.
   a. The first example deals with a simple trust with respect to which the fiduciary distributes all (but only all) of the trust's current net income (i.e., the fiduciary distributes, e.g., cash or property which is equal to the total amount of distributable net income (DNI). Because all of DNI is distributed to the recipient (or recipients), the fiduciary is only income taxed on the net capital gains and not income taxed on any of DNI.
   b. The second example deals with a simple trust with respect to which the fiduciary distributes more than the amount of the total of distributable net income. In this case, the excess of the distribution comes from the principal of the trust which is not income taxed to the beneficiary (or beneficiaries). Therefore, again, the recipient (or recipients) of the distribution is income taxed on the amount of DNI in the same manner as in the first example above, excluding, as stated above, any current net excludable income.
   c. The third example deals with a complex trust with respect to which the fiduciary distributes less than the amount of the total of distributable net income. In this case, there is no amount of the distribution which is attributable to principal of the trust unless a section 663 distribution has been made to a particular beneficiary. Therefore, the recipient (or recipients) of the distribution is income taxed only on the amount of DNI (except for the portion of DNI which is attributable to current excluded net income) which is attributable to the distribution which such beneficiary (or beneficiaries) receive from the fiduciary. As to the character of the amount of DNI which is attributable to the distribution which is made to a particular beneficiary, the amount of each category of current net income (DNI) is determined by using the separate percentage that each separate amount of current net income is of the total of DNI multiplied times the amount of the distribution of current net income that is made to such beneficiary.
9. As you reflect on all of this, remember that the first dollar and all of the rest of the dollars distributed by a trust or an estate will be attributable to the trust's or estate's current income and that no principal will be considered to be distributed to a beneficiary until all of the current income has been distributed WITH THE EXCEPTION OF A SECTION 663 DISTRIBUTION (WHICH WILL COME FIRST FROM PRINCIPAL). Specifically, if a trust agreement grants or a last will and testament devises a specific amount of money or other property to, e.g., an individual, then that is a section 663 transfer which means that the fiduciary may not take a distribution deduction for the money or property and the recipient is not required to include the amount of money nor the value of the other property in the recipient's gross income.
10. If a traditional passthrough entity has a deductible net loss in one of the columns of income which is to be allocated to an owner, then such net loss is deductible to the owner, subject to two or three limitations. That is, the owner may deduct such loss only to the extent of the lower of:
    a. The amount of the net loss;
    b. The owner's adjusted basis for the owner's ownership interest in the entity;
    c. And, if the loss is a passive loss to the owner, then to the extent of the amount of any passive gain which the owner has.
11. A beneficiary of a trust or estate does not have an adjusted basis for the beneficiary's interest in the trust or estate.
12. If a fiduciary has a net loss in one of the columns of current income which is to be allocated

to a beneficiary, then unlike the passthrough treatment of such a net loss of a traditional passthrough entity (which is subject to the three possible limitations), such a net loss of a fiduciary is NOT deductible by a beneficiary of a trust or an estate unless that loss occurs in the last taxable year of the trust or estate or the net loss is carried over to the last taxable year of the trust or estate.

13. That is, a net loss of a trust or estate does not pass through to a beneficiary of a trust or estate in the taxable year in which that loss occurs unless the net loss occurs in the last taxable year of the trust or estate or unless the net loss is a net operating loss which carries over to the beneficiary of the trust or estate from the last taxable year of the trust or estate.
    a. That is, if a net loss of a trust or estate occurs in a taxable year prior to the last taxable year of the trust or estate and the character of such net loss is either a net capital loss or a net operating loss either of which or both of which carries over from the taxable year in which the net loss occurs is carried over to the last taxable year of the trust or estate, and then, carries over to the beneficiary of the trust or estate may not deduct such a net loss unless the loss meets the provisions of section 642(h).
    b. There is one other deduction which passes through from a trust or estate to a beneficiary.
        (1) The deduction is referred to as an "excess deduction", i.e., it is a deduction which consists of all other expenses (other than operating losses and capital losses) which exceed all types of business income and capital gains of the trust or estate.
        (2) This deduction does not carry over from year to year at the trust or estate level. However, if it is created in the final year of a trust or estate, then to the extent that the deductions in this category exceed the income in this category such excess will pass through from the trust or estate, pro rata to the beneficiaries of the trust or estate.

X. <u>S corporations and their shareholders</u>.

A. <u>The eighth statutory exception involves S corporations</u>.
1. Read section 1374 et seq.
2. Most individuals who are well-educated with respect to the assignment of income doctrine and who are also familiar with S corporations would not think that S corporations and their shareholders involve the assignment of income doctrine.
    a. However, it does not take much imagination to see that this situation is one in which one person (the S corporation) is entitled to some gross income and the other person (the shareholders) report the gross income.
    b. Of course, the main difference has to do with "who is to pay income tax with respect to the income" and in this case, the income tax is not being shifted from the corporate income tax rates to the individual income tax rates unless you accept the notion that - - - that is precisely what happens with the S corporation election.

XI. <u>Corporate reorganizations</u>.

A. <u>The statutory exception involves corporate reorganizations</u>.
1. Read section 368.
2. There are many types of corporate reorganizations, but the clearest examples of exceptions to the assignment of income doctrine are the reorganizations which involve the transfer of assets of one corporation to another corporation.
    a. Examples of these types of reorganizations are referred to in section 368(a)(1).
        (1) Section 368(a)(1)(A) which involves a statutory merger or consolidation.
        (2) Section 368(a)(1)(C) which involves the transfer of assets of a corporation to another corporation in return for the latter corporation's stock.

(3) Section 368(a)(1)(D) which involves corporate divisions.

3. Each of these transactions involves the transfers of assets from one corporation to another and if the reorganization is properly executed, then the corporation which transfers its assets to another corporation will not recognize any gain even if the transfer involves assets with respect to which there is accrued income.

XII. Below market interest loans.

A. The tenth statutory exception involves below market interest loans.

1. Read section 7872.
2. Certain loans made at below-market interest rates are treated as if the lender made a transfer of the foregone interest to the borrower and as if the borrower re-transferred such interest to the lender.
3. The assumed transfer of the foregone interest by the lender to the borrower is treated as a gift, compensation for services, a dividend, etc., in accordance with the nature of the transfer.
4. The assumed retransfer of the interest to the lender by the borrower is treated as a payment of interest by the borrower, resulting in interest income to the lender and a possible income tax deduction for interest paid to the borrower.

B. Section 7872 applies to the following types of below-market loans.

1. Gift loans.
2. Compensation-related loans between an employer and employee, or between an independent contractor and a person for whom the contractor performs services.
3. Corporate-shareholder loans.
4. Loans with a tax avoidance purpose for the interest arrangement.
5. Other loans specified in the U.S. Treasury Regulations if the interest arrangement has a "significant effect" on the federal tax liability of the lender or the borrower. Read section 7872(c)(1).

C. Some important comments about gift loans.

1. Gift loans aggregating $10,000 or less between any two individuals are not subject to section 7872 unless the loan is used by the borrower to purchase or carry income-producing property. Read section 7872(c)(2).
2. In the case of gift loans aggregating $100,000 or less, the amount of investment income is limited to the borrower's net investment income, unless tax avoidance is one of the principal purposes of the interest arrangement under the loan.
   a. Net investment income of $1,000 or less is disregarded. Read section 7872(d).

D. Some additional comments about the treatment of below interest loans.

1. The interest rate for determining whether or not a loan is below-market and for determining the amount of interest foregone is the applicable federal rate (AFR), which is determined monthly by the IRS through section 1274(d) for three categories of obligations: short term (three years or less); mid term (three to nine years); and long term (over nine years).
2. If the loan is repayable on demand (a demand loan), then the imputed interest is computed on a daily basis using the federal short term rate in effect through section 1274(d). Read section 7872(f)(2)(b).
   a. The interest is deemed to be transferred by the lender and repaid by the borrower on the last day of each calendar year during which the loan is outstanding. Read section 7872(a)(2).
   b. If the loan required interest of 6% annually and the applicable federal rate were 10%, then the imputed interest would be 4%, or $4,800 each taxable year.
   c. In the case of a loan for a fixed period (a term loan), then the applicable interest rate is the applicable federal rate (AFR) in effect through section 1274 at the time the loan is made. Read section 7872(f)(2)(a).

(1) The excess of the amount loaned over the present value of the scheduled repayments is treated as a transfer from the lender to the borrower at the time the loan is made. Read section 7872(b)(1).

3. In the case of a gift loan, the imputed interest is computed and deemed paid by the borrower to the lender as of the last day of each calendar year, as in the case of a demand loan. Read section 7872(a).

a. For other term loans, however, the excess of the amount loaned over the present value of scheduled repayments is treated as original issue discount, to be taken into income by the lender and deducted by the borrower over the term of the loan in accordance with the original issue discount rules in section 1272. Read section 7872(b).

4. If the loan is a compensation-related or corporate-shareholder loan, however, then foregone interest is to be computed by comparing the amount of future payments to be received by Mary ($120,000) with the present value of those payments ($99,174, computed by discounting $120,000 to present value using a discount rate equal to the applicable federal rate of 10%). The accrual of $20,826 is reported as interest received by Mary and paid by Beverly in accordance with the original issue discount rules, as follows:

Year 1: $99,174 x 10% = $9,917

Year 2: $109,091 x 10% = $10,909

a. An exclusion is provided for compensation-related and corporate-shareholder loans aggregating $10,000 or less (a de minibus exclusion), unless one of the principal purposes of the interest arrangement under the loan is tax avoidance. Read section 7872(c)(3).

E. Some examples.

1. Example. On January 1, John loaned $120,000 to Peter, payable on demand with no interest. If the applicable federal rate is 10% compounded annually, then the foregone interest is $12,000 for each taxable year during which the loan is outstanding. John has ordinary gross income (interest income), for each of such taxable years, and Peter has an ordinary income tax deduction for the same amount, subject to the limitations with respect to interest income tax deductions.

2. Example. On January 1, Mary loaned $120,000 to Beverly for two years with no interest. If the applicable federal rate is 10% compounded annually, then the foregone interest for a gift loan is $12,000 each taxable year. This amount is treated as interest paid by Beverly and received by Mary on the last day of each calendar year.

Some Tax Procedures

I. A little bit of tax procedure. The many problems can be caused if you do not follow the tax procedure provisions in these tax texts. Some of the important concepts of tax procedure are as follows.

A. The number of days that a taxpayer has to file a petition in the United States Tax Court.

1. After receiving a notice of deficiency, the taxpayer has 90 days to file a petition in the United States Tax Court and, as a general rule, the 90-day period may not be extended by the IRS or by anyone else, though in very rare circumstances the United States Tax Court has accepted a late filed petition. Read section 6213.

B. The name of the court in which the taxpayer may file a petition without paying the disputed tax.

1. The name of the only court in which a taxpayer may file a petition to have the taxpayer's controversy heard without paying the tax in advance is: United States Tax Court.

C. The name of the two courts in which a taxpayer may file a complaint for a tax refund.

1. The names of the only two courts in which a taxpayer may file a complaint in order to have the taxpayer's controversy heard after paying all of the taxes in controversy and interest

thereon and after filing a claim for refund with the IRS and having the claim disallowed are: United States District Court; and, United States Court of Federal Claims.

D. The percent of the tax which a taxpayer owes due to a negligence penalty.

1. The percent of the tax which a taxpayer owes as a penalty due to negligence of, e.g., preparing the taxpayer's return is: 20% of the understatement of tax. Read section 6662.

E. The percent of the tax which a taxpayer owes due to the fraud penalty.

1. The percent of the tax which a taxpayer owes as a penalty due to fraud of, e.g., preparing the taxpayer's return is: 75% of the tax omitted due to the fraud. Read section 6663.