1. Is the distinction between an exclusion and a deduction the above/below line distinction? Or is there more of a difference between the terms?

The terms are much different.

An exclusion (such as for section 102 and gifts or for 132 and employee discounts) never appears on your tax return – it is not part of gross income.

A deduction (such as for 162 business expenses) appears on your tax return as a subtraction from income: you pay tax on the difference.

An above the line deduction (those listed in section 62) always make it to your tax return. A below the line deduction (all deductions not listed in section 62) are subject to many limitations and may, or may not, show up on your tax return. Thus, sometimes it makes no difference whether a deduction is “above” or “below”; however, often it does matter, so, on balance, you’d rather have the “above” type. Look at section 62 for the list.

2. In 108(e)(4), I’m not sure I understand the mother-in-law thing. Am I right in saying that if a man buys his mother-in-law’s debt, this paragraph does not apply and it’s like regular DOI, but if his mother-in-law buys his debt, this paragraph applies and he has income?

Per *Kirby Lumber Company*, if you buy your own debt for less than face value [*i.e., you owe $1000, but you “buy” your note for $700*], you have income equal to the difference [*$300*].

Per section 108(e)(4), if a member of your family buys your debt, it is treated as if you bought it. Thus, if your Father buys your debt for less than face, as in the above example, it is the same as you buying it [hence, the same $300 income]. If, instead, your Father buys your $1000 debt for $1000, you have no income, just as you would have none if you paid $1000 to the person you owed $1000.

The tricky part of 108(e)(4) is the definition of “family.” You are a member of your mother-in-law’s [or father-in-law’s] family; hence if you buy their debt, it is as thought they did so. However, they are
not a member of your family; hence, they could buy your debt for less than face and nothing happens in a tax sense. The definition of family and relationships is very important for tax law, but also very inconsistent.

3. Also, since it’s a family member forgiving the debt, can’t that be considered a gift?

The above question is not an issue of forgiving the debt . . . based on the example I gave, if your father bought your $1000 debt for $700, you would have income of $300, but you would owe your father $1000.

Now, if your father forgave all or part of the $1000, this would be excluded as a gift, per section 102, if he did so for “detached and disinterested generosity” as defined in the Duberstein case. If, instead, your father forgave the $1000 debt because you became insolvent, you would have an additional $700 discharge of indebtedness income [$300 was already taxed when he bought the debt for less than face]. This additional income would be subject to exclusion under section 108 and the resulting tax attribute reductions. It would not be a gift because it resulted from your insolvency rather than “detached and disinterested generosity.” But . . . remember the conclusion in the prior sentence involves a question of fact: exactly what were the motivations for the discharge – gift or insolvency. If the motives are mixed, we face another situation of apportionment or letting the dominant motive control (the “all-or-nothing” approaches of Duberstein and determination of business versus investment or personal motives).

4. Why is the situation in Rev. Ruling 84-176 not a purchase-money debt reduction?

In the ruling A failed to ship B some goods. B filed a claim for breach of contract. B also owed A $1000x on an unrelated transaction. A “forgave” $500x of the debt in exchange for release from the breach suit.

This is not a discharge of the debt; rather it is a payment. It is also not “purchase-money” debt because the two items were unrelated.

It is as if B paid the money owed and then A paid B $500x for the breach. The unrelated contract giving rise to the debt from B to A would be unaffected and would result in tax consequences to A and B unrelated to the breach claim. Also, the breach claim would result in A having a deduction per 162 or 165 or the expense or loss and B having income equal to $500x for the claim (he would not have a basis in the right to receive damages, thus it would be an accession to wealth).

A purchase-money situation would arise if the debt from B to A involved the goods for which the breach occurred. In that case, no income would result and B would reduce his basis in what he purchased.

5. According to Gehl, non-recourse lenders have the most tax liability and the people they loan to have the least amount of debt liability? That doesn’t seem fair...
Per Gehl, a transfer of property to satisfy recourse debt is a sale up to the value of the property and a discharge for any remaining debt forgiven.

For example, A owes B $100,000 on a recourse debt and he transfers Whiteacre, worth $80,000, in full satisfaction of the debt. A has an amount realized of $80,000 for the sale of Whiteacre: hence, if his basis were greater than that, he would have a loss and if his basis were less than that he would have a gain. This gain or loss would be characterized according to the manner in which A held Whiteacre (capital, ordinary, or section 1231 gain). B would have purchased Whiteacre for $80,000 and would receive a basis of $80,000 in Whiteacre. In addition, A would have discharge of indebtedness income of $20,000, which would be ordinary income, subject to possible exclusion under section 108 and attribute reductions under section 108 and 1017. B would have a loss of $20,000 from the worthlessness of the debt, which would be deductible under section 166(a) if it were a business bad debt (resulting in an ordinary loss) or 166(d) if it were a non-business bad debt (resulting in a short term capital loss). If A’s obligation constituted a “security” as defined in section 165(g)(2)(C) and as provided in section 166(e) (which would result in a long term capital loss).

If, instead, the debt from A to B were non-recourse, and a mortgage on Whiteacre secured the debt, the result would be controlled by the Tufts decision. A would be treated as if he sold Whiteacre for the full amount of the debt, $100,000. Thus he would have gain if his basis were less than $100,000 and a loss if it were greater. This gain or loss would be characterized with reference to his holding purpose and holding period of Whiteacre. (e.g., if it were a capital asset held more than one year, the gain or loss would be long term capital gain or loss; if held less than one year, the gain or loss would be short term capital gain or loss. Or, if Whiteacre were an ordinary asset – such as inventory – the gain or loss would be ordinary. Or, if the asset were section 1231 property, the gain or loss would be 1231 gain or loss to be subsequently characterized by the section 1231 hotchpot). B would have a basis of $100,000 in Whiteacre. No discharge of indebtedness income would result for A and no section 166 bad debt deduction would be appropriate for B.

So, yes, non-recourse and recourse lenders are sometimes, as in the above example, treated differently. And, per this example, the non-recourse lender indeed has greater current tax liability (he does not have the bad debt deduction in the recourse example); however, he also has a greater basis in the asset effectively purchased (Whiteacre). Without more facts, I cannot say whether he is better off or worse off: perhaps the bad debt deduction lost would have been a short term capital loss and thus limited by sections 1211 and 1212 or offset against long-term capital gains and thus effectively worth 20 cents on the dollar. Perhaps also, the basis in Whiteacre is depreciable quickly for increased ordinary deductions or perhaps Whiteacre is inventory and the increased basis will quickly result in less ordinary income or an ordinary loss for B. In these scenarios, B is
better off than the comparable recourse lender.

Similarly, the non-recourse debtor does not have the $20,000 discharge of indebtedness income, which would seem to make him better off than his recourse counterpart. However, if the recourse-A's discharge of debt income were excluded per section 108 and if the resulting attribute reduction were unimportant, Mr. Recourse-A would actually be better off than Mr. Non-recourse-A.

Thus I don’t believe the premises of your question hold true in all events.

6. So if a payment of debt (whether through money, services, etc.) is taxed as income, then people who repay a debt with already taxed income pay twice?

If I pay a debt with services, I am taxed on the value of the services because I essentially sold them for the amount of the debt payment. If I pay with property, I am treated as receiving an amount realized equal to the value of the property I transferred; hence, I am either taxed or I have a loss.

If I pay a debt with money, I am not taxed: I may have been taxed when I got the money, but that depends on how I got it. If it was a gift or inheritance, I would not have been taxed. If I borrowed it, I would not have been taxed. If I earned it, I would indeed have been taxed. But I would not be taxed a second time (unless the money were property . . . but U.S. dollars are not considered property for this purposes, only foreign money is so considered).

7. If you have a transaction for profit (like the property developer who buys land and then sells at a higher price but doesn’t do all the extra work, like dividing into smaller lots, installing sewers, etc.) and you purchase property that you will later use in this transaction for profit, can you deduct that cost or capitalize it? I realize that section 167 doesn’t allow you to depreciate it.

Clearly, the property actually bought for later sale at a profit must be capitalized and is not depreciable. However, as you suggest, you may also buy property which is useful to maintain the “sale” property, such as a rake to rake the leaves or a lawn mower or something more substantial. This should be deductible under section 212(2) if small, or capitalized and depreciated per sections 167/68. Treas. Reg. Section 1.212-1(b) defines “production of income” as including “holding for gain.” As a result, the maintenance equipment – such as the lawn mower – should be depreciable.

8. I don’t think I entirely followed our discussion of 1231. Here are my notes on the topic:

1231 property is sectioned off by Congress for special treatment, produces capital gains but ordinary losses, applies to:

- personal (not real) depreciable property and real property held more than a year and used in a trade or business
- plus capital assets used in a trade or business
Miscellaneous Questions from Students

must have been held more than one year.

1231 is triggered by dispositions, but excepts almost everything but sales or exchanges.

1245(b): dying, gifts, transfers to a corporation or partnership

1) all gains and losses from 1231 property are netted together
2) If there is a net gain: then all the individual transactions are treated as long-term capital transactions
3) if there is a net loss: then all individual transactions are treated as ordinary transactions resulting in ordinary loss treatment

This is correct for the “hotchpot” of 1231(a). Before this calculation, however, you must compute the “firepot” consequences of 1231(a)(4)(C)

Basis calculated by 1245(a)(2):

1) 1016 + all prior depreciation (so will usually equal original basis)
2) take lower of recomputed basis, amount realized if sold, or FMV if got rid of some other way and subtract 1016 basis
3) the difference will be treated as 1231, usually won’t be any left over unless the value of the property went up

If the amount of depreciation allowed is less than the amount allowable and the taxpayer can so prove, you must use the amount allowed for this computation described in 1).

No to 3): the difference will be treated as ordinary income per section 1245 and any extra gain will be 1231 gain if this is section 1231(b) property.

What I don’t understand:

1) I don’t see in the code where the basis of 1231 property is calculated in reference to 1245.

Section 1245(a)(1) provides that 1245 gain “shall be treated as ordinary income” and “shall be recognized notwithstanding any other provision of this subtitle.” Thus it overrides section 1231 characterization.

2) do I have the above steps right? I don’t see the point of subtracting 1016 basis, and I don’t see where it says to in the code. That can’t be right. I probably just wrote this down wrong.

Your steps are correct. Section 1001 deals with gain recognition, providing that gain recognized is the difference between amount realized and “adjusted basis.” Section 1016 defines “adjustments to basis.” Thus, to determine gain, we must subtract 1016 basis. Then, we must characterize that gain. Because section 1245 overrides everything in Subtitle A (Income Tax), we go there first for characterization. Then we go to 1231, 1222 and other characterization provisions (e.g., 1235 (sale of patents), 1237 (safe harbor for sales of subdivided property), 1239 (sales to related persons), 166(d)(1)(B) (worthless non-business bad debts), 165(h)(2)(B) (net personal casualty gains), 1253 (some sales of franchises, trademarks and tradenames, 1271 (retirement of some debt instruments)).
3) Can you give me an example? What if TP had real property that she had been using in her trade or business for more than a year. She paid 75K for it and sold it for 100K. And then, what if she paid 100K for it and sold it for 75K?

I need to know her 1016 basis as well as depreciation allowed and allowable. If this is land, the 1016 basis is 75K, the gain is 25K and 1231 will characterized that gain. If this is a building, then the 1016 basis is 75K less the greater of the depreciation allowed or allowable. The recomputed 1250 basis will add back a portion of that depreciation (the excess of the greater of the allowed or allowable over the straight-line amount.). Unless the taxpayer erroneously took too much depreciation or the property was placed into service prior to 1986, the recomputed basis will equal the 1016 basis. If, instead, 1250 indeed characterized a portion, it will be ordinary. Any remaining gain will be characterized by section 1231. Finally, to the extent “net section 1231” gain includes “unrecaptured section 1250 gain” (defined in section 1(h)(7)(A) essentially as if section 1250 paralleled section 1245), the gain will probably be taxed at 25%.

If she paid 100K and sold it for 75K, I would still need to know her 1016 basis to determine gain or loss. If this were land – non-depreciable – and no other basis adjustments were appropriate (e.g., for improvements) she would have a section 165(a) loss of 25K. Section 1231 would characterized this loss if the property were held more than one year in a trade or business; otherwise, the loss would be ordinary (this is not a capital asset per section 1221(a)(2)).

She would have $500 gain from the exchange of section 1231(b) property (depreciable property used in a trade or business and held more than one year). Section 1231 would characterize this gain by the process of the 1231(a) “hotchpot.”

9. I am not sure whether there is a hard and fast rule about whether the legal costs of defending or perfecting title to real property are considered deductible expenses under 212 or whether they are “capital” costs under Sec 263.

In Woodward v. Comm’r (a 1970 case) the SC acknowledged that costs in defending or perfecting title to real property are “currently deductible under Sec 212”. However, Treas. Reg 1.263(a)-2(c) identifies the same as an example of a capital expenditure. In the Woodward case the particular litigation expenses were deemed to be part of the “acquisition cost” for the stock. So is the answer that it comes down to a factual determination of whether the legal costs were necessary for acquisition of property having a useful life substantially beyond the taxable year? If YES, then your facts fall under Woodward (a 263 capital expenditure) and if NO then your facts might fall under “production of income” expense (212).

Is this analysis correct?

This sounds fine . . . I don’t really care for the expression of “facts falling under Woodward” because the case does not
establish any law, it merely explains it. Section 263 overrides section 212 (as well as sections 162 and 167).

Certainly no “hard and fast” rule exists . . . I would need to know the amount of the costs, why they were incurred, when they were incurred, whether they are material in terms of the value of the property and the income of the taxpayer, as well as whether they are related to acquisition or maintenance of the property (against what claim do they arise). Such facts would help me decide whether to capitalize or expense the costs.

10. I have a question about the Simon case (“antique” violin bow case). I have read the case but can’t find an answer to this very basic conceptual question. The TP (Simon) was arguing that he should be allowed a depreciation deduction under ACRS. Why wouldn’t the TP be arguing for the even more favorable treatment as a 162 expense? After all, the bow was used in his trade and it was arguably ordinary and necessary because the artist must use a bow and this particular one was the “equipment” that the artist chose to use in his trade. It would seem to me that the TP would be arguing for 162 status, but willing to concede to 263 status if the government won. Instead we have the TP arguing for 263 status and the govt arguing for no deduction at all?? I must be missing something very basic here.

Your basic error involves the distinction between “capital expenditure” and “expense.” A capital expenditure involves a “cost” or the “creation of an asset” having a useful life extending substantially beyond the end of the current year. The distinction also has elements of “materiality.”

The bow in Simon v. Comm’r, 103 T.C. 247 was quite expensive and thus quite “material.” It also, as an antique, had already existed for a long period of time and was expected to exist as a useful item in the business for a long period to come. As such, it is not even close to being a section 162 expense. It also would not appear to qualify under section 179, as that section existed in 1985 and the taxpayer was inclined to elect it.

That left the taxpayer with the only possible “cost recovery” [deduction] being sections 167/168 for depreciation. Section 167 refers to “exhaustion, wear and tear” as well as “useful life.” Section 168, which largely replaced section 167 in 1981, requires merely that the asset be tangible, placed in service after 1980, “subject to an allowance for depreciation” and used either in a trade or business or for the production of income. The key issue in section 168 involves “subject to depreciation.” The Tax Court held those words to refer to “exhaustion, wear and tear,” as used in section 167. The “useful life” concept was largely replaced by the “catch-all” category of five-year property (which includes everything that does not have a class life under the old ADR system).

Because use of the bow caused deterioration, the Tax Court found it to be depreciable.