

Chapter 6

p.311

Return of Capital/Timing

How determine the allocation between principal & income (P&I) when payments received under a “term-certain” annuity? Options include:

- 1) All capital return first, then income.**
- 2) All income first, then capital return.**
- 3) Same income proportion of each payment.**
- 4) Level amortization, reducing principal amount – back loaded ROC; cf., home mortgage**
- 5) Endowment contracts - Front loaded ROC.**

Importance of Choice of Income Reporting for Tax

Note: Cf., taxpayer is the “lender,” i.e., banker, & wants a return for “time value of money” –

1) Taxpayer prefers to postpone income recognition and accelerate deductions (unless tax rate increases are imminent);

2) IRS prefers to accelerate income recognition (and delay income tax deductions).

3) What is the economically accurate method for determining the income amount? A “constant interest rate”?

Fairfield Plaza p.314

Tax Basis Allocation

Tax Court decision: Allocation of the tax cost between three portions of one tract of property.

Allocation was not done on a pro rata basis, since one portion (the frontage segment) was more valuable than the other parcel sold.

Cost of improvements was allocated to middle property which was retained. These costs are frozen in tax basis for this property until its future disposition & are not currently available to offset proceeds from sales of other segments.

Rev. Rul 70-510 p.317 Code §1016 re Tax Basis

Do amounts received constitute a tax basis reduction (capital return) under §1016?

USG payment for a “flowage deed” (easement) to enable USG to flood portions of a taxpayer’s property. Amount paid was 20% of the property value. Amount constitutes a capital return – and no separate tax basis allocation to this “easement.” Open transaction treatment.

Previously: Inaja Land case & river pollution damages treated as a capital recovery.

Problem 1

p. 319

1) How allocate basis to property components: e.g., land, building, subsurface rights, air rights?

2) What allocation if a division is made on a temporal basis, i.e., between the life estate and the remainder? Problem: Property doubles in value from 400x to 800x & the life estate in the property is sold for 500x.

What portion of this property has been sold?

$\frac{5}{8}$ th? (500 received/800 times total fmv?)

Next slide

Problem 1

p. 319

Allocation options for horizontal ownership interests:

- (1) 50-50 (life interest/remainder), or**
- (2) based on relative actuarial values (at the time of the deal) of each interest?**

See the “uniform basis” rules – Regs. §§ 1.1014-4 & 1.1015-1(b); tax basis is allocated between the several property interests based upon actuarial probabilities.

Problem 2

p. 319

Blocks of stock sold:

- a) 100 shares bought for \$20 per share, & then
- b) 200 shares bought for \$32 per sh., & then
- c) 100 shares are sold @ \$30 per share.

Which block of shares is sold?

100 shares bought at \$20 deemed sold and, therefore, gain of \$10 per share (not loss).

Reg. § 1.1012-1(c) has a FIFO presumption.

Cf., mutual funds – average cost basis.

Capital Expenditures & Cost Recovery p.319

How allocate receipts between income and the return of capital? Consider receipts from:

- a) Land and corporate stock: all current receipts are gross income (rents or dividends), until final disposition proceeds are received. Then, offset sales proceeds by the tax basis of the property to determine (capital) gain.
- b) Capital expenditures for a wasting asset that yields benefits beyond the current year:

See next slide

Depreciation Deductions p. 321 (& also Ch.15)

§167 provides a deduction for exhaustion, wear and tear, and obsolescence of property used for producing income, spreading cost over the asset's useful life.

Objective: matching revenue and costs so as to identify the current net income from property.

§168 provides for accelerated depreciation &, therefore, greater deferral of income tax.

Greatest benefit results from immediate
“expensing.”

Depreciation Deductions continued p.321

Some property is not exhausted by usage (e.g., land) and, therefore, no interim depreciation deduction is available. Result: Offset sales proceeds by entire basis as of disposition.

Similarly, no depreciation is available for personal costs, e.g., wasting assets/consumer durables such as auto and personal residence.

But, gain recognition is possible (although basis is not reduced by any depreciation deductions and probably a loss is incurred at disposition).

Commercial Annuities (& Pension Annuities) p.324

What is an “annuity” (contract)? Payments are made periodically for (1) life (lives), or (2) term.

How is an annuity purchased? An annuity can be purchased for (1) a lump sum, or (2) with periodic payments (including under a “qualified” retirement plan – with zero tax basis since plan contributions are deductible/pre-tax).

From whom is the annuity contract purchased? (cf., a possible “private annuity” - a deal with a non-commercial issuer of the annuity).

Types of Annuity Payouts

p.324

Types of annuity contract payout arrangements (other than a lump sum payment only annuity):

1) Fixed payments – an agreed sum at intervals for (a) a term or (b) a life (or lives).

2) Variable payments – based on results from equity security investments through an annuity.

3) Joint and survivorship payment – until the death of the survivor of multiple annuitants.

Usually results in a longer payout period since based on two life expectancies (lesser amounts).

Annuity Income Taxation – Options p.325

What tax policy choices exist for determining the timing of any gross income inclusion?

1) As value/interest accrues to the contract.

Cf., amounts credited to a bank savings account or a money market mutual fund – current gross income inclusion is required; otherwise, a “tax shelter” is achieved through tax deferral.

2) As payments are made either (a) before, or (b) after annuity contract payments commence. *(see next slide).*

Annuity Income Inclusion for Payments Made p.325

- 1) Recovery of the entire tax basis first.
- 2) All income 1st – as identified by the insurer.
- 3) A specified percentage (e.g., 3%) of each payment as an includible “interest equivalent.”

See Egtvedt case (p. 325) unsuccessfully challenging the 3% rule. Cf. (a) an annuity existing for considerable period (with significant internal buildup based on investment return) and (b) a recently purchased annuity. *continued*

Annuity Income Inclusion for Payments p.325

4) Current method – a specified percentage of each payment is included, based on (1) the investment in the contract and (2) the expected total return from the contract (*see next slide*).

5) Apply a constant interest rate, similar to home mortgage amortization, i.e., level payments, declining principal balance & therefore lesser interest return and increasing return of principal. But, how deal with the “life expectancy factor”?

Annuity Income Current Inclusion Method - §72(b)

- 1) Determine the total income tax basis.
- 2) Determine the expected return, i.e., (a) the payment amount times (b) the anticipated number of payments (how determine this?).
- 3) This ratio is applied to each payment when received. The formula is:
 - a) Total tax basis/expected payments *times*
 - b) Each payment *equals*
 - c) Amount to be excluded from gross income for each payment.

Current Inclusion Method - §72(b) - Example

15 Year Term Certain (or life expectancy)

a) Total tax basis = 100x

Expected payments of 10x for 15 years =
150x (or 2/3rds)

applied to

b) Each payment of 10x

equals

c) 6.67x (the amount to be excluded from gross income for each payment).

Annuity Contracts - Income Variations

1) **Borrowing before the annuity payments commence – income inclusion. §72(e)(4)(A).**

2) **After annuity payments commence –**

a) **Living too long - §72(b)(2) – no exclusion after income tax basis has been fully recovered.**

b) **Dying too soon (i.e., no full cost basis recovery of cost, i.e., actuarial loss is incurred).**

See §72(b)(3) – tax deduction available for the unrecovered tax basis (on the final individual income tax return)

Annuity Income – “Refund Feature” Considered

**P. 327. What is purpose of a “refund” feature?
Is this a life insurance equivalent?**

What is the impact of a “refund feature” in determining the annuitant’s “investment in the contract” for §72 annuity income purposes?

See Code §72(c)(2) concerning the impact of the refund feature on (a) the “investment in the contract,” and, therefore, (b) the annuity income inclusion/exclusion fraction in §72(b).

Deferred Annuities

p. 328

Definition: Front-end payment(s) for annuity payments to start in the future. Significant accrual of an internal investment element.

- 1) Tax inclusion is postponed until payment; cf., income on deposits in bank savings account.**
- 2) Cash withdrawals prior to annuity starting date are income to the extent of the cash value of the contract in excess of investment.**
- 3) Loans against the policy are also treated as cash withdrawals.**

Cash Method of Accounting p.330

Cash receipts & disbursements overall method of accounting - §446(c)(1). (Note: Sanford & Brooks case previously). E.g., for services businesses. Cf., the accrual method is required for taxpayers with inventories (except small retail taxpayers - §263A(b)(2)(B)).

Reg. §1.446-1(c)(1)(i) – income inclusion occurs in the year the cash is received.

Possible application of the “constructive receipt” rule – Reg. §1.451-2.

Situation 1 – **no** current GI inclusion where employee is entitled to additional compensation; only an employer’s **“reserve account”** is created, and amount payable only when retiring.

Situation 2 – amount is deferred for a corporate officer; distributions commence at retirement age. Only a **contractual agreement** & not GI.

Situation 3 – contract with author and publisher to retain royalty amounts and pay later in limited amounts & no segregation of amounts.

continued

continued

Situation 4 – professional athlete receives signing bonus (plus salary) and this bonus amount is held by an escrow agent (i.e., 3rd party). Holding: bonus is includible in gross income when the amount is paid to escrow agent. Constructive receipt occurs (or economic benefit doctrine applies?).

Note: no employer deduction is available until the income inclusion occurs. Situation 4: a tax deduction is available to the employer.

Timing of Commitment to Defer Income p.338

What if before payment, but after earning income, the contract is renegotiated to provide for deferred payment?

IRS says deferral is permitted only when income receipt postponement is agreed prior to earning.

Courts reject the IRS position that no deferral if renegotiation of the payment occurs when the income has been earned but is not yet payable.

What is a “novation” of a contract? Is this concept relevant here?

Economic Benefit Doctrine

p.339

When does a promise to pay money in the future amount to a current payment in kind?

The “economic benefit doctrine” requires current inclusion in gross income.

Requirements: 1) a fund is set aside, e.g., in trust; and,

2) the fund is immune from the claims of creditors of the employer/payor.

Pulsifer v. Commr. P.339

Minor wins Irish Sweepstakes but is not entitled to current funds until (1) becoming of majority or (2) court approval for funds release.

Held: Winnings are to be included in GI for the year of the award, and not for the subsequent year when actually retrieved.

The funds were irrevocably assigned for benefit of minor and only needed to apply for the funds. “Economic benefit” occurred in the earlier year.

Restricted Property

p. 339

§83 provides that if the employee's right to funded deferred compensation becomes "transferable or not subject to a substantial risk of forfeiture" then GI inclusion is required in advance of the actual receipt.

E.g., compensation that becomes vested after the employee satisfies an employment duration (i.e., years of service) requirement.

Rabbi Trust p.340

Constructive receipt?

Employer puts assets into a trust but the trust is within the control of the employer. Assets are designated as for the benefit of the employee.

But, the assets remain subject to the claims of the creditors of the employer.

Therefore, no constructive receipt of these funds by the taxpayer/employee.

Cf., a “secular” trust (trust benefits are vested in the employee) – resulting in current inclusion in gross income.

Cash Equivalence

Doctrine p.341

Gross income for receipt of cash or a “cash equivalent.”

Receipt of the employer’s promissory note is the equivalent of cash for purposes of requiring gross income inclusion to the cash basis employee recipient of that note.

However: What if the employer has no financial stability? At what point is the promissory note no longer a “cash equivalent”?

I.e., a “Cowden” note- p.341.

ERISA

p.341

Tax Law & Labor Law

“Employee Retirement Income Security Act of 1974.”

Purpose of ERISA (1974) is to enable economic protection of employees financial rights.

Both “labor law” and “tax law.”

Rules re forfeiture & funding of plan benefits for qualified plans.

No discrimination favoring highly compensated (next slide).

Qualified Pension/Profit Sharing Plans p.342

Personnel objectives: Enable employee loyalty and employee incentives (including investing in the employer's stock; cf., Enron Corp. stock).

Defined benefit (DB) plan: employer agrees to pay fixed retirement benefits based, e.g., on (1) years of service, and (2) final pay amount.

Defined contribution (DC) plan: an amount is contributed based on a formula (e.g., 5% of current compensation) and the amount paid at retirement is based on the investment return.

Qualified Pension/Profit Sharing Plans p.342

Qualified retirement plan & income tax results:

- 1) **Employer deduction for plan contributions.**
- 2) **No current GI to the employee-participant; GI inclusion upon later distributions to retiree.**
- 3) **No GI for investment returns received by the intermediary holding entity (e.g., a trust).**
- 4) **Non-tax benefit – funds are protected from employer's financial risks (although possible actuarial underfunding for DB plans).**
- 5) **Income when distributions occur. *Continued***

Qualified Pension/Profit Sharing Plans p. 342

Limitations on qualified plan structuring:

- 1) **Non-discrimination rules – can not favor highly-paid employees (but social security “integration” is permitted).**
- 2) **Vesting – benefits become nonforfeitable; cf., effect of termination before retirement?**
- 3) **Funding – infusion of contributions into a separate trust enables security of funds.**
- 4) **Limits on contributions made by employer (& therefore a limit on the tax deduction).**

Special Retirement Plan Structures

- §401(k) plans – cash or deferred arrangement.
- But, other mechanisms for corporate plans?
- IRAs – individual retirement accounts – e.g., when employer is not providing benefits. §408.
- Roth IRA – nondeductible contributions, but non-inclusion for accruals and distributions.

Note re timing issues: (1) Penalties for early withdrawals, & (2) Required minimum distributions (RMDs) starting at age 70 ½.

Nonqualified Deferred Compensation Limits

P. 344

§409A – various limits on deferral opportunities with nonqualified deferred compensation plans.

E.g., 1) election to defer prior to time services are rendered.

2) Distributions only at specified events.

3) Timely elections for further delay of distributions.

Original Issue Discount (OID) Example P.345

Debt instrument provides for either (1) no current interest or (2) inadequate (i.e., below market) interest.

Example: 10 year debt instrument issued at zero interest with 100x face value when the applicable market interest rate is 5 percent.

“Original issue price” of the note may be, e.g., .614% of the value (see discount factor tables).

Alternative: Same debt instrument paying 2 percent interest (and then a 3 percent discount).

Original Issue Discount (OID) Income P.345

Income tax treatment: Discount must be currently accrued as income – whether for (1) a cash basis or (2) an accrual basis taxpayer, i.e., treat the “unstated interest” as OID income.

OID is the difference between the (1) “issue price” and (2) the redemption price. §1273.

Tax policy objective: No interest income delay for lender when a current interest expense deduction exists (for an accrual basis taxpayer).

OID Income Tax Treatment

P.345

See Code §1272(a)(1) which requires current inclusion of the annual OID in the holder's GI.

Determined on constant interest rate.

See certain exceptions in §1272(a)(2).

Note: The current interest income accrual (included in GI) increases the income tax basis to the holder of the OID instrument.

Income on Maturity of the OID Obligation?

What is the tax treatment on the receipt of proceeds of the OID obligation at the time of its maturity? Capital gain? Tax basis recovery?

See §1271(a). Note: All OID has previously been included in gross income. Prior income inclusion enables an addition to the tax basis of the debt instrument. At maturity (1) the tax basis and (2) the proceeds are the same – i.e., no realized gain. Before the OID rules: treat all this gain as capital gain when the obligation matures & debt is paid by the borrower.

Market Discount & the Income Tax Effect p.347

Borrower issues debt at a 5% market rate (e.g., receiving 100x par value at time of issuance).

Market interest rate later increases (e.g., to 8%) with the 100x obligation declining to 70x(?) fmV.

Purchaser then acquires this discounted obligation for 70x and receives (1) 5% interest (current income) on 100x, and (2) 30x profit when debt instrument matures. How treat the 30x? §§1276 and 1278 specify that this gain is ordinary income – but not until debt proceeds are actually received. Prior sale? Same result.

Debt Obligation Issued for Property §1274 p.347

Sale of property occurs for a specified arm's length amount. The price is financed with debt owing to the seller. But, the debt instrument is determined to have a FMV less than the face of the promissory note. How is this determined?

Query: Is the interest rate adequate? Compare (1) the stated interest rate to (2) the real economic rate (i.e., the AFR). E.g., sale of 100x property for debt and getting a promissory note worth 90x (because of inadequate interest).

continued

Debt Obligation Issued for Property §1274, cont.

What is the appropriate interest rate for this purpose, i.e., the “applicable federal rate” (AFR). How is rate determined? See §1274(d).

What is the present value of the imputed principal amount – based on the current AFR?

Any difference will be **OID** – to be reported on a *current basis* (although the **OID** is not actually received until maturity). This **OID** to be recognized will be added to income tax basis for debt instrument.

Exceptions to OID Current Inclusion Rules P.348

Sale for deferred payment(s) of (a) a principal residence, or (b) a farm for less than \$1 million (e.g., for a principal amount without any interest) or (c) a price less than \$250,000.

§1274(c)(3) states OID rules are not applicable.

However, see §483 – provides for treatment of discount portion (1) as interest income (and not as capital gain), but (2) only when the payment is received. A recharacterization rule: not a timing (i.e., accrual) rule for a cash basis seller.

Exceptions to OID Current Inclusion Rules P.348

Example re §483: Sell residence for \$1 million note with entire amount due in five years (& no stated interest). Seller's tax basis is \$400,000.

If the AFR is 10 percent:

- 1) At maturity Seller receives the \$1 million, consisting of (a) \$620,921 for the house (220,921 capital gain – protected under §121; 250,000 limit)), and, (b) \$379,079 of interest income.**
- 2) Buyer (a) pays \$379,079 interest expense and (b) has tax basis for the house of \$620,921.**

Treatment of Deferred Rent Payments p.348

§467 provides for application of these OID concepts to deferred rent payments:

(1) (Cash basis) lessor to include both (a) deferred rent and (b) interest on deferred rent in current income (as if an accrual basis taxpayer).

(2) (Accrual basis) lessee can deduct a similar amount each year.

Not applicable to total payments not exceeding \$250,000. §467(d)(2).

Accrual Method Accounting

p.348

Code §446(a) requires using for income tax purposes the accounting method which is used for keeping one's "books." This might (often) include the "accrual method." What is GAAP?

Code §446(b) specifies that the taxpayer's accounting method must "clearly reflect" income.

See Code §448 re those taxpayers required to use the accrual method.

Prepaid Income &

Accrual Basis

p.349

American Automobile Association

One year membership fee is paid in advance.

When earned by AAA? Ratable allocation to each month (& a partial deferral to next year).

IRS says immediate inclusion in gross income.

Ratable reporting was not permitted.

What if proof of delivery of services is provided?

What if the method is consistent with GAAP?

Effect of repeal of §452 & §462? Note §455?

3/6/10 Cf., dissent: What about the expense side?

Subsequent Prepaid Income Cases p.356

Schlude (Sup. Ct., p.356): prepaid dance lessons; inclusion at time of receipt of payment.

Artnell (7th Cir.) – deferral until games played.

Boise Cascade (Ct. Cl.) – inconsistent receipts. Must consistently report income when services are rendered (not requiring any earlier reporting if an advance receipt).

§456 was subsequently enacted: to enable membership organizations to spread prepaid dues over anticipated service period.

Subsequent IRS Action p.361

IRS takes administrative action to enable limited deferral when prepaid receipts.

1) Rev. Proc. 2004-34 (re: services) – reporting in the current or the subsequent year, if consistent with financial accounting (i.e., a “booking requirement” is imposed).

2) Regs. §1.451-5 , p. 371 (sales of goods) & similar treatment as services rules for reporting advance payments for goods.

Why Rev. Proc. vs. Treas. Reg. mechanism?

Security Deposits v. Advance Payments p.372

Indianapolis Power & Light (28-0).

Advance deposits paid by customer to enable establishing electric service. Interest is paid by the utility on the deposit amount. Eventually \$\$ are credited against the customer's account.

No separate escrow or segregation of funds.

Held: Equivalent to loans by customers, rather than advance payments. Loan repayment was possible and a prepaid income amount was *not* received. Same treatment for lease deposits?

Inventory Accounting

§§ 471-472

p.378

How is capital recovery relevant to inventories?

Inventory items may (or may not) be held as of the close of the year.

Objective, of course, is to sell inventory items and, therefore, determine cost recovery as the items are sold. If item is not sold the cost basis for the inventory has not yet been recovered.

Therefore, inventory cost recovery timing is indefinite – dependent upon disposition, not the mere lapse of time (e.g., depreciable items).

Inventory Accounting

§§ 471-472

p.378

Inventory accounting is mandated for the seller of goods who either (1) purchases goods to be sold for resale, or (2) manufactures goods for sale to customers. §263A(a)(1)(A) specifies that - for a taxpayer having inventory - certain costs for this inventory are included in “inventory costs.” These costs include both: (1) “direct costs,” and (2) “indirect costs.” See §263A.

- Exception for taxpayer with gross receipts (as a reseller) of \$10 mil. or less. 263A(b)(2)(B).

Determining Inventory Cost for a Tax Year

Gross income from a business selling inventory is computed as follows for each tax year:

Gross receipts: _____

Less: Inventory cost _____ (*next slide*)

- i.e., Cost of goods sold
(CGS) - how calculated?

Equals: gross income _____

Note: Not all inventory will be sold during a particular tax year (unless business liquidation).

Determining CGS (the Cost of Goods Sold)

Calculation of the cost of goods sold (CGS):

- 1) **Opening inventory cost**
- 2) **Plus: additions to the inventory during the tax year whether (a) purchased goods for resale or (b) goods produced, including parts.**
- 3) **Less: Closing inventory (how valued?)**
- 4) **Equals: Cost of goods sold (CGS)**

Tax planning objective: minimize the closing inventory amount (thereby increasing CGS).

Method for Identifying Closing Inventory Value

Use valuation on the basis of (1) cost, or (2) market, whichever is lower (using FIFO – *next slide*)?

I.e., if the inventory value is lower at year end, then a greater cost of inventory is treated as incurred during the current year.

Therefore, with greater inventory expense the gross income from the inventory sales is reduced.

Method for Identifying Closing Inventory Items

Use the **FIFO** or the **LIFO** method (p.379)?

FIFO (first-in & first-out) – the remaining (year-end) inventory consists of those goods most recently added to the taxpayer's inventory (the “conveyor belt” approach).

FIFO is usually similar to the actual physical flow of goods.

LIFO method (last-in & first out) - as authorized in §472.

Inventory Accounting Example for Tax Year

§61(a)(2) identifies gross income as including business sales income. How determined?

1st: buy 100 of Item X for \$10 = \$1,000 cost

2nd: buy 100 of Item X for \$13 = \$1,300 cost

& sell 120 of Item X for \$15 each = \$1,800.

Gross income computation options are:

a) FIFO - 100 items @\$10 & 20 items @\$13 =
\$1,260 cost & \$540 income (1,800 less 1,260).

b) LIFO – 100 items @\$13 and 20 @\$10 =
\$1,500 cost & \$300 income (\$1,800 less 1,500).

“Booking Requirement” for LIFO §472(c)&(e)(2)

If the taxpayer uses LIFO for federal income tax purposes the LIFO method must also be used for reporting to shareholders and creditors (i.e., for GAAP purposes).

What is the purpose of this financial statement consistency requirement?

Why might a company not choose LIFO when inventory costs are rising? What impact on the earnings reported to shareholders & creditors (under the “booking requirement”)? P. 379

Farmers & Feed

p.379-380

Current deduction of feed by the farmer on the cash method of accounting? Reg. §1.162-12.

§464 – limit on tax deductions for farming.

**1) Farming expenses of a “farming syndicate.”
Deduction limited to feed, etc., consumed during the year.**

2) Other farmers – limit applied to prepaid feed costs – when the prepayment for more than 50 percent of the farming expense.

Prepaid Interest Deduction

p. 380

See Code §461(g) requiring:

- 1) allocation of prepaid interest to a capital account, and,
then**
- 2) allocation as a deduction to the period for which relevant.**

Thor Power p. 380

Clearly Reflecting Income

Write-down of inventory of spare parts to “net realizable value” or scrap value.

But, these inventory items were not actually eliminated & were still available for sale.

Write-down conformed to GAAP, but GAAP does not control here.

Determined to not “clearly reflect income.”

§446(b) requires “clear reflection of income.”

No effort to determine the actual purchase or reproduction cost. Who has “burden of proof”?

Legislative Proposals

p. 390

(Former) Obama Administration:

- 1) Repeal the LIFO method, and**
- 2) Repeal the “lower of cost or market” method.**

These proposals were (again) included in the U.S. Treasury’s “Greenbook” for FY 2017, noting that the “asymmetrical treatment” of LCM is not appropriate.

Do these proposals make tax policy sense?

General Dynamics Corp. Sup.Ct. P.391

Deduction was claimed for medical expenses which were reimbursable to employees:

- 1) when the expense was incurred, but
- 2) no current reimbursement claim to the employer had been made at end of the tax year.

Amount claimed was based on estimates of past experience. Sup. Ct. (6-3): “All events” test was not satisfied; some employees might not file a claim for reimbursement. *continued*

General Dynamics Corp. Sup.Ct. Dissent - p.391

O'Connor dissent: Reference to Hughes Properties case (Supreme Court – p.395).

Progressive slot machines – required to eventually pay out winnings; but, payout may not occur in current year.

In Hughes Properties the conclusion was that the “all events” test was satisfied and a current deduction of the accrued payout amount was permitted. Processing of claims was “routine.”

The “Economic Performance” Test P.397

§461(h)(1) enacts the “economic performance” test. Reg. §1.461-1(a)(2)(i). No “premature” accruals of expenses are permitted.

This provision specifies that the “all events” test is not treated as met any earlier than when economic performance for that item occurs.

A fixed obligation to pay an amount for services to be performed next year can not be deducted currently.

Structured Settlements

p.402

§461(h)(2)(C)(ii). Tort settlements - economic performance occurs when the payment is actually made. Buy annuities to deduct cost?

Consider the possibility of obtaining an immediate tax deduction, although the actual payment is delayed over several years.

What is time value of these deferred payments?

Note at p. 403 re Ford Pinto (1) tort and then (2) tax litigation.

Inconsistent Methods & Matching

p.406

Related party transactions, p. 406

Example: An accrual method taxpayer owes an expense or interest amount to a “related person” who uses cash method of accounting.

Under accrual method (1) the item of expense would be deductible under the “all events” test; but, (2) the income item would not be included in the gross income of the cash basis taxpayer.

Objective of §267(a)(2) – to assure consistency of timing—obligor to use cash basis for this item.

Inconsistency between Years P.408

Earlier year – item of income (e.g., property) received, but no inclusion in gross income.

Subsequent year: Loss is incurred on the disposition of that property (even though no earlier income inclusion). Is a deduction permitted? Is tax basis available for the property sold?

See §§ 1311-1314 re dealing with inconsistent treatment (although S/L is applicable). These Code provisions not in student Code volume.

Inconsistency between Years, cont. P.408

Code § 1311 provides that if a “determination” (described in § 1312, i.e., as to an error of inclusion or deduction) is made and on that date correction of the effect of the error is prevented by any rule of law (e.g., a statute of limitations) then an adjustment shall be made (in the amount and manner as specified in § 1314).

Problem 1

p. 410

Inclusion in gross income in first year, but should have been spread equally over several year period when received by a cash basis taxpayer.

If a determination occurs that the income arises in 2004, 2005 and 2006, then can obtain a refund for 2002.

This situation is described in §1312(1).

Problem 2

p. 410

During the current year reporting only part of salary received. Claiming part in earlier year – but had not been reported in the earlier year.

Determination: See Code §1312(3)(B) re no relief to IRS unless statute of limitations not expired when IRS asserting deficiency for the current year.

Problem 3

p. 410

Failure to report income and, therefore, no tax basis.

Entire \$20,000 should be reported as income (i.e., zero basis for the stock and capital gains treatment) – even though would have had a \$8,000 basis if initially properly reporting income on receipt of the stock bonus.

If reporting \$12,000 gain – then within §1312(7) – i.e., taking an inconsistent position.

Compensating Employees

p. 412

Albertson's, Inc. (2nd decision by 9th Cir.) re tax treatment of deferred comp. arrangements.

Issue: Can the employer deduct the accruing “interest” component of the “deferred compensation agreement” under §163?

Or: Is this governed by §404 which requires a “matching principle”, i.e., deduction permitted only when inclusion in employee’s income. Yes.

Cf., treatment of “qualified plans.”

Note rejection of §163 “plain language” – p. 421.

Stock Options & Restricted Property P.423

What is a “stock option”?

In (1) the employment context and (2) the investment/ financial market context.

Here: Consider the employee’s right to buy stock (the employer’s common stock?) at a specified price during a defined period of time. Compensation is provided in this format as an additional work inducement.

Cf., a “listed option” for stock/investment & trading by investors (not employees). *continued*

Stock Options & Restricted Property P.423

Timing: Should the issuance of an option to purchase employer's stock (or other property) constitute employment income when issued to an employee?

Yes, an economic benefit is derived in this exchange of property value for rendered services. Assuming the exercise of the option is not encumbered.

However, see next slides:

Commr. v. LoBue

p. 423

The grant of non-transferable stock options was contingent on continued employment.

Subsequent exercise of options produced favorable financial results.

Taxpayer argues not compensation but a proprietary right in corp.; Tax Court so held.

Sup. Ct. – employer transferred valuable property to employees as compensation.

Question re timing of this income. Held: When exercised & not when granted. Cf., dissent.

Options – Timing & Characterization Issues

Option One:

- 1) Employee includes value of option in GI for the year of the grant of the option. How valued?
- 2) Employer deducts that amount as compensation in the year of grant.
- 3) Employee increases tax basis for option/shares when income at the option grant.
- 4) Employee has capital gain when subsequently selling shares at a price above his/her tax basis.

Options – Timing & Characterization Issues

Option Two:

- 1) Employee includes nothing in GI in the year of grant of the option. Possible forfeiture?
- 2) Employer deducts nothing as compensation in the year of grant, but later when exercised.
- 3) Later employee exercises option & realizes compensation income for FMV less option price (or, earlier when forfeiture conditions lapse?).
- 4) Employee has capital gain when subsequently selling shares at price above tax basis (Item 3).

Options – Timing & Characterization Issues

Option Three (i.e., bargain purchase):

- 1) Employee includes nothing in GI in the year of grant of the option. Possible forfeiture?
- 2) Employer deducts nothing as compensation (neither in year of grant nor when exercise).
- 3) Employee exercises, but no compensation income (for FMV of stock less option price).
- 4) Employee has capital gain when subsequently selling shares at price above tax basis (and no compensation income).

Property is transferred in connection with the performance of services.

Excess of FMV of property over price paid is gross income:

- **When rights to property are transferable, or**
- **When rights are not subject to a substantial risk of forfeiture.**

§83(b) permits election to include in gross income in the year of transfer to the person performing services.

Alves v. Commr.

p. 428

§83 applies to an employee's purchase of "restricted stock," including when the amount paid for the stock equals its fair market value.

Here: stock was subject to a substantial risk of forfeiture and an §83(b) election was not made.

Ordinary income when restrictions lapsed? See p. 429 that no reporting of income at that time.

Holding: §83(a) applies to taxpayers asserting the purchase of restricted stock as an investment; compensation treatment applies.

Current Stock Option Taxation Alternatives

1) Statutory stock options, i.e., incentive stock options (ISOs). §422 (*next slide*)

Income tax treatment: Only capital gain treatment upon the eventual stock disposition.

2) Nonstatutory stock options, i.e., dependent upon the tax accounting rules. But, see treatment under §83 concerning possible current gross income inclusion.

Incentive Stock Option (ISO) Rules §422 P.434

Statutory structure permitting GI inclusion as limited to capital gain upon the sale of stock.

What is ISO stock? See §422 rules:

- 1) Stock retention requirements.
- 2) Option price at FMV when granted.
- 3) Granted under an option plan.
- 4) \$100,000 limit on option stock amount.
- 5) No employer deduction for compensation.

Net benefit if (a) employer loses immediate deduction but (b) deferral of cap. gain for EE?

Nonstatutory Stock Options

p.434

Stock is available to employee but is subject to restrictions on transferability and a risk of forfeiture. No inclusion since a valuation issue?

Note §83(a) – inclusion in GI when stock option is issued if having “readily ascertainable” FMV.

No current GI inclusion when the option is “nontransferable” and a “substantial risk of forfeiture” – inclusion when conditions lapse.

GI inclusion when exercise for the difference between (1) exercise price and (2) stock value.

Election to Accelerate Inclusion re NSO p.434

§83(b) – employee can elect current inclusion (even if a forfeiture risk) to the extent of FMV.

GI inclusion is based on the value of stock (not options?) without restrictions.

No income tax (loss) deduction by an employee who made a §83(b) election if a forfeiture of the option subsequently occurs.

But, §83(b) is not applicable if an option “lacks a readily ascertainable fair market value.”

§83(e)(3).

Problem 1

§83

p. 435

Employer transfer of stock for 10x, subject to restriction for five years.

Stock is worth 15x when transferred and 35x when later restrictions lapsed. Later sale at 50x.

Result: Compensation of 25x (35x less 10x) when the restrictions lapsed; unless an §83(b) election, then 5x income on the original transfer.

Sale: Capital gain of (a) 15x on sale (35x basis), or (b) 35x LT CG (15x basis) if §83(b) election.

Problem 2

§83

p. 435

Transfer of stock subject to restriction for one year further employment requirement.

When one year expires (2010) stock can be purchased for \$21 and the value of stock is \$65 per share. The value of the bargain at that time is \$44 per share – then includible in compensation income (& the transfer restriction does not delay the timing of income recognition).

Problem 3

§83

p. 435

Sale of stock (before substantial vesting) for delivery in a subsequent year & the sale is for \$35 per share.

Rule of tax on vesting does not apply (see last sentence in §83(a)).

Income is \$14 (\$35 amount realized less \$21 cost).

Chapter 6