Presentation:

Federal Income Taxation

Chapter 10 Personal Deductions, Exemptions, Credits

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October 2, 2017
§163(a) Deduction generally allowed for interest

§163(d) Limitation on deductions for investment interest

§163(h) Exception: Disallowance for interest for personal interest.

§163(h)(2)(D) Exception to Exception: Qualified Residence interest is not “personal interest” within the meaning of §163(h)
FACTS: Knetsch will pay an insurance company ~$140,000/year interest ($294,570 over two years) and will receive an increase in cash surrender value of his annuity contracts of ~$100,000 a year ($203,000 over two years) that he borrowed against to partially pay this annual interest. Why would anyone enter into the deal?

Court Holding: Denied interest deduction on grounds that transaction lacked economic substance. “Plainly, therefore, Knetsch’s transaction with the insurance company did “not appreciably affect his beneficial interest except to reduce his tax. . . .”

Question: How did this transaction artificially reduce Knetsch’s taxes?

Subsequent Events: See §72(e)(2); §7701(o).
Tillie Goldstein: Won Irish Sweepstakes ($140,218.75). Tillie borrowed two loans (totaling $945,000) to purchase $1 million of US Treasuries bonds that were pledged as collateral for the loans. Tillie prepaid the first two years of interest of ~$81,000. The purpose of the plan was to shield the sweepstakes winnings in the year of receipt by reducing net income for that year, with the expectation that the profit when the investments were subsequently closed could be reported as long-term capital gain.

Court Holding: Transactions were not shams as conducted by true independent parties with independent significance. However, “[o]n the other hand, and notwithstanding Section 163(a)’s broad scope, this provision should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer’s desire to obtain the tax benefit of an interest deduction: and a good example of such purposeless activity is the borrowing of funds at 4 percent in order to purchase property that returns less than 2 percent and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential.”
Rev. Proc. 72-18 states that Section 265(a)(2) denies an interest deduction for debt incurred to purchase tax-exempt bonds. But, in applying this restriction, this revenue procedure provides that there must be “direct evidence” that indebtedness was incurred to purchase tax-exempt bonds and absent direct evidence Section 265(a)(2) would not be applied. Direct evidence exists in two instances:

.02 Direct evidence of a purpose to purchase tax-exempt obligations exists where the proceeds of indebtedness are used for, and are directly traceable to, the purchase of tax-exempt obligations. Section 265[(a)](2) does not apply, however, where proceeds of a bona fide business indebtedness are temporarily invested in tax-exempt obligations.

.03 Direct evidence of a purpose to carry tax-exempt obligations exists where tax-exempt obligations are used as collateral for indebtedness.
Taxpayer traded stocks for his own account. He purchased undervalued stock and held until stock traded at fair value. He often provided business advice to companies he invested into. Margin debt ranged from ~$42 million in 1979, ~54 million in 1980, and he had margin debt of ~70 million at his death.

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Issue: Was the taxpayer’s interest expense subject to Section 163(d)’s limitation?

Holding: Court said “yes” because Yaeger was an investor, not in trade or business of buying and selling stock.
§163(a) Allows interest expense deduction generally.

§163(h)(1) Disallows interest expense deduction for personal interest

§163(h)(2) Exception: interest on a qualified residence is excepted from §163(h)(1)’s prohibition.
Qualified Residence Interest

EXAMPLE A: A buys a house for $1.5 million, with a down payment of $300,000 and a loan of $1.2 million. Acquisition indebtedness accounts for $1 million (which is the limit) of the loan. Tax Court in Pau v. Commissioner, 73 T.C.M. 1819 (1997) said that $1 million is the overall cap that applies. But, in Rev. Rul. 2010-25, 2010-2 C.B. 571, the IRS indicated it would allow $1.1 million via treatment of the extra $100,000 as a home equity loan.

EXAMPLE B: B buys a house for $300,000, with a loan of $115,000 and the remaining $185,000 from her savings. A month later she borrows $125,000, secured by the house. The entire amount of the first loan ($115,000) is acquisition indebtedness. The second loan ($125,000) is a home equity loan and qualifies only up to $100,000. If B had borrowed the entire $240,000 at the time of the purchase of the house, the entire amount of the loan would have been acquisition indebtedness. Can you think of any sound justification for this difference in result?

EXAMPLE C: C bought a house many years ago for $50,000. It is now worth $300,000. The debt incurred at the time of the original purchase was paid off several years ago. C takes out a loan of $140,000; the loan is secured by the house. Since the loan was not used to buy, build, or improve the house, the qualified residence interest is limited to the home equity indebtedness amount, $100,000. Note that home equity indebtedness may exceed basis. Note also that if C had sold her present house for $300,000 and had bought another house for the same price, but with a loan of $140,000 secured by the house, she would have wound up with $140,000 in cash from the transaction (just as if she had borrowed that amount on the security of the first house), but the entire loan would have qualified as acquisition indebtedness. (The same possibility arises in Example B.) Why would Congress create that kind of incentive?
Prof. Shaviro (NYU) has commented that some “special tax breaks [...] don’t merely create perverse incentives but seriously aggravate major economic problems” (writing in the context of the $500,000 exemption for home appreciation).

(M. Sullivan, Tax Notes, 29 September 2008)
§164 Deduction for State and Local Taxes

Reason: Income measurement principle?

Recognition of paying for complimentary government function.
FACTS: New York imposed a real property tax on renters in their state, but the total amount of rent that could be charged was subject to rent control.

ANALYSIS: The fact that New York treats a portion of the total rental as real property tax payments does not establish that those payments are in fact real property tax payments because the focus is on the nature of the transaction under federal law. The New York renters tax does not impose on the renter any economic burden that did not exist prior to the enactment of section 304 of the New York Real Property Tax Law. In the event of the renter’s nonpayment, section 304 looks to the owner for payment.

HOLDING: The New York State renters tax paid by renters is not a tax on the renter for federal income tax purposes, but rather is part of the renter’s rental payment.
Reg. §1.165-7(b) – the amount of the deduction is limited to the lesser of the asset’s fair market value or tax basis.

Consider the appreciated property lost in casualty – deduction is limited to basis.

No loss if an insurance recover?

Possible casualty gain (with insurance)?

Consider the Madoff scams – what income tax effect? Theft loss?
Nancy Carpenter placed her diamond engagement ring in a water-glass of ammonia to clean it. William Carpenter picked up the glass and emptied its contents down the sink drain and then activated the garbage disposal. The damaged ring (originally worth $1,010) was recovered and determined to only be worth $30 due to the damage, so a $980 loss. William Carpenter bought a replacement ring for $169.50.

Section 165(c)(3) provides for certain deductions for personal losses: fire, storm, shipwreck, or other casualty, or from theft.

Subject to a 10% floor & $100 limit. What purpose of the 10% floor?

Note 3: “Suddenness Requirement”
- jewelry loss?
- fast-eating termites?
- dry rot? No.
(a) A bought an automobile for personal use, paying $26,000. She was in an accident in which the car was damaged. The car was worth only $10,000 after the accident. What amount is allowable as a deduction on account of this loss?

(b) B bought a house (land and building) for use as his personal residence for $240,000. Later when the property (land and building) was worth $260,000, the house burned down. The land is worth $40,000. How much is allowable as a deduction? What if B recovered $180,000 in fire insurance on account of the loss?

(c) C owned a piece of property with a basis of $40,000 and a fair market value of $30,000. How much can C deduct if this item is stolen?
Facts: Taxpayer burned wife’s cloths in fit of rage and set whole house on fire. Taxpayer claims a casualty loss deduction of $97,853 for the destruction of the house and all its contents. IRS disallows the casualty loss.

Holding: No casualty loss deduction. “It is well settled that the negligence of the taxpayer is not a bar to the allowance of the casualty loss deduction. . . . On the other hand, gross negligence on the part of the taxpayer will bar a casualty loss deduction. . . . In our judgment, the petitioner’s conduct was grossly negligent, or worse.”
Medical expense is a uniquely personal cost, but the cost is (partially) deductible. Why?

Not a consumption item?

Consider the “tax expenditure” cost.

Code §213(a) - provides a deduction for medical expenses in excess of 10% of the taxpayer’s “adjusted gross income”. Cf., §165(h)(2) 10% loss floor.
Defining The Term  
“Medical Care”  


Amounts paid for diagnosis, cure, mitigation, treatment, or prevention of disease.

Not for some cosmetic surgery - note the Code §213(d)(9) limitation. Is a “business expense” deduction available as an alternative (since not treated as deductible for medical care)? No?

Birth control pills? See Code §213(b) & (d)(3) re prescribed drugs.

Psychological counseling?


Not lavish: $50 per night limit.

Travel from the cold north to a warm weather environment in the winter (with a doctor’s prescription)?
Deduction for medical insurance premiums.
   Code §213(d)(1)(D), (6) & (7).
   Self-employed coverage costs - §162(l).

Medicare contributions.
   Code §213(d)(1)(D).

Long term care premiums. p.144
   Code §213(d)(1)(C) & (10).

Exclusion – next slide
Facts: Taxpayer instructed by doctor to not mow his lawn, so taxpayer deducted the lawn care costs as a medical expense deduction.

Held: Not a medical expense.
FACTS: Kids agitated parent and were sent to boarding school. Taxpayer claimed boarding school costs as medical expense.

Holding: Expense was nondeductible family expense under §262. Distinction drawn between direct medical expense and increase in family living costs due to illness of parent. This is not “medical care.”
Additions to a Residence – Capital Improvements

Are the following “medical expenses” for deduction purposes:

An elevator in the home?

A swimming pool at home?

A weight room & sauna?

A tennis court?

See Rev. Rul. 87-106: “However, an expenditure which otherwise qualifies as a medical expense under section 213 shall not be disqualified merely because it is a capital expenditure.”
Pyramiding of §§ 67 and 68 Limitations —

1. AGI $350,000

2. **Miscellaneous Itemized** deductions
   a. Profit-seeking expenses under §212(1) & (2) $7,000
   b. Consulting Fees for Personal Tax Items §212(3) $1,000
   c. Unreimbursed employee expenses $1,000
   d. Total **miscellaneous itemized** deductions $9,000

3. Less: §67 floor (2% of line 1) <$7,000> $2,000

4. Plus: All other Itemized Deductions:
   a. Charitable Contribution $1,000
   b. §165(c)(3) Casualty Loss (40,000 – 100 - $35,000) $4,900
   c. §213 Medical Expenses ($36,000 - $35,000) $1,000

**Total Itemized Deductions subject to §68** $8,900

5. §68 Overall Limitation on Itemized Deductions
   Lesser of (1) or (2) below.
   (1) 3% of amount by which line 1 exceeds $261,500 $2,655
       \(((350,000 - 261,500) \times 3\%)\)
   (2) 80% of Itemized [not excluded by §68(c)] (80% \(\times\) 3,000) $2,400

6. **Total Itemized Deductions after §67 & §68** $6,500

   Claim larger of Itemized Deductions or Standard Deduction