QUESTION 37

When Corp pays the premiums on health insurance for Avery, Avery does not have gross income. IRC § 106. Nor does Avery have gross income when the insurance company pays, or reimburses Avery, for medical expenses. IRC § 105(b).

The fact that Avery is given a choice between family insurance coverage and salary potentially raises the issue of constructive receipt. However, if the arrangement qualifies as a "cafeteria plan," as defined in IRC § 125, neither the plan's payment of the premiums nor its payment of health care benefits results in gross income. One of the requirements of a cafeteria plan is that it not discriminate in favor of highly compensated employees.

Assuming that Avery itemizes her deductions, she is entitled to a deduction for out-of-pocket medical expenses, but only to the extent that they exceed 7.5 percent of her adjusted gross income for the year.

The payment by Corp of club dues constitutes gross income to Avery. There is no exclusion in the Code for such benefits. The dues are not a working condition fringe as defined in IRC § 132(d), because if Avery had paid the dues herself, she would not have been entitled to a deduction. Deductions for club dues are forbidden by IRC § 274(a)(3), even if the taxpayer uses the club for business entertainment. Separate treatment for the cost of meals may be possible under Reg. § 1.274-11.

The entire amount of the cash bonus is gross income, ordinary income, to Avery when she receives it in 2022. When she repays some of it in 2024, IRC § 1341 gives her a choice to either deduct the repayment on her 2024 tax return or take a credit against her 2024 tax for the tax she paid in 2022 on the portion of the bonus that she had to return. Because the deduction would be disallowed as a miscellaneous itemized deduction under IRC § 67, under current law Avery may be left with no choice but to take the credit. No amended return for 2022 is required or allowed.

The settlement for wrongful termination is gross income to Avery, ordinary income, except to the extent, if any, that it represents reimbursement for medical expenses, not previously deducted, arising out of emotional distress. To determine the extent to which the settlement represents such a reimbursement, excludible from gross income, an allocation of the $300,000 amount must be undertaken. Courts look to the intent of the payor in determining to what extent settlement payments are meant to compensate for particular elements of damage.

Avery is entitled to a deduction under IRC § 212 for her attorney's fees and court costs, because the lawsuit was brought for the production of income. Reg. § 1.262-1(b)(7). However, these are miscellaneous deductions and not allowed under current law.

Corp may deduct the health insurance premiums it pays for Avery and her family, as well as the full amount of the bonus. Corp may also deduct the settlement paid to Avery, and Corp's attorney's fees and court costs, because the origin of Avery's claim was clearly attributable to Corp's business. Because the club dues are treated as compensation income to Avery, Corp may deduct them as compensation expense rather than entertainment expense. IRC § 274(e)(2).

When Corp receives repayment of a portion of Avery's bonus in 2024, Corp must report the recovery as gross income, ordinary income, on its 2024 tax return under the tax benefit rule, unless the earlier deduction of the bonus paid did not produce any tax benefit to Corp, see IRC § 111. No amended return for 2022 is required or allowed.

None of the deductions is a capital loss. All of the deductions are allowable against the taxpayer's ordinary income or capital gains.

QUESTION 38

Rents paid by tenants of Rentacre are gross income, ordinary income, to the recipient.

When Mona dies, the gain on Rentacre is not realized.

The receipt of Rentacre as an inheritance is not gross income to Dina; it is a gift. IRC § 102. The basis of Rentacre in Dina's hands is its fair market value of the date of Monas death, or $5,000,000. IRC § 1014. Any rent that is due from tenants when Mona dies does not receive the step-up in basis, and is taxed to Mona's estate or Dina, as income in respect of a decedent, when received.

Is the three-way transaction involving Rentacre and Viewacre a nonrecognition transaction, in which Dina's realized gain ($5,100,000 minus $5,000,000, or $100,000) is not recognized? Yes. It is a like-kind exchange under IRC § 1031. One might question whether Rentacre was "held" by Dina for productive use in a trade or business or for investment because she owned it for only a short time. However, she did not decide to part with it until shortly after she received it, and so it would likely be treated as "held" for the proper purpose, especially since she apparently never used it for personal purposes. She intends to hold Viewacre for investment and the timing requirements of IRC § 1031(a)(3) are met.

Upon receiving Viewacre without recognizing any gain, Dina gets a basis in Viewacre of $5,000,000 (a carryover basis from Rentacre), plus an additional $600,000 cost basis for the money she paid to obtain it, for a basis in Viewacre of $5,600,000.

The real estate commission is a capital expenditure because it was incurred to obtain Viewacre, a long-lived asset. It may not be currently deducted; it must be added to basis of Viewacre, bringing the basis to $5,998,000.

The payment of $2,000 to Hank may also be a capital expenditure, because it may be a betterment to Viewacre. The removal of the fence remediates a defect that was present when Dina acquired Viewacre. Expenditures of this nature tend to be capital expenditures that must be added to the basis of the acquired asset rather than being deducted, at least if the amounts are significant (which may not be the case here). If the payment to Hank is a capital expenditure, Dina's basis in Viewacre is increased by another $2,000, to $6,000,000.

When part of a larger property is sold, the property's overall basis must be allocated "equitably" between the portion sold and the portion retained. Only the basis allocated to the portion sold may be subtracted from the amount realized in computing the taxpayer's realized gain or loss on the sale. Because half of the acreage was sold here, one might allocate half of Dina's basis (or $3,000,000) to the portion sold. Subtracting that basis from the $3,200,000 amount realized on the sale, Dina would realize and recognize a $200,000 gain. This is a long-term capital gain because it arises from the sale of a capital asset held for more than one year.

When Vin pays the rent to Gabe, it is gross income to Dina. The rules on income-splitting forbid "carving out" an income interest while the assignor of the income continues to own the underlying property. The rent is not gross income to Gabe; it is treated as a gift to him from Dina. Medical school tuition does not likely meet the requirements for a deductible business expense under Reg. § 1.162-5 because it qualifies Gabe for a new trade or business or is entry-level education for Gabe's current job. A lifetime learning credit under IRC § 25A may be available.

Property taxes incurred in a rental business, such as Mona's, are deductible. Mona may be entitled to a deduction for qualified business income under IRC § 199A. Dina may be entitled to a tax credit for Gabe as her qualifying child or qualifying relative.