Question 37

Receipt of the Pubco stock as a gift is not gross income to Natalia. IRC § 102(a). Natalia's realized gain or loss on the sale of the Pubco stock is determined by subtracting from her $7,500 amount realized (see IRC § 1001(b)) the stock's adjusted basis. IRC § 1001(a). Under section 1015(a) of the Code, because the fair market value of the stock at the time of the gift was less than the stock's fair market value at that time, the adjusted basis of the stock for purposes of determining a loss subsequently realized by Natalia is the lower figure, $8,000. Therefore, Natalia's loss on selling the Pubco stock is $500. It is a capital loss. The capital loss is long-term. For individuals, capital losses are deductible only against capital gains for the year, plus up to $3,000 of ordinary income. Deductions for losses on sales of property, as here under section 165(c)(2), are taken above the line. IRC § 62(a)(3).

Borrowing money does not constitute gross income. Natalia's payment of interest on the loan is deductible as an ordinary and necessary business expense, and it is an above-the-line deduction. IRC §§ 62(a)(1), 162. However, a deduction for business interest is limited by section 163(j) of the Code, generally to 30 percent of the taxpayer's net business income for the year. Because the landscaping business is only modestly profitable, the interest Natalia pays on the $500,000 loan may exceed the limit. However, this limit applies only to businesses whose gross receipts for the year exceed $25,000,000. Any nondeductible interest payment may be carried forward indefinitely under section 163(j)(2). The deduction for business interest is ordinary, i.e., not a capital loss. It is taken above the line. IRC § 62(a)(1). Principal repayments are not deductible.

Equipment and vehicles used in a business give rise to a deduction for depreciation under sections 167 and 168, or an election for immediate deduction under section 179. Either is an above-the-line deduction. Natalia's landscaping business may be eligible for a qualified business income deduction under section 199A. This would be a below-the-line deduction, but not an itemized deduction. These are ordinary deductions, i.e., not capital losses.

If she itemizes her deductions, Natalia may deduct the interest paid on the acquisition indebtedness incurred to buy the principal residence, up to interest on $750,000 of debt. IRC § 163(h)(2)(D). If she itemizes, she may also deduct the property taxes, subject to the $10,000 annual limit for state, local, and foreign taxes in section 164(b)(6). As for her other expenses relating to her home, she may deduct, above the line, a portion allocable to the bedroom used as an office, including a depreciation deduction, but only if the home office is her principal place of business and only if she uses the bedroom exclusively and regularly for business purposes. IRC § 280A(c)(1). The deductions would be limited by Section 280A(c)(5) to the gross income derived from the use of the office. All of these are ordinary deductions, i.e., not capital losses.

None of the deductions implicated by the facts of the question are miscellaneous itemized deductions.

The settlement payment received from the promoter is not gross income to the extent that it represents compensatory damages for personal physical injury. IRC § 104(a)(2). To the extent it represents punitive damages, however, or is a payment to keep matters confidential, the settlement is gross income (ordinary income) to Natalia. The allocation of the $1,500,000 payment between taxable and nontaxable portions depends on the intent of the payor, i.e., the promoter. More facts are needed to determine that intent. Any allocation of damages in a settlement agreement would likely be binding on Natalia for federal income tax purposes.

Question 38

When Jay receives the bicycle as payment for his services as a musician, the fair market value of the bicycle, $15,000, is includible in his gross income as ordinary income under section 83(a) of the Code. His subjective valuation of the item is irrelevant.

As a result of being taxed on receipt of the bicycle, Jay receives a basis in the bicycle of the fair market value on which Jay is taxed, namely, $15,000. Reg. § 1.61-2(d)(2)(i) (last sentence). When Jay sells the bicycle for $8,000, he realizes a $7,000 loss, but it is not deductible. IRC § 165(c).

If Jay itemizes his deductions, he may seek a charitable contribution deduction under section 170. A threshold question is whether the transfer of the acreage to the school district is a contribution at all. Given the substantial benefit Jay receives in return for the transfer, the IRS may argue that the transfer is not a "contribution or gift" eligible for the deduction. A gift is defined for income tax purposes as a transfer out of detached and disinterested generosity; that may not be the case here.

If the transfer of the land is a gift, the amount of the deduction must be reduced by the value of the benefit Jay receives from the school district's improvements. More facts would be needed to develop that valuation. Because Jay is an investor, the amount of the deduction is generally the fair market value of the property, $2,000,000, reduced by the value of the return benefit. However, if Jay has held the land for a year or less, the starting point for the amount of the deduction would be its basis, $1,300,000, rather than its fair market value. IRC § 170(e)(1)(A). The deduction is capped at 30 percent of Jay's "contribution base," essentially his adjusted gross income, for the year of the deduction, with a five-year carryover of any excess. IRC § 170(b)(1)(C). To be eligible for the deduction, Jay must meet the substantiation requirements in the regulations under section 170.

As Jay is not holding Blackacre for sale to customers (see IRC § 453(b)(2)(A)), his sale of Blackacre is an installment sale. The default treatment of such a sale is the installment method of reporting gain. Under that method, a portion of each payment received is treated as taxable gain, and the remainder of the payment is treated as a tax-free return of basis. The portion treated as taxable gain is determined by the dividing the gross profit on the overall sale by the total contract price. IRC § 453(c). Here, the gross profit is $1,000,000 ($2,000,000 overall sale price minus $1,000,000 adjusted basis), and the total contract price is $2,000,000. Therefore, the inclusion ratio applied to each payment of principal received is one half ($1,000,000 / $2,000,000). When Jay receives each $400,000 payment (including the down payment), $200,000 is taxable gain. The gain would be capital gain.

If Jay elects out of the installment method under section 453(d), Jay would recognize all or most of his gain at the time of the closing. This would all be capital gain. The gain would be calculated by subtracting the $1,000,000 adjusted basis from Jay's amount realized at the closing. The amount realized would be $400,000 cash plus the fair market value of the note, see IRC § 1001(b). If the fair market value of the note is less than its face amount of $1,600,000, the difference would be taxed to Jay as interest income over the term of the installment note.

All of the interest payments Jay receives constitute gross income, ordinary income, to Jay when he receives them.