

QUESTION 37

The grant of a stock option to an employee is not gross income unless the option itself has a readily ascertainable fair market value, which the option granted to Rae does not. Consequently, Rae has no gross income on account of the option. Xco is not entitled to a deduction for the grant of the option.

The \$100,000 payment upon retirement is likely to be gross income. Under section 102(c) of the Code, transfers from employers to employees cannot be excluded from gross income as gifts. One could argue that at the time of the payment, Rae was no longer an employee. In that case, the *Duberstein* test would apply, and the payment could be a gift, and therefore not gross income, if it were motivated primarily by detached and disinterested generosity. Such income would be ordinary income. If the payment is not a gift, Xco can deduct it as an ordinary and necessary business expense, compensation for services rendered, under section 162. However, if the payment is a gift excluded by section 102(a), Xco's deduction is limited to \$25. IRC § 274(d).

Gifts are not gross income to the recipient, nor are they realizing events for the donor. Thus, the gift of the sculpture does not give rise to gross income for Rae or Sam. Sam's basis in the sculpture carries over from Rae, \$2,000. If Rae paid any gift tax with respect to this gift, the basis is increased by part of any gift tax paid. When Sam sells the sculpture, his amount realized is the \$60,000 cash minus the gallery's commission, or \$54,000. Subtracting his basis, Sam recognizes a \$52,000 gain. It is a long-term capital gain. If Sam is young, the gain may be subject to the "kiddie" tax under section 1(g). Sam's basis in his new investments is their cost.

Rae's payment of tuition is not deductible, despite her profit motive, because the education qualifies her for a new trade or business. However, Rae may be entitled to a lifetime learning credit under section 25A. Rae's wardrobe expenses are likely to be nondeductible, because the clothing is likely to be suitable for ordinary wear.

Rae's travel expenses may be deductible, but only 50 percent of the cost of any meals may be deducted. Deductions from Rae's new comedy business are "above the line," i.e., taken in computing adjusted gross income, under section 62(a)(1), unless Rae is deemed to be an employee of the clubs at which she performs. A portion of any startup expenditures in connection with the business is deductible, and the rest of such expenditures is amortizable, under section 195.

Money that Rae receives from the comedy shows and website is gross income (ordinary income). Ongoing expenses of the business are deductible under section 162. Depending on the amount of her taxable income, Rae may be entitled to a deduction under section 199A for qualified business income arising out of her comedy activities.

The deductions in this question are all available to be taken against ordinary income as well as against capital gain, as none of the deductions are for capital losses.

QUESTION 38

The money Andy borrows is not gross income to him. Andy's basis in the Plex begins with his cost of \$500,000, increased by the \$2,000 fee paid to the attorney. Transaction costs in acquiring property are treated as part of the cost basis. Because they are performed before Andy places the Plex in service, the window replacement and deferred maintenance also give rise to capital expenditures that add to the basis of the Plex, so that Andy's basis becomes \$540,000.

The rent Andy receives is gross income, ordinary income.

When Andy takes \$40,000 of depreciation deductions with respect to the Plex, his basis is adjusted downward by that amount.

Andy's payment of interest on the loan is deductible as business interest, subject to the limitations of section 163(j) of the Code if Andy's annual gross receipts exceed \$31,000,000. Repayments of principal have no tax consequences to the borrower.

Andy's deductions in his rental business are taken above the line, thus reducing adjusted gross income, under sections 62(a)(1) and 62(a)(4). The deductions are not capital losses. Andy may be entitled to a deduction for qualified business income under section 199A.

The exchange of the Plex for the vacant lot is a like-kind exchange covered by section 1031. Andy's realized gain is computed as follows: amount realized of \$220,000 (fair market value of the lot) plus \$380,000 (the outstanding balance on the mortgage, under *Crane*), minus basis of \$500,000, or \$100,000 realized gain.

Under the last sentence of section 1031(d), the \$380,000 mortgage is treated as money received by Andy, and therefore "boot" subject to section 1031(b). Under that provision, his entire realized gain is recognized because it is less than the "boot." The gain is capital gain under section 1031(d), but subject to depreciation recapture under section 1250. Therefore, it is taxed at less favorable rates than other capital gain, but at a more favorable maximum rate than ordinary income.

Andy's basis in the vacant lot immediately after the exchange is his adjusted basis in the Plex (\$500,000), reduced by the money deemed received (\$380,000), and increased by the gain recognized (\$100,000), for a basis of \$220,000.

Any income or loss that Andy's business generates is probably not passive income or loss, because Andy likely fits within the exception from the passive loss rules for real estate professionals in section 469(c)(7).