Taxation of Individual Income

Fifth Edition

2001 Supplement

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Chapter 1

INTRODUCTION

The 2001 Tax Act:

The Economic Growth and Tax Relief Reconciliation Act of 2001 (hereinafter the 2001 Tax Act) affects a number of provisions discussed in this Chapter. The 2001 Tax Act reduces individual tax rates (see pages 8, 17), over a 6-year period, from 28% to 25%, from 31% to 28%, from 36% to 33%, and from 39.6% to 35%. (For 2001 the rates are, respectively, 27.5%, 30.5%, 35.5% and 39.1%.) In addition, a new 10% rate bracket is created, applicable to specified portions of taxable income currently taxed at a 15% rate.

Personal exemptions (page 16) are subject to phase-out for taxpayers with sufficiently high levels of adjusted gross income. Starting in 2006, the 2001 Tax Act eliminates these phase-out provisions over 1 5-year period.

Section 68 (page 16) limits allowable itemized deductions when adjusted gross income exceeds certain inflation-adjusted amounts. Starting in 2006, the 2001 Tax Act phases out the § 68 limitation over a 5-year period.

Starting in 2005, the basic standard deduction (page 16) for married taxpayers is increased by the 2001 Tax Act over a 5-year period so as to be twice the amount for unmarried individuals. Also, the 15% tax bracket for married taxpayers is widened, over a 4-year period starting in 2005, so as to be twice the size of the bracket for unmarried individuals.

The child tax credit of $500 per child (page 18) is increased by the 2001 Tax Act, over a 10-year period, to $1,000. For 2001 through 2004, the credit amount is $600.

2001 Inflation Adjustments

The year 2001 inflation adjustments for various amounts -including the tax rate tables, the standard deduction, the personal exemption and the personal exemption phaseout, and the overall limitation on itemized deductions -are contained in Revenue Procedure 2001-13, Section 3, Part I, 2001-03 I.R.B. 1.

Chapter 5

GIFTS, BEQUESTS AND INHERITANCE

Page 85:

[C] Part-Gift, Part-Sale

The hypothetical in this section posits a sale of property between family members where the property's value is $50,000, the sales price is $10,000, and the seller's basis is $20,000. The text notes that the transaction is in effect a part-sale, part-gift, that under Regulation § 1.1001-1(c), no loss may be recognized, and that gain is recognized only to the extent the amount realized exceeds the basis of the seller-donor.

Suppose that the property in the hypothetical were subject to a liability of $10,000, and that the buyer, in lieu of paying the seller-donor $10,000 in cash, assumes the $10,000 liability when receiving the property. The same result obtains as in the original hypothetical: the transaction is still in part a gift and in part a sale; the amount realized by the seller-donor, on account of the assumption of the liability, is still $10,000, pursuant to Regulation § 1.1001-2(a)(1), (4)(ii),)iii), and neither gain nor loss is recognized on the transaction. Note, however, that gain can be recognized on a part-gift, part-sale if the liability assumed exceeds the seller-donor's basis in the property. Thus, for example, if the liability assumed in our revised hypothetical were $25,000 (and the basis remained $20,000), the amount realized would become $25,000, and gain of $5,000 would be realized and recognized on the part-gift, part-sale. *See also Diedrich v. Commissioner*, 457 U.S. 191 (1982).

Chapter 6

SALE OF A PRINCIPAL RESIDENCE

Page 97: Add the following problem:

On June 1, 1998, Matthew leased a house with an option to buy. On January 1, 2000, he purchased the house and continued to live there until July 1, 2000 when he decided to move into a condominium in the same town. Matthew retained ownership of the house, however, until August, 2002 when he sold the house at a $100,000 gain. After moving out of the house, Matthew rented it. Between June 1, 1998 and July 1, 2000, the house was Matthew's principal residence. Assume that Matthew spent August and September of 1998 and 1999 traveling in Europe. May Matthew exclude the gain realized on the house sale?

Page 98: Add the following to the Chapter assignment:

Prop. Reg. § 1.121-1 -1.121-4.

Page 103:

The 1998 legislation clarifies the computation of the exclusion in the case of a married couple filing jointly who do not satisfy the requirements of § 121(b)(2)(A). According to § 121(b)(2)(B), the exclusion will equal the sum of the amount each spouse would be entitled to exclude vis-a-vis the residence under § 121(b)(1) if the spouses had not been married. For purposes of the computing that amount, the each spouse is to be treated as owing the property during the period that either spouse owned the property.

> **Example:** A purchased home three years ago. Eighteen months ago, B moved in with A. A and B were married six months ago. A and B sold the home this year at a gain of $300,000. A and B will file jointly this year. Under these circumstances, § 121(b)(2)(A) will not apply because B has not used the residence as a principal residence for the required two year period. Applying § 121(b)(2)(B), the exclusion available to A and B on their joint return will equal the sum of the exclusion available to A and the exclusion available to B under § 121(b)(1). For the purpose of computing the exclusion, if any, available to B, B will be deemed to have owned the residence for three years, i.e., the same period that A owned the residence. A would be entitled to an exclusion of up to $250,000 under § 121(b)(1). B, however, would not be entitled to any exclusion since B had failed to use the residence as a principal residence for periods aggregating two years. Thus, the total exclusion available on the joint return would be $250,000.

In the above example, however, if A and B sold the home because B accepted employment in another state, § 121(c)(1) would then apply and

B would be authorized to exclude an amount up to a fraction of the $250,000 limitation of § 121(b). That fraction would be 3/4, i.e., B would be deemed to have owned and used the residence for 18 months which represents 3/4 of a two year period. As a result, B could exclude up to 3/4 of $250,000 or $187,500 and A could exclude up to $250,000. Since the gain on the sale of the home is $300,000 and since presumably each spouse is treated as realizing $300,000 of gain, A and B will be entitled to exclude up to a total of $437,500 in gain. Because the total gain is only $300,000, all $300,000 will be excludable on the joint return filed by A and B.

Chapter 8

LIFE INSURANCE AND ANNUITIES

Page 121-22: Some printings of the Fifth Edition of this text contain a typographical error that begins with the last 2 lines on Page 121 and continues into the first 6 lines on Page 122. These lines should read as follows:

Why do the mortality gains for the winning taxpayers receive tax-free treatment? A number of reasons could be advanced. Life insurance proceeds might be viewed as somewhat equivalent to gifts and bequests, which are excluded from gross income under § 102. The exclusion of the increase in the "value" of the policy (in our example, from $100 at the time of purchase to $50,000 at death) is similar to the exclusion provided by the basis step-up rules of § 1014 for property passing at death. In addition, by providing tax-free treatment to life insurance proceeds under § 101, and nondeductibility of their premiums under § 262, the whole matter can be seen, in the aggregate at least, as roughly a wash from the standpoint of the government. Assuming that taxation of the proceeds would entail allowing a deduction for premiums, or for recovery of basis in some fashion, the present system may be viewed as the simplest and most efficient way of dealing with the issue. Moreover, we may simply want to use the tax system to encourage people to provide some protection against sudden loss of family earnings. Finally, of course, the circumstance in which life insurance proceeds are received -upon the death of the insured, who may perhaps be the family breadwinner -may obviously be regarded as a particularly inappropriate time to tax the beneficiary.

Page 127: Some printings of the Fifth Edition of this text contain a typographical error that begins 8 lines from the end of the first paragraph. The lines should read as follows:

Thus, the first 15 payments would be fully taxed as income, and the last 10 payments would be the nontaxable return of basis. We could also choose an in-between method, and prorate the income over the term of the payments, and indeed this is the approach taken by § 72. Thus, with a $10,000 investment and $25,000 in total payments, 10/25 (40%) of each payment is nontaxable return of basis. The $15,000 of income is 60% (15/25) of the $25,000 total, so 60% of each payment is income. The result is that of each $1,000 payment, $600 is gross income and $400 is nontaxable. At the end of 25 years, Taxpayer will have received $10,000 tax-free ($400 x 25) and been taxed on $15,000 ($600 x 25).

Part C: Individual Retirement Accounts

Page 131:

The second sentence of the first paragraph under *Deductible IRAs* notes that the $2,000 deduction is phased out when the taxpayer or the taxpayer's spouse is an active participant in an employer-sponsored retirement plan and has an adjusted gross income in excess of a specified dollar amount. Under pre-1998 law, where either taxpayer or the taxpayer's spouse was an active participant, the same phaseout range on joint returns applied to both of them with respect to their ability to deduct their separate IRA contributions. Under the 1998 amendments to § 219, different phaseout ranges will apply. For the spouse who is an active participant, the phaseout range for the year 2000 is $52,000 to $62,000 on joint returns. However, the spouse who is not an active participant may make deductible contributions of up to $2,000 at much higher income levels -$150,000 to $160,000 on joint returns. § 219(g)(7).

Page 131-132:

Note, contrary to the text, that distributions from deductible IRAs and nondeductible IRAs must commence by April 1 of the year following the year the taxpayer reaches age 70 1/2. The distributions may not be postponed until retirement if that date is later. § 401(a)(9)(C)(ii)(II).

Page 131:

Under the 2001 Tax Act, the contribution limit for IRAs is scheduled to increase to $3,000 in 2002, and rise to $5,000 by 2008, with adjustments for inflation thereafter. § 222(b)(5). Special higher limits are provided for taxpayers over age 50. A limited credit for IRA contributions is available to lower-income taxpayers whose adjusted gross incomes do not exceed specified limits. § 25B(a).

Chapter 9

DISCHARGE OF INDEBTEDNESS

Page 136:

In November 1998, Treasury issued final regulations amending the regulations under § 1017. Read Reg. § 1.1017-1(a) and (b)(1) and (3). Skim § 1.1017-1(c) -(f).

Page 142:

5. Discharge of Deductible Debt

In *Johnson v. Commissioner,* T.C. Memo. 1999-162, *aff'd Johnson v. IRS* , 211 F.3d 1265 (4th Cir. 2000), the outstanding loan balance on taxpayer's home at the time of foreclosure included mortgage principal, accrued and unpaid interest, and other charges. The home was sold for somewhat less than its stipulated fair market value, and the lender discharged the balance of the obligation. The Commissioner conceded that the measure of the taxpayer's discharge of indebtedness was nonetheless the difference (here, about $55,000) between the loan balance and the home's fair market value. Furthermore, pursuant to § 108(e)(2), the total accrued mortgage interest, about $23,500, was then excludable from the discharged debt on the grounds that its payment would have given rise to a § 163(h) deduction.

Page 154: Insert the following material after the *Merkel* case.

The Ninth Circuit, in a split 2-1 decision, has affirmed the Tax Court's decision in *Merkel.* The Ninth Circuit majority's review of the relevant judicial and legislative history led it to conclude that:

> We agree with the Tax Court's conclusion that 'an indiscriminate inclusion of obligations to pay . . . in the statutory insolvency calculation . . . , without any consideration of how speculative those obligations may be, would render meaningless any inquiry into whether assets are freed upon the discharge of indebtedness.' We also agree, based on Congress' purpose of not burdening an insolvent debtor with an immediate tax liability, that Congress considered a debtor's ability to pay an immediate tax on discharge of indebtedness income the 'controlling factor' in determining whether the § 108(a)(1)(B) exception applies. Accordingly, a taxpayer claiming to be insolvent for purposes of § 108(a)(1)(B) and challenging the Commissioner's determination of deficiency must prove by a preponderance of the evidence that he or she will be called upon to pay an obligation claimed to be a liability and that the total amount of liabilities so proved exceed the fair market value of his or her assets.

> The dissent urges instead that we adopt a construction of § 108(a)(1)(B) and § 108(d)(3) which would define 'liability' as including all liabilities discounted by the probability of their occurrence. We agree with the dissent that as a general proposition ' "[d]iscounting a contingent liability by the probability of its occurrence is good economics and therefore good law." ' (quoting *Covey v. Commercial Nat'l Bank* , 960 F.2d 657, 660 (7th Cir. 1992) (construing 11 U.S.C. § 101(32)(A), which defines insolvency for purposes of bankruptcy). As sound as the economic policy outlined by the dissent may be, however, it is not the law Congress enacted when it sought to 'accommodate' bankruptcy policy with tax policy . . . . Unlike the statutory provision at issue in Covey, the definition of insolvency in the Internal Revenue Code expressly requires a fair market valuation of assets only and not liabilities. *See* 26 U.S.C. § 108(d)(3) . . . . Moreover, that Congress explicitly provided under [the bankruptcy provisions of] 11 U.S.C. § 101(32)(A) that both 'debts' and 'property' were to be valued 'at a fair valuation' suggests that it knows how to provide for comparable treatment of liabilities and assets when that is what it intends to do." *Merkel v. Commissioner* , 192 F3d 844 (9th Cir. 1999). In determining whether, for purposes of the § 108 insolvency exception, a taxpayer has an "excess of liabilities over the fair market value of assets" -the § 108(d)(3) definition of insolvency -*Merkel* focused on the meaning of the term "liabilities." In *Carlson v. Commissioner* , 116 T.C. No. 9 (2001), on the other hand, the question was whether assets exempt from the claims of creditors under state law should be excluded in calculating the § 108 insolvency exception. The Tax Court, as in *Merkel* , reviewed the legislative history of § 108 and concluded that the answer was "No" -exempt assets were includable, and the Congressional decision not to define "insolvency" so as to exclude them from the calculation was, according to the court, an intentional one.

Page 160:

Author's Note: The Tenth Circuit has recently criticized the Third Circuit's application of the "contested liability" or "disputed debt" doctrine in *Preslar v. Commissioner* , 167 F.3d 1323 (1999). The following excerpt from the majority opinion in *Preslar* provides a helpful analysis of the "contested liability" doctrine:

> The "contested liability" or, as it is occasionally known, "disputed debt" doctrine rests on the premise that if a taxpayer disputes the original amount of a debt in good faith, a subsequent settlement of that dispute is "treated as the amount of debt cognizable for tax purposes." *Zarin v. Commissioner* , 916 F.2d 110, 115 (3d Cir.1990). In other words, the "excess of the original debt over the amount determined to have been due" may be disregarded in calculating gross income. Id. The few decisions that have interpreted this doctrine have generated considerable controversy.