The Federal Income Tax

Policy goals of taxation:

- Taxing the ability to pay, as indicated by taxing only income from which the actual tax payment can be drawn
  - Taxing only on a “realization event”
- Construing income under Section 61 very broadly
- Taxing only on profit, and not underlying investments
  - Maxing income to expenses incurred in generating it
- Taxing amounts which can be accurately measured as having a fair market value
  - Cash and tradable property can be assessed easily
  - Securities and other speculations cannot
- Studiously maintaining the sanctity of the taxable year
  - NOL, Claim of Right, Tax Benefit
- Not allowing deductions that would frustrate public policy
  - Particularly if the taxpayer’s actions giving rise to the claimed deduction are criminal or negligent
    - Grossly negligent action by the taxpayer is an automatic bar to allowing a business expense or casualty deduction
- Mobility of capital
  - To encourage money to flow easily between investments, as taxpayers believe that new opportunities may better utilize capital than old ones.
- Balancing equity against simplicity
- Horizontal equity
  - Equally situated taxpayers should be treated alike
  - If they aren’t, why not?
  - Economically similar transactions should be treated the same way
- Symmetry
  - Making sure the tax treatment of both sides of a transaction make sense
- Deferral of income/time value of money
  - Taxpayers would rather have money in their hands now, and recognize gains/pay taxes as much later as possible
- If receiving cash was a possibility in a transaction, even if the taxpayer received something else he can be taxed
- Bifurcation
  - Splitting a tax event into component transactions that receive different treatment

The Government’s Power to Tax

- The Constitution: Article 1, Sections 2 & 8
  - Mandated that tax be apportioned on states by population
  - Cited by the Supreme Court to overturn early attempts at an income tax
- The 16th Amendment
The power to tax income

Tax liability is broadly assessed based upon **ability to pay**
- Total ability is called a “wage rate”, i.e. the rate at which one *can* earn money
  - Taxes are not assessed this broadly

What is ability to be assessed by?
- **Income**
- **Consumption**
  - “The Flat Tax”
    - Often proposed, but never enacted
    - Example: Income placed in an IRA is not taxed when earned, but only when withdrawn from the account. The flat tax would simply treat all income as saved, and would only assess tax when on the portion of that income that was “withdrawn” and spent
- **Wealth**
  - Under our current system, increases in value of investments (such as stock or art) are not taxed until they are realized (i.e. sold).

The government generally analyzes tax effects based on the **Tax Expenditure Budget**
- A table that treats each tax benefit/exclusion as an expenditure by the gov’t
- **“Tax Incidence”** refers to where the ultimate burden of a tax falls
  - A corporation that is taxed but which adds that tax to the price of its product moves the incidence of the tax to its consumers
- **“Putative Tax”** refers to the difference in value between taxable and non-taxable purchases that a consumer feels when he forgoes taxable options in favor of non-taxable
  - Example: purchasing non-taxable bonds with a return of 7% rather than taxable bonds with a return of 10%
- The government does not take inflation into account when assessing income tax
  - This is particularly bothersome when applied to taxes on investment income

Tax is assessed progressively
- Starting at $0, each given block of income is taxed at progressively higher rates
  - Example: The first $30,000 that *everyone* earns (regardless of total income) is taxed at 15%, the next $25,000 at 20%, and so on.
  - This means that people with more income not only pay more total tax, they also pay a higher proportion of their income in taxes
- **Rate Schedule** defines the levels of income at which each tax increase occurs
  - **Taxable Unit**: The grouping of one or more persons who may be taxed together:
    1. Married Couples: May file jointly (both peoples’ incomes are added together and taxed once). Filed under the most favorable rate schedule.
      - Also available to widowed spouses
    2. Heads of Households: A single person who supports others. Not quite as good as the married person schedule.
    3. Unmarried Individuals: A catch-all group that files at a less favorable rate
    4. Married Individuals Filing Separately: The least favorable schedule
- **The Marriage Penalty**: When two individuals of relatively equal wage rate get married and file jointly, they actually pay more in tax even though they now qualify for the more favorable rate schedule
For example, each person filing separately might enjoy a 15% tax on both of their first $20,000 of income; together they are taxed at 15% only once. This can be much more costly as the rate schedule gets higher.

- The marriage penalty was recently alleviated by allowing married joint filings to include twice as much income at each schedule.

**The Secondary Worker Disincentive**

- When one person in a marriage makes significantly more than the other person, the secondary earner may have an incentive not to work.
  - The secondary earner’s income is taxed at a high rate, because when a married couple files jointly, the primary earner’s wages “use up” the lower brackets of their rate schedule.
  - By working at home, the secondary earner may be able to provide services (such as child care) with value (this untaxable value is called **imputed income**) greater than what they could earn, thus giving her an incentive not to work.

Assessing Tax Liability – 4 Questions

1. Is it income?
2. To whom is it income?
3. When is it income?
4. What kind of income is it?

Compliance and Administration

- The federal income tax is administered by the IRS.
- Taxpayers must assess their own tax liability.
  - There are civil and criminal penalties for non-compliance.
    - Civil penalties have no statute of limitation.
    - Criminal sanctions must be sought within six years.
  - Employers file “**informational returns**”, which detail payroll information.
  - A relatively small number of returns are selected for audits.
  - The IRS has three years to assert any deficiencies in filing.
- All underpayments must be repaid with interest.
  - Interest rate is quarterly and equal to the US short term treasury rate + 3%.
  - A penalty of 20% of the total underpayment is assessed for negligence.
    - Usually applied only in cases of recklessness/intentionality.
  - A substantial understatement exceeds either $5000 or 10% of the total tax.
    - $10000 limit for corporations.
  - Many other penalties exist, but are usually only applied in cases of highly flagrant behavior.
  - Penalties are waived where “good cause” can be shown.
  - The overall lack of IRS enforcement resources favors aggressive tax positions.
- Review of IRS decisions.
o If a disagreement regarding tax liability between a taxpayer and the IRS cannot be resolved, the IRS will order payment
  ▪ The taxpayer can appeal to Tax Court
    • Only available if the tax is unpaid
      o May be paid after the suit is filed to stop interest charges from accruing
    • Bench trial with a specialize tax judge
    • Appealable to the US Courts of Appeals, and thereafter the Supreme Court
  ▪ The taxpayer can immediately pay the tax and sue for a refund in US District Court
    • Regular jury trial
    • Standard chain of appeal
  ▪ The taxpayer may also sue for a refund in Federal Claims court
    • Same chain of appeal

Tax Base
  • **Tax Base** is the amount of income/consumption/wealth a taxable unit is liable for
  o Gross income, from which allowances/deductions are subtracted
  o **Gross income** is narrowly defined by section 61 of the IRC
  o **Adjusted Gross Income (AGI)** is arrived at by subtracting items in section 62 from gross income
  o **Personal exemptions** are then deducted from the AGI to determine **taxable income**
    ▪ Standard or itemized deductions
  o Taxable income is then indexed to the rate schedule to determine tax liability
  o Liability may be offset with various **tax credits** available
    ▪ Example: money expended on child care is a credit
    ▪ This differs from an exemption because an exemption saves the taxpayer only the taxable portion of the exempt amount
  o There is an **alternate minimum tax** available that is computed at a base rate
    ▪ It is payable only if more than the tax computed under normal rules
  • **Capital gains and losses** are those incurred by the purchase and sale of property and inventory, and are taxable in a different manner
    o Dividend income from stock is taxed as a capital gain

Tax accounting
  • **Cash receipts and disbursements method**
  • **Cash method**
    o **ACRS**: capital costs, if the capital is designed to last for more than one year, are spread out as deductions for a period less than the estimated life of the product
    o **Constructive receipt**: if cash is available to the taxpayer (such as a paycheck not yet picked up), it is counted as taxable income
    o **Cash equivalence**: payment in valuable goods is taxed as cash
  • They assign tax liability based on either the receipt and discharge of obligations (Cash, i.e. when you actually spend/receive money), or on the incurrence and disposal of obligations (CR&D, when you are obligated/entitled to spend/receive money)
Entities

- **Sole proprietorship**
  - Single person owns a business
  - Income and expense treated as though it were of the individual

- **Partnership**
  - Two or more people who own a venture jointly
  - The partnership files a single return, and each partner is individually liable for their pro-rata share of the net profits; the partnership itself pays no tax
  - Often used as **tax shelters**, where because of rules like ARCS, an investment produces a tax loss on paper while still producing an economic gain

- **Trust**
  - The trustee holds and invests property for the benefit of other(s)
  - Complicated; like a partnership, but sometimes required to pay a tax because of indeterminate/yet-to-be-realized ownership

- **Corporation**
  - Treated as a separate taxpaying individual, but subject to different rate schedules
  - Dividends (shareholder profits) are taxed twice; once as corporate income and once as capital gains for the shareholder

Deferral

- The right to pay a tax at a future date
- Can be worth a shit ton of money, assuming the money to be paid in tax can be invested at a reasonable rate of return

Sources of tax law

- The Internal Revenue Code (IRC) of 1986
  - Previously passed in 1939 and 1954
  - Heavily amended, with voluminous legislative history used to interpret it by the courts
- Treasury Regulations
  - Administrative rules promulgated by the Treasury Dept. for enforcement by the IRS
- Administrative decisions of the IRS
  - **Revenue Rulings** and **Revenue Procedures** are published weekly in the **Internal Revenue Bulletin (IRB)**
  - Semi-annually in the **Cumulative Bulletin (Cum. Bull.)**
  - Individual taxpayers are given advice in **private letter rulings (Ltr. Rul.)**

**STARTING FROM SCRATCH: DEFINING THE TAX SYSTEM (8-22)**

Raising Revenue

- This is tied to how much the government plans to spend. Increasing spending while lowering taxes can create a deficit. The minimum required costs of administering the government is the **necessary rate**.
Providing Incentives
- Some promote economic growth
  - Reduced capital gains taxes
  - Homeownership benefits
- Some promote social behaviors
  - Charitable giving
  - Marriage
- Some discourage behaviors

Administrative Costs
- The tax code must not be too costly to enforce
- It must not be too complicated to enforce by the government
- It must be easy to comply with or people just won’t bother
- The code must be sufficiently equitable to generate agreement
  - It must also respect people’s ability to pay
  - It must try to avoid double taxation
  - The tax rates themselves must be of a reasonable level (*vertical equity*)
  - The tax rates must be fair with regards to what is defines as its tax base (*horizontal equity*)
  - It must redistribute wealth (in the form of differential between the tax rate on the poor and the rich) at an acceptable rate

The main tension is between simplicity and equity
- The more nuances a tax system takes into account in tweaking fairness, the harder it is to administer, enforce and even understand

(8-29)

What is Income?
- SCOTUS has defined income very broadly, and without much specificity
- Haig-Simon defines it as (1) the market value of a person’s consumption + (2) the change in value of their store of property rights
  - This would include unrealized asset appreciation and some imputed income
  - This would not utilize tax incentives
- Income as actually defined in the tax code focuses more on readily observable and accountable inflows and outflows of money
- Non-cash benefits, such as being paid for work with goods, services, or property, is taxable
  - If they were not taxed, industries that could pay their employees in such benefits would be heavily favored for non-industrial reasons, and it would lead to inefficiency
  - However, it is often difficult to ascertain the true value such non-cash benefits have for tax purposes
  - Moreover, particularly in cases of small benefits, for the tax payer to simply not report the gain
Fringe Benefits

- Non-cash payments that employees receive
- Excludable under Section 132
  - “No additional cost” services, such as a free flight an airline employee receives on a non-sold out plane
    - Item at issue must be sold to customers regularly
    - Not available if the fringe goes only to highly compensated employees
  - Qualified employee discounts, such as a percentage discount store employees receive on goods bought from that store
    - Item at issue must be sold to customers regularly
    - Not available if the fringe goes only to highly compensated employees
  - Working condition fringes, such as the use of a company car for business purposes
  - De Minimis fringes, i.e. any fringe for which the value is so low as to be more hassle than its worth
  - Qualified transportation fringes, such as free bus passes to get to work
  - Moving expenses
  - Retirement planning services
  - Gym memberships

- Section 125 allows for “cafeteria plans”, which allow employees to choose between receiving their full, taxable salary, or forgoing a portion of it in favor of non-taxable fringe benefits
  - This allows those who need the benefits (such as child care) to receive them without disfavoring employees who have no use for them

- Employer-provided health care is one of the most prominent fringes
  - The value of the coverage provided to the employee is excludable from Gross Income for the employee
  - It is tax-deductible for the employer, meaning self-employed people deduct from AGI
  - Those who buy insurance from sources other than an employer must still pay tax on the income used to buy the insurance
    - They can deduct all expenses that exceed 7.5% of their gross income, under 213

**Turner v. Commissioner**
13 T.C.M. 462 (1954)

- Turner won 2 first class steamship tickets from North Carolina (his home) to Buenos Aires on a radio call-in show. He exchanged them with the steamship company for four tickets to Rio De Janeiro (his wife’s birthplace), and took his wife and two children. He reported the tickets as $520 worth of income. The tickets had a retail value of $2,220, and the Commissioner contended that such was Turner’s taxable income.
- The court found that the tickets had a taxable value of $1,400.
  - The court noted that the tickets were not worth retail value to Turner, since it would have been completely impracticable for him to buy them.
The tickets were non-salable and non-transferable, and even if they were, the court reasoned that Turner could not have obtained retail value for them. On the other hand, Turner and his family did receive the benefit of a free trip, free board, and a vacation.

- **McCoy v. Commissioner**
  - McCoy won a Lincoln auto (worth $4,453), which he then traded in for a less-expensive Ford (worth $2,600) plus $1,000
  - The court ruled that he owed $3,900

- **Rooney v. Commissioner**
  - Rooney’s accounting firm received payment for services in the form of goods.
  - Rooney was allowed to report the income as the market price of the goods received.

*Imputed Income*

Property other than cash
- An example of imputed income is home ownership, where one receives the value of what it would cost to rent the home
- Because this income is untaxed (whereas income spent on rent or received from investment is taxed), it has the effect of encouraging home ownership.
  - Interest paid on mortgages/home loans is also deductible
- This is observable to a lesser extent with timeshares

Services
- Working overtime to acquire enough money (which is taxable) to pay someone to paint your house, versus forgoing extra work in favor of painting it yourself
  - The benefit you receive from painting is untaxed
  - However, clearly no one wants this to be taxed for reasons of enforceability, comprehension, etc.
- A more controversial example is a one-worker family where one member stays home to keep house, watch kids, etc. versus a two-worker family that hires a housekeeper
  - The latter pays more taxes, but receives the same benefits as the first
  - This scenario might induce the second worker of the latter family to stay home instead of working. The lost value of her labor is called **deadweight loss**
- Another example is human capital
  - When one forgoes work to gain a more valuable skill, one forgoes earning taxable income in favor of gaining an untaxed yet valuable skill

*9/6/06 Class example*

An interest-free loan from an employer
- The money from the loan itself is clearly not income
- However, the interest rate that the borrower does not have to pay is treated as income that is **retransferred** to the lender as interest, and is therefore taxable
  - That money may be used for a deductible expense, such as a mortgage
- Employers may list this same amount as a deductible business expense
However, that money, since it is considered retransferred, is also treated as interest income

Annual Accounting and Its Consequences

Periodic Assessment

- Tax is assessed based on the income received during a fixed accounting period
  - This is as opposed to assessing tax based on the income received at the completion of particular transactions
  - Entities that have negative income pay zero tax
    - Most often as a result of transactions that cost more than they produce
    - This can result in negative tax liability for one year, with no way to carry over the negative losses to the next when an entity may receive positive income from the same transaction
    - There are provisions in Section 172 for Net Loss Carryovers (NOL’s) that can carry losses forward or backward to mitigate transactional income fluctuations
    - This results in unprofitable companies with attractive NOL’s being attractive for purchase by larger profitable companies purely for tax purposes

- **Claim of Right Doctrine**: If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to report for that year.
  - If the taxpayer is later required to return that money to some other entity by dint of an appeal or other such cause, the amount may be deducted for that year.
    - Section 1341 allows that, where the subsequent deduction exceeds $3K, the taxpayer may claim either: (1) a deduction for the amount repaid, or (2) a credit in the repayment year for the tax that would have been saved by excluding the amount in the earlier year (whichever is more favorable).
  - This does not apply to cases of
    - Contractual refunds
    - Simple arithmetic errors
    - Embezzled funds that are returned
  - This firmly establishes the test for when income is reportable

**United States v. Lewis**
**SCOTUS, 1951**

- Lewis received a $22K bonus in 1944, which he reported that year. A subsequent state court judgment found that he received twice as much as he was entitled to (through no fault of his own), and ordered him to return $11K, which he did in 1946. Lewis claimed that he was entitled to a recalculated refund for his 1944 taxes, while the IRS claimed that he was to claim a deduction in 1946 for the amount refunded. The tax court found for the IRS, but the Court of Appeals reversed.
  - Held: Lewis was to report the deduction on his 1946 return.
    - Under the Claim of Right Doctrine, Lewis was entitled to and received the full $22K in 1944, as such he was required to report it in that year
• Dissent, DOUGLAS: It is unconscionable that the government can simultaneously take back the money which Lewis received in 1944 while still claiming that he had to pay taxes on it that year.
• Judgment: Reversed.

The Tax Benefit Rule

The opposite of Claim of Right: When a taxpayer claims a deduction in a previous year that is, for a variety of reasons, wiped out retroactively
• Examples include deductions for bad debt, thefts, and other misfortunes, which are then later rectified
• Two aspects of the rule: Exclusionary and Inclusionary

The Exclusionary Aspect
• When a deduction that is later rectified produced no tax savings in the year in which it was claimed, and also has expired all possible use as a carryover deduction
• The taxpayer does not need to include the recovered value of the loss in his income
  o This protects against adverse marginal rate changes in cases of zero tax liability
  o However, if the deduction claimed in the past saved the taxpayer very little, he still must include it as income when it is recovered, even if this results in paying more tax than was saved in the prior deduction

The Inclusionary Aspect
• Where the deduction has generated tax savings when claimed, it must be reported as income for the value at which it was claimed as a deduction, even where that value of the offsetting gain is unclear
  o However, that income is taxed at the rate applicable for the period in which it is received. Alice Phelan Sullivan Corp.
  o A more transactional model of accounting
  o What happens when a deduction is later refunded to a taxpayer corporation, but for whatever reason the actual funds are distributed to the shareholders or other 3rd party?

Recoveries for personal and business injuries

Companies
• Corporate entities that recover lost profits or punitive damages report it as taxable income in the year in which it is received
• Recoveries on damaged property are taxable to the extent that the recovery exceeds the cost basis of the property
  o If the income is reinvested into the same or similar use, it may not be taxable. Section 1033.
• Recoveries constitute court-ordered awards, settlements, and insurance payments

People
• Court-ordered awards and settlements are tax free, provided that they are based on personal physical injury or sickness. Section 104.
  o Punitive damages are not excludable
• Recoveries on property are treated the same as corporations
• Recoveries from medical insurance are not taxable
  o Money paid in to an insurance plan, as part of income, is deductible only to the extent that it exceeds 7.5% of AGI
  o However, where an employer pays a lower salary and uses the difference to provide medical insurance, the foregone salary/value of insurance is not taxable
  o Actual medical expenses are excludable under 106
    ▪ If that sum is reimbursed from employee-purchased insurance, that sum is excluded under Section 104(a)(3)
    ▪ Same for employer-provided under Section 105
    ▪ Excess un-reimbursed expenses are deductible under Section 213
• Section 104 excludes worker’s comp payments

**Income and Debt**

Loans are not income
• Receiving them is not income, and paying them back is not a deduction
• This is true regardless of whether they are **recourse** loans (borrower personally liable) or **non-recourse** (guaranteed by collateral).
  o Loans do not increase wealth because they come with corresponding liability
• Applies to both cash and accrual accounting methods
• **United States v. Kirby Lumber**
  SCOTUS, 284 U.S. 1 (1931)
  o In 1923, Kirby Lumber issued $12M worth of bonds. Later that year, it purchased back $1M worth of those bonds for $862K, for a difference of $138K.
  o Issue: Was that difference taxable income for the year 1923?
  o Holding: Yes, no reason to depart from the inclusive def. of income and the accepted rule in this case.
• Under Section 108, losses attributed to insolvent debtors can be excluded

**Discharge of Debt as Income**
• In order to have income from the discharge of debt, the tax payer must:
  o Be indebted under Section 108(d)(1)
    ▪ There must be debt for which the taxpayer is liable, or
      • Liability is the legally enforceable obligation to repay
    ▪ subject to which the taxpayer holds property.
• Contested liability doctrine: If a taxpayer contests in good faith how much he owes, and then reaches a settlement on that debt, the sum settled for is treated as the amount of the outstanding debt, and no tax is owed. *N. Sobel Inc. v. Commissioner*.
  o This applies regardless of whether the amount of the debt can be accurately determined

**Embezzlement**
• The *James* test: In a typical embezzlement, the embezzler intends at the outset to abscond with the funds. If he repays the money during the same taxable year, he will not be taxed. If he spends the loot instead of repaying, he cannot avoid tax on his embezzlement income simply by signing promissory notes later in the same year.
However, a taxpayer does not realize income on the withdrawals from a corporation where:
1. He withdraws funds which he fully intends to repay
2. He expects with reasonable certainty he will be able to repay
3. He believes that his withdrawals will be approved by the corporation
4. He makes a prompt assignment of assets sufficient to secure the amount owed
Gains and Losses in Investment in Property

Helvering v. Bruun (SCOTUS 1940)

- Bruun leased some of his land to a guy, with the conditions that the leasee could tear down and build pretty much as he pleased, but that anything he built would revert to the ownership of Bruun at the termination of the lease. The lease was eventually terminated for non-payment, and Bruun received ownership of a building that was worth approx. $50K more than the one the lessee tore down. The IRS said he received taxable income on that gain.
- The court held that the building did constitute taxable income in the year in which the land was repossessed by Bruun
  - While the difference in values of the two buildings might not accurately reflect the changed value of the land, it is undeniable that Bruun realized a gain in the transaction that is within the scope of Section 61’s definition of income
  - The realization of a gain need not come in the form of disposable cash to be taxable
  - The distinction found in the stock dividend cases was based on the rationale that the recipients of the dividends did not materially improve their financial situations, but rather received a structurally different but substantively equal representation of their ownership. Bruun recognized a gain here.
- This no longer applies, see Section 109: Gross income does not include income (other than rent) derived by a lessor of real property on the termination of a lease, representing the value of such property attributable to buildings erected or other improvements made by the lessee.

Non-recourse Borrowing in Excess of Basis

Woodsam Associates, Inc. v. Commissioner (2nd Cir. 1952) GET HELP ON THIS

- Woodsam owned some property. After acquiring it, Woodsam executed a second mortgage on the property, thereby receiving an unsecured loan in excess of the value of the property. The IRS argued that because the money was in excess of the liability, and was unsecured by any personal obligation to pay, the money was income. Does that excess count as income?
- Holding: No, executing the second mortgage did not count as a taxable disposition of the land under Section 1001.
  - Although the mortgage receipt exceeded the basis, Woodsam was still in the position of creditor to the mortgagee.
  - Woodsam still controlled the property in the same manner after the second mortgage as before
- Judgment: No tax due on the excess

Gains and Losses on Transactions

Section 1001: A taxable event occurs upon the sale or other disposition of property
• A gain is the excess of the amount realized from the sale over the adjusted basis provided in section 1011 for determining gain, and
• A loss is the excess of the adjusted basis provided in such section for determining loss over the amount realized.
  o Exchanges of property must be materially different, in the sense that the new property acquired must give the owner different rights and powers than his previous property did

• **The Open Transaction** concept: If the consideration for a transaction is sufficiently uncertain, it is not realized until payments received actually exceed the basis.
• **Closed Transaction**: The expected payments are computed for value at the time the promise is received, and that is applied against the basis all at once for a gain or loss
• **Installment Method**: The basis is pro-rated, and applied against the expected income as it is received. The preferred method today in Section 453, (A) and (B).

**Constructive Receipt and Economic Benefit**

Constructive Receipt:
• For taxation purposes, income is received or realized when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession.
  o So viewed, it makes no difference why the taxpayer did not reduce to actual possession. The matter is in no way dependent upon what he does or upon what he fails to do. *It depends solely upon the existence of a situation where the income is fully available to him.*
    • The right must be secured by a legal means to receive the money on demand
  o A promise to be paid at a later date does not equal a realized gain in the present.

The economic-benefit theory
• An individual on the cash, receipts, and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the payor's creditors.
  o Income that is subject to the economic-benefit theory must be subject to valuation at the time the right is received
    • That right can be valued if it is:
      1. Non-forfeitable
        • If a recipient must perform or refrain from performing further acts as a condition to payment of benefits, the recipient's rights are regarded as forfeitable.
      2. Fully vested in the taxpayer
      3. Legally secured against the payor’s creditors.
  o The difference between this and constructive receipt is that constructive receipt involves the right to reduce the money to possession *now*. Economic benefit comes into play when the taxpayer doesn’t yet have the right to receive money, but has the absolute guarantee to receive it as a specified future time.
In the past, accountants often structured deferred payment plans that were ostensibly unsecured, but that had acceleration clauses or other bailouts included for scenarios in which the employer experienced financial hardship. Section 409A eliminated those possibilities.

- Enron execs, upon learning that Enron would fail, exercised these clauses to the tune of some $50 million in deferred salary.

**Al-Hakim v. Commissioner**

**Tax Court Memo, 1987**

- Al-Hakim was a baseball agent for Lyman Bostock, for whom he negotiated a 5 year, $2.25M contract with the Angels. The contract was pro-rated over 12 years, and Al-Hakim’s fee of 5% ($112,500) was pro-rated for 10 to be paid in equal installments of $11,250 every year. Al-Hakim then secured an interest-free loan from Bostock (who received it from the Angels) for $112,500, to be repaid over the same 10 years. For 1978, Al-Hakim reported only $11,250 of income.
- Held: That’s the amount of income he received.
- Today, an interest free loan would be subject to Section 7872.

**Retirement Funds**

- Traditional retirement funds aren’t terribly beneficial in tax terms:
  - Standard plans involve either a payment of a fixed amount periodically upon retirement, or a payment based on a formula of years worked, salary at the time of retirement, etc.
  - Since the money in these funds is not taxable to the employee until he receives it, it is not deductible by the employer until that same time.
- Qualified pension, profit-sharing, and 401(k) plans do much better:
  - Any money paid into them is not taxable for the employee, even if the rights are vested:
    - i.e. 401(k)’s allow for up to $15K of contributions tax free every year.
  - Employers get an immediate deduction for contributions to the plan.
  - Investment earnings of the fund are not taxed either.
  - Under the alternate Roth IRA, the employee’s contributions are still taxable, but the disbursements aren’t.
  - To qualify, a pension plan cannot discriminate in favor of more highly paid employees:
    - Absent regulation, more highly paid employees benefit to a greater degree because they have more disposable income.
    - Plans must provide comparable benefits to all employees.
  - Other rules governing qualified pensions are found in the ERISA act.
  - Self-employed individuals may use regular and Roth IRA’s, subject to slightly different rules under TEFLA.
Exchange of Property

Section 83 governs the transfer of property in exchange for services

- 83(a): If an employee receives property that is transferable and not subject to substantial risk of forfeiture, the taxpayer must report the value as income
  - 83(e)(3): reporting is only required if a fair market value can be assessed.
  - 83(a)(2): If the property becomes freely transferable and not subject to substantial risk of forfeiture at a later time, it must be reported in the year that it becomes free from those restrictions
    - However, if the property gains an ascertainable fair market value but is still subject to encumbrance, it is not reported until the property is actually sold
  - Stock options and other types of property that are available only on the condition of performance of substantial services by the employee, as is often the case, is not taxable at the time of receipt
- 83(b) allows taxpayers with property that is non-transferable or subject to forfeiture to nonetheless elect report the property as taxable income
  - 83(e)(3): election is only possible if a fair market value can be assessed.
  - Benefit: If that property later vests or becomes transferable at a significantly higher value, the profits from sale of property is a capital gain
  - Risk: If the property fails to vest, the reported value cannot be claimed as a capital loss
  - As with 83(a), if the taxpayer could have elected to report but did not, and the property later becomes free of encumbrance, it must be reported that year

Stock Options

A stock option is a right granted to an employee:

1. To buy a certain number of shares in the employer company
2. At a specifically named price (the exercise price)
   - Usually the value of the stock at the time the options are granted
3. At a specific future time (vesting schedule)
   - All of the stock may vest at once, or it may vest gradually over a period of time
- Stock options are profitable to an employee if the price of the stock increases above the exercise price by the time the shares vest
  - The employee may then exercise his option to buy the shares at the exercise price, and then immediately sell the shares at the market value, pocketing the difference
  - An employee doesn’t need to buy at the vest date; he may continue to hold the option
  - If the employee does exercise the option, he may also hold onto the stock he buys
- Section 422 allows employees who receive stock options (Incentive Stock Options) to report no tax until the sale of stock bought with options
Employees report no income when the options are granted, and no income at exercise. At the sale of the stock, income equals the sale price less the basis (exercise price). Subject to the following restrictions:
1. Employee must hold the option for two years after receipt, and hold the stock for one year exercising the option
2. The exercise price must be no less than the market price at the time of issuance
3. The company shareholders must approve the options plan
4. No individual may possess more than $100K of unexercised options

- Non-qualifying options are treated under Section 83.
  - Options with a readily ascertainable fair market value must be reported in the year received. 83(a)
    - Options subject to non-transferability and forfeiture need not be reported
    - However if either condition lapses, they become reportable
  - Taxpayers with options subject to non-transferability or forfeiture can elect to report if the options can nonetheless be valued. 83(b)
  - When options are exercised, the difference between the exercise price and the fair market value of the stock is reported as income.
    - The (exercise price + the amount of value taxed) then becomes the capital basis against which capital gains from sale of that stock is assessed against. Section 1012.

The Accrual Method

- Used (and in most cases required) by almost all medium and large businesses
- Reports income when the taxpayer has a right to receive it, discounted against any outstanding debts they might have
  - Different from the cash method primarily in that actual receipt of funds is not taken into account
- Specifically, a taxpayer has accrued income when all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy. Section 461(h)(4).
  - If a taxpayer has a reasonable expectation that a right to income will not ever be paid by the debtor by dint of a pending contingency, then such income has not accrued.
  - Under Section 455, an organization that receives prepaid dues for a period of time not yet completed may pro-rate those dues over the length of the period
  - Under 461(h), deductions for liabilities incurred cannot be stated until they have been economically performed.
    - Creates a hybrid type of accounting

Deductions

Subtracted from AGI to arrive at taxable income
• An individual may itemize their deductions, or simply take the standard deduction of set amount
  o Itemized deductions are phased out as an individual’s income gets larger
    ▪ Phased-out deductions cannot be less than 80% of the otherwise allowable deduction
    ▪ Medical care, casualty loss, and interest income are not subject to phase out
• All individuals are also entitled to a personal deduction of set amount for themselves and each of their dependents
  o This deduction is phased out as an individual’s income gets larger

Casualty Losses

A taxpayer may deduct for casualty losses not covered by insurance under Section 165(c)(3)
• Losses that arise from fire, storm, shipwreck, or other casualty, or from theft.
  o Limited to losses exceeding, in aggregate, 10% of AGI
    ▪ Also reducing by a $100 “floor”

Dyer v. Commissioner
US Tax Court, 1961
• The Dyer’s owned a vase, and their cat broke it as a result of an epileptic fit. They tried to claim it as a deduction under 165(c)(3), which at the time had no floor and no AGI percentage restrictions
• Held: The breakage of ordinary household equipment by a cat or other pet is not “other casualty” under the Section.
  o “Other casualties” must be comparable to a fire, storm, or shipwreck in order to count.
• A casualty loss within the meaning of I.R.C. § 165(c)(3) arises when two circumstances are present.
  o First, the nature of the occurrence precipitating the damage to property must qualify as a casualty.
    ▪ The word "casualty" as used in I.R.C. § 165(c)(3) has been defined, through application of the principle of ejusdem generis, by analyzing the shared characteristics of the specifically enumerated casualties of fire, storm, and shipwreck.
    ▪ Generally this means a sudden and destructive force must cause the loss
      • Gradual decline in value, even from things like termites or dry rot, won’t cut it
  o Second, the nature of the damage sustained must be such that it is deductible for purposes of I.R.C. § 165.
    ▪ The loss generally must be physical damage to the property, or abandonment thereof
      • At the very least, a claimed casualty loss must have been caused by the casualty
    ▪ Temporary decline in market value is not a casualty loss
Courts have traditionally disallowed business expense and casualty loss deductions under section 162 or 165 where national or state public policies would be frustrated by the consequences of allowing the deduction.
  - The frustration must be severe and immediate
  - The specific facts of each case must be analyzed, with the illegality of the action giving rise to the casualty being but one factor
    - Conviction of a crime for the action that caused the loss will show frustration, but is neither determinative nor essential
    - However, the negligence of a taxpayer is not an automatic disallowance, either
    - Gross negligence is an automatic disallowance, if shown

**Medical Expenses**

Under Section 213(a), medical expenses are deductible
  - Only to the extent that they exceed 7.5% of AGI
    - 10% for the Alternative Minimum Tax
  - Can be phased out under Section 68
  - Akin to free medical insurance with a deductible of 7.5% of AGI and a 100% co-pay minus marginal tax rate
    - This, combined with the employer deduction for insurance under Section 106, gives a strong incentive to provide group plans
    - Specifically, it provides incentive to employers to provide no-deductible coverage, because any deductible would not meet the 7.5% threshold
    - In response, Congress passed the Health Savings Account act (Section 223), which mandates a minimum deductible for employer health insurance
      - Employers can pay money into the account on behalf of the employee (deductible for the employer and nontaxable to the employee)

**Taylor v. Commissioner**
54 T.C.M. 129, 1987
  - Due to a grass allergy, Taylor could not mow his law. He claimed the money he spent on a lawn mowing service.
  - Was that expenditure a medical expense under 213(a), or on-deductible personal expenses under Section 262?
  - Held: Lawn mowing does not fall within the parameters of “medical care”, but rather as a personal expense with therapeutic benefits.

**Henderson v. Commissioner**
Tax Court Memo, 2000-321
  - The Henderson’s son had spina bifida, and they bought and modified a van specifically for the purpose of transporting their son to and from school, to medical appointments, and for other travel. They claimed deductions for the cost of the van, the cost of the modifications, and depreciation. The IRS challenged the deduction for depreciation
  - Was the depreciation in value of the van a deductible medical expense under 213(a)?
  - Held: Depreciation is not an “expense paid” under 213(a).

**Ochs v. Commissioner**
2nd Cir. Court of Appeals, 1952
Mrs. Ochs had a thyroidectomy which revealed cancer. While she underwent treatment and for several years, Mr. Ochs maintained the couple’s two children at a boarding school on the advice of their physician. Mr. Ochs claimed a medical deduction for that cost.

Was the cost of boarding school a deductible medical expense under 213(a)?

**Held:** The costs are not deductible

- The costs were made necessary only due to the loss of Mrs. Ochs’ services, not as a cost of her medical treatment.

**Dissent:** The test for medical expenses should be: would the taxpayer have incurred the cost being claimed but for the illness

In general, costs that are incurred as a direct cause of the illness, and that would not have been incurred otherwise, are deductible to the extent that they do not enrich the taxpayer.

**Charitable Contributions**

Section 170 allows for deductions of contributions to charities

- A charitable contribution is defined, in part, as "a contribution or gift to or for the use of a State, or any political subdivision thereof, but only if the contribution or gift is made for exclusively public purposes."
  - A contribution made to a charity is not made for exclusively public purposes if the donor receives, or anticipates receiving a substantial benefit in return.
    - Special rules for college athletics donations, where a right to buy discounted tix is received
  - “Substantial” means a benefit greater than a member of the general public would incidentally receive in making the donation
  - The fair market value of any quid-pro-quo received for a charitable donation is subtracted from the deduction

- Generally limited to 50% of AGI
  - Private foundation donations and “use of” donations are limited to 30%
- Charitable entities are defined in 170(c)
- Many charities are tax-exempt, but not all
  - However, all tax exempt institutions must be “charitable” under common law definitions
    - They must provide a “public benefit”
  - Must act consistently with public policy and constitutional aims
- Capital property with long-term capital gain potential that is donated may be deducted at its full, fair-market value
  - Short term capital gain property is limited in deduction value to the donor’s basis in the property

**Interest on Personal Loans**

The interest that a taxpayer pays on debt incurred is deductible under Section 163, divided into several types

- **Qualified Residence Interest** (163(h)(2): Interest paid on a home mortgage loans
- **Acquisition Indebtedness**: Interest paid on loans to buy, build, or improve a home, with an upper limit of $1 million
- **Home Equity Indebtedness**: Any debt secured by equity in a home, with a limit of $100,000 and not exceed the fair market value of the home
    - The loan may exceed basis
- All other interest on debt is non-deductible
  - The rule is based on what secured the loan, not what the loan proceeds are used for
  - Even interest from personal loans secured by business property are not deductible
  - When loans from multiple secures are commingled for mixed personal and business purposes, treasury regulations provide detailed tracing procedures for determining what parts of loans from what sources are deductible
- Expenses related to the processing of the loan (fees for credit checks, escrow, etc) that are passed on to the debtor are generally non-deductible
  - Fees for processing the loan calculated as a percentage of the total loan are deductible because they are assessed “for the use of the money”
  - If escrow fees, etc. are assessed with interest, and not separately, they are deductible
- **Shared Assessment Mortgage (SAM)**: Loans granted with an interest rate lower than usual, but for which the debtor agrees to pay the creditor a portion of any appreciation of the value of the property. The debtor has all usual incidents of ownership, and the creditor does not pay costs of depreciation
    - The IRS allows all appreciation payments to be deducted
    - Not applicable where the loan proceeds are used for business or investment purposes, or where the creditor acquires greater rights to the property
- State and local taxes are deductible under Section 164
  - Income and property are the largest
    - Taxpayers in states with no income tax may, in lieu of those, deduct sales tax
  - The IRS issues tables that state a standardized deduction for state taxes that the taxpayer may claim in lieu of figuring it out on their own

**Recovery of Capital**

**Basis** – The cost of obtaining capital
- Since our system assesses tax on profits, you should get your basis back tax free
- Basis is determined using Section 1012
  - Basis in property is the purchase price of the land
    - If the property is sold, improvements are added to the basis for the purpose of determining capital gain if the sale of the property includes those improvements
- Section 1016: Basis is then adjusted for expenditures, receipts, losses, or other items, properly chargeable to capital account
  - Non-deductible capital expenditures (listed in Section 263) are properly chargeable to capital account
In the broadest sense, a capital expenditure (i.e. one that is chargeable to capital account) is an expenditure that is not deductible:
- For example, Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.
- Therefore, ordinary and necessary expenses incurred carrying out a business are not chargeable.
- An example is the oil and gas used in operating an eighteen-wheeler used in a shipping business. Its an ordinary and necessary expense, therefore it is deductible immediately by the business, but is not chargeable to the capital account of the truck.
- Depreciation deductions are subtracted from the basis:
  - They are immediately deductible under Section 167.

Three ways in which capital can be recovered:
- Immediately, under Section 179:
  - Expenses with no basis, such as oil and gas
- Spread out over the life of the capital, under Section 197:
  - Amortized over the usable life of the capital
- Upon the sale of the capital, as an offset under Section 1001:
  - Gain or loss from the sale of a business is allocated on an asset by asset method, based on the fair market value of each asset in the business.

Basis in capital when received in exchange for other capital under Section 1012:
- Three possibilities:
  - Cost of the capital transferred
  - Fair market value of the capital transferred
  - Fair market value of the capital received
- The basis is the fmv of the capital received in the transaction:
  - The value of property being exchanged at arms-length is usually equal in value, or at the very least the parties assume its value to be equal.

Partial Sales of Capital: When part of a piece of non-homogenous capital (originally purchased for a lump sum) is sold, how are capital gains computed?
- Capital gains on partial sales of homogenous capital (such as shares of stock in a single company) are easy; basis is the original price of the capital divided by portion of the capital being sold.
- However, where a disposition of a portion of capital cannot be accurately apportioned to a percentage of that capital, and where such amount if less than the total cost basis of the property, that amount is chargeable to the capital account of the property.
  - This results in a lower adjusted basis of the property, but no taxable income at the time of disposition.

Recovery on a Loss

Clark v. Commissioner
40 B.T.A. 333, 1939
• Clark, a married guy, retained experienced tax counsel to file his tax returns in 1932. Tax counsel screwed up a deduction, and Clark got hit with an additional assessment of about $32K. Compounding this error was the fact that Clark could have avoided about $19K of this if his counsel had his return filed separately from his wife’s. Therefore, Clark’s counsel paid him the $19K back. The IRS said it was taxable income under *Old Colony* because a 3rd party paid Clark’s taxes. Clark said the money was payment for damages.

• Held: Its not income.
  o Clark discharged his obligation to pay his taxes as they were computed entirely on his own. Incidental to that discharge, he incurred a loss due to the counsel’s negligence. Recompense for that loss was unrelated to the discharge of his tax liability.
  o Recovery of damages is not income derived from capital or labor (no longer a good point of law).
  o Clark never took a deduction for the damages incurred from negligence.

• This holding is only applicable to recovery on overpayment on the true amount due.
  o Recovery for having to pay more than was initially expected is taxable, provided that the ultimate amount paid is accurate
  o Recovery for extra taxes paid based on the outcome of structuring a deal a certain way (i.e. an accurate but unnecessarily larger assessment) is taxable

**The Costs of Earning Income**

*Current Expenses vs. Capital Expenditures*

• Section 162 allows a business to immediately deduct all of the costs normally associated with doing business
  o The *Lincoln Savings* test:
    1. an item must be 'paid or incurred during the taxable year,'
    2. be for 'carrying on any trade or business,'
    3. be an 'expense,'
    • Courts seem to interpret an expense as occurring where a business takes action to fix or remediate an ongoing problem, but not where a business builds something new, no matter how miniscule the benefit is
      o For example, a sprinkler system installed as required by law is capital, as is a drainage system installed under threat of litigation where the drainage system was required to operate the business
      o However, repairs to a basement wall, or costs to remediate soil contamination are deductible business expenses
    4. be a 'necessary' expense, and
      • The term "necessary" imposes "only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business
    5. be an 'ordinary' expense
• This does not imply that the expense is incurred regularly or even that the expense has ever been incurred by the taxpayer before. Rather, the expense must be a normal way of dealing with whatever matter it is incurred to address.
  o “An expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.” *Welch v. Helvering*
  o It is the kind of transaction in which the expense arose, and its normalcy within the particular business which are controlling. *Deputy v. DuPont.*
  o However, determining what is capital and what isn’t is very fact specific, and each case requires individualized assessment
• However, Section 263 requires costs incurred from investment, such as building a new factory, must be capitalized as basis
  o *Lincoln Savings* defined capital expenditures as any that serve to create or enhance a separate or distinct asset
  o Crudely stated, capital assets are any asset that will generate income beyond the year in which money is expended to create or acquire it
    ▪ This is not to be taken to its logical extreme, which would result in the capitalization of virtually any business expense
    ▪ Incidental or speculative benefits to capital assets do not disqualify an expense from being deductible under 162.
• Damage to a capital asset (165 + 263) vs. Business expense (162)
  o When a capital asset is damaged, the owner has two alternatives
    ▪ He can deduct the value of the loss immediately as an uninsured loss under 165 (reducing the basis by that amount), and then pay for repairs (non-deductible), adding the value of the repairs to the basis
    ▪ Alternately, he can immediately deduct the cost of the repair as a current expense under 162, with no effect on the capital account
  o The business owner cannot do both, as it would result in a double deduction
• Section 197 specifically addresses costs attributable to acquiring goodwill
  o 197 allows a taxpayer to amortize the value of an “intangible”, as defined by the section
• Section 263A specifically addresses costs allocable to the production of inventory
  o The direct and indirect costs of the production of inventory must be capitalized
  o Even if a repair cost (or other ordinary and necessary expense that would ostensibly fall under 162) is theoretically deductible, it must still be capitalized by Section 263A if it is incurred in the production of inventory

**Depreciation**

• Capitalized costs can be deducted over the useful life of a piece of capital, subject to the rules of Section 167 (*Accelerated Cost Recovery System*)
  o Tangible assets (like a truck) are deducted based on depreciation under Section 168
Intangible assets (like a copyright) are deducted based on amortization. ACRS is designed not to reflect the exact economic value of depreciation of an asset (which would be almost impossible), but rather to overstate that value each year, thus encouraging business investment.

The rate of depreciation is determined by ascertaining:

1. The useful life of the asset
   - A given asset will fall into any one of a number of IRC categories that define the useful life that a taxpayer is allowed to use for an asset of that type.

2. The adjusted basis of the asset
   - Formerly, the salvage value of the asset (its value if sold for parts) was deducted from the adjusted basis in determining the amount to be depreciated.
   - Under modified ACRS, salvage value is always assumed to be $0, favoring taxpayers.

3. The application of a method of allocating the cost, in excess of the salvage value, over the useful life
   - Most taxpayers utilize the declining balance method specified in 168, whereby they deduct a specified multiple of the straightline percentage deduction from the remaining cost balance of the asset each year.
   - In cases where that percentage is greater than the straightline amount (such as deducting 200% of the straightline each year), the taxpayer switches to straightline deductions of the remaining amount.

Recapture: When the disposition of a capital asset exceeds the value of the basis adjusted for depreciation deductions. Such income might be treated as a capital gain but for recapture rules directing that it be treated as regular income.

- By treating an ostensibly capital gain as normal income in this situation, recapture rules seek to correct the inherent assumption of depreciation; that the value of the asset has declined over its life.
- An asset that is sold for equal to or more than its basis after depreciation clearly has not actually depreciated.
- Gains above the undepreciated basis remains a capital gain.

Section 169 allows for rapid amortization of certain assets, and certain investments may be deducted outright under 174.

Special Issues in Connection with Sale or Transfer of Property

Substituted Basis of a Gifted Capital Asset

- When a capital asset has appreciated in value and is then gifted to a new owner, the new owner’s basis in the asset is the same as the original owner under Section 1015.
  - This is as opposed to allowing the new owner to claim the fair market value of the asset as its new basis at the time of transfer.
    - If this were the case, an owner of a capital asset could dodge any tax by simply transferring the asset right before selling it.
If the asset’s value has fallen below the basis, the new owner’s basis is the fair market value at the time of transfer under 1015.  
- However, under Section 102, the donor doesn’t get to claim a loss

- If the asset is received as compensation (i.e. received in trade for services rendered), then the basis is the fair market value of the good or service exchanged under Section 1012

- If the asset is received by reason of death, the basis is the fair market value at time of transfer under Section 1014, or at the election of the executor under Section 2032, the value at a later date specified in the section
  - This encourages a taxpayer to hold on to an appreciated capital asset until death
    - An asset transferred before death is taxed on appreciation, and then subject to the estate tax at death
    - An asset held is only taxed as estate, however it is taxed at full market value instead of the amount reduced by income tax

Gifted Assets for which the Donee is bound to pay the gift tax
- Under Section 2502, the donor of a gift incurs liability for the gift tax in 2501
  - A donor who makes a gift of property on condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property.
  - This treats the property given as partially a gift and partially a sale to pay the gift tax
    - Thus, whatever proceeds of the sale exceed the adjusted basis are treated as taxable gains
    - However, if the donor’s basis exceeds the gift tax liability, treasury regulations prohibit the donor from claiming a deduction.

- Exception: A bargain (less than fmv) sale to a charitable organization under Section 1011(b)
  - The basis is allocated proportionally by the percentage of the property deemed to have been sold.
  - Example: Property with a $100K value and a $20K basis that is sold to a charitable org. for $20K. The sale price is 1/5th of the fmv, so 1011 treats the taxpayer as having sold 1/5th of the property, and gifted the rest
    - As such, $4K (1/5th of the basis) is allocated against the sale price ($20K), and the other $16K of the basis is treated as a taxable gain

Property Secured by a Non-Recourse Loan
- **Crane rule:** A mortgagor who owns property subject to a non-recourse loan who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the outstanding balance of the mortgage as well as the additional consideration
  - Section 1001 states that the gain is the boot + the fair market value, but Crane rules that the outstanding balance of the loan is substituted for fair market value in the equation
  - The mortgagor’s basis when she acquires the property is equal to the outstanding balance of the non-recourse loan under Section 1012
    - The basis is then adjusted for depreciation deductions under Rule 1016
  - Taxable gain = Benefit (unpaid balance of the loan + boot) – Basis (original loan amount – depreciation deductions)
• What happens when the outstanding balance of the loan exceeds the fair market value of the property at the time of disposition?
  o Under Section 1001 (Benefit (fmv) – basis (loan amount adjusted for depreciation)), the taxpayer could ostensibly claim a loss equal to the difference between the adjusted basis and the loan amount
    ▪ This would be especially favorable where a taxpayer claims a lot of depreciation while not paying the loan down, and then disposes of the property before the adjusted basis drops below the fair market value
    ▪ Furthermore, they could deed the property to another taxpayer, who’s basis would then reset to the full unpaid loan balance
  o However, Tufts rules that the Crane rule holds in this case, meaning that the taxpayer still has income equal to the full amount of the loan minus the adjusted basis
    ▪ This recaptures those depreciation deductions
    ▪ The taxpayer still gets the time value benefit of taking those deductions earlier

• In either scenario, the fmv of the property involved is irrelevant, contrary to the language of 1001
  o The inclusion of unpaid debt as income is codified in Treas. Reg. 1.1001-2: the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

• O’Connor’s Bifurcation approach: The property transaction and the loan transaction are treated completely separately
  o The Property
    ▪ The taxpayer’s basis in the property when he acquires it is the amount of the loan, because that’s what he pays for it
    ▪ When he disposes of the property, he receives a benefit equal only to the fair market value of the property, because that is all that the mortgagee can expect to receive as compensation on the loan
      ▪ This is consistent with the economic reality affecting the property
    ▪ The new purchaser of the land then has a basis in it at fair market value
  o The Loan
    ▪ The taxpayer receives the loan proceeds untaxed, because he also incurs the obligation to repay
    ▪ When he is no longer encumbered by the loan, he receives a benefit equal to the difference between the original loan amount and what he has already paid down on the loan

Express Non-Recognition Events
• Realization: A realization of income from the sale or disposition of property
• Recognition: Whether that realization will have tax consequences now, or whether some statutory provision allows tax consequences to be postponed
• Section 1031: No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.
- **Revenue Ruling 82-166**: In exchanges of investment assets, the assets must be of the same type of underlying investment. The valuable characteristic of the assets must be fundamentally the same, such that their relative values are affected by the same types of events.

- **Boot and Basis**
  - If a taxpayer receives a boot in addition to a like-kind property exchange, that taxpayer deducts the boot from their adjusted basis in the property.
  - The payor of the boot
    - The amount of the boot is added to the payor’s basis in his new farm.
    - If the boot is another piece of property, then the gain is taxable.

- **Section 1033**: If property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is involuntarily converted, the new property is not taxable.
  - If the taxpayer receives insurance money and buys substitute property, that money is not taxable either.
  - Any insurance payout in excess of the basis of the property is taxable.

- **Section 121**: Originally intended to avoid excessive tax hits on elderly people who sold their homes with no intent to buy another (i.e. moving into an assisted living facility), this provision now allows taxpayers to exclude any income from the sale of a home used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

### Splitting Income

Income is taxed by those who earn it, not by who it is diverted to. *Lucas v. Earl*, Section 482

- The Income Tax Amendment can assess tax on salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it.
  - The fruit of labor is taxed to the tree from which it grows.
    - Income attributable to a taxpayer from services performed for charity are usually not taxable. *T. Reg. 162-2.*
    - Also to services provided to a political party. *Rev. Rul. 68-503.*
    - Attorney’s Fees paid on contingency are taxable to the taxpayer and the attorney.
    - The taxpayer can deduct them under Section 67 & 68.

- **Income Diverted By Law**
  - Where income has been assigned to others by operation of law, the income is not taxable to the earner.
    - The taxpayer must not possess the right to receive the income. If he does, than he is taxable for whatever income is generated by his labor, even if he does not actually receive it.
    - Situations where the taxpayer merely has the power to designate a beneficiary still do not result in tax liability.
    - If the law or ruling assigning the income arises as a result of a bargained exchange, such as an employment contract, than the income will still be taxable to the earner. *Armantrout v. C.I.R.*
Lucas also stands for the proposition that who is taxable on income is not determined by any attenuated subtleties or complex arrangements that determine where the income must go to or who is had technically vested with, but rather should rest on the construction of the applicable taxing act.

Seaborn: State law created community property between a husband and wife of all earnings by both parties. Thus, the husband and wife were taxable individually for one half of the total earnings, even where all earnings came from the husband’s work and owned property.

- In the Earl case, the earnings and property was originally owned by the husband, thus necessitating the assignment to his wife by contract to obtain the joint tenancy. Here, by operation of law, the property was never owned by husband in the first place.
- Dunkin v. Commissioner: Where a recently divorced man decided to continue working instead of retiring, and where his former spouse would have been entitled to half his pension, the court ordered him to pay her money equal to half the pension until she died. Tax Court held that this income was divided.
- Commissioner v. First Security Bank of Utah: Where a taxpayer is legally prohibited from earning a type of income, but makes arrangements whereby another taxpaying entity receives them, the former is not taxable.
- Teschner v. Commissioner: Even where the taxpayer in fact earned the income, where the law forbids him from receiving it he is not taxable, even if he personally designates the recipient.

The Marriage Bonus/Penalty
- After the Seaborn decision, the benefit to community property-state married taxpayers was much greater, and Congress eventually adopted the laws that allow for joint filing
  - Joint filing allows married taxpayers to file one return, and gives them a much larger set of progressive rate windows
    - However, these larger windows are still not as beneficial as it would be if each partner could file completely separately for one half of earnings
    - Thus, there is a marriage bonus for single income marriages, and a penalty for married couples who both earn relatively equal amounts

Transfers of property and income derived from such property
- Income from property is generally attributed to the owner of the property
  - Where property is assigned from one owner to another, the new owner becomes taxable on any income subsequently derived from the property
  - However, where the owner of property merely assigns the income from that property, he remains taxable on the income
    - The distinction turns on the definition of property:
- Under Treas. Reg. §1.102-1(e), gifts of income from property are not taxable to the recipient where the same income is taxed to the grantor of a trust or assignor of income
  - This blocks the operation of Section 102(b)(2).

Capital Gains and Losses
- Capital gain is divided into two types, as defined by Section 1222
- Long-term capital gain, on capital held for more than one year
- Short term capital gain, on capital held for less than one year

- Capital gains result from the sale or exchange of a capital asset
  - Capital assets are defined by Section 1221, subject to 8 notable exceptions
    - Real and depreciable property owned by a business is one, however
      Section 1231 allows a taxpayer to treat losses on this type of property as
      normal losses, but gains as capital gains
    - 1221 exceptions are given relatively broad and inclusive interpretation by
      the courts
- Capital losses may be deducted against capital gains, and excess losses may be deducted
  from normal income up to $3K per year.
- Under Section 1221(a)(1), stock in trade of the taxpayer or other property of a kind which
  would properly be included in the inventory of the taxpayer, or property held by the
  taxpayer primarily for sale to customers in the ordinary course of his trade or business is
  not a capital asset and is treated accordingly

- Securities
  - Under Section 475, securities dealers may elect to use **Mark to Market**
    accounting, whereby at the end of each fiscal year, they treat all held securities as
    being sold on the market. They claim capital gains or losses on value changes,
    and readjust the basis for all held securities to fmv.
  - Under Section 1236, a securities dealing firm may segregate securities it holds for
    sale into “investment accounts”, which then qualify those securities for capital
    gain and loss treatment

- Defining a capital asset