Federal Income Taxation – Course Outline

I. The Nature of Income.
  A. The Tax Base in Overview.
    1. § 61(a) – Gross income defined.
    2. Benaglia (p.42) – Room and meals for manager of hotel and his wife were found to be provided "primarily for the need and convenience" of the employer. "Under such circumstances, the value of meals and lodging is not income to the employee, even though it may relieve him of an expense which he would otherwise bear." Therefore, not part of income/compensation under § 61. The less choice and control that the taxpayer has in deciding whether to take the benefit, the more likely it is that the "benefit" is not really part of the taxpayer's employment compensation, but instead for the need and convenience of the employer.
    3. Exclusion, § 119(a) – Meals or lodging furnished for the convenience of the employer. Codification of *Benaglia*, safe harbor.
    4. Exclusion, § 132 – Certain fringe benefits.
    5. Exclusion, § 125 – Cafeteria plans. Use it or lose it rule.
    6. Turner (p.59) – Turner won two round-trip tickets for a cruise through a radio talk-show. The FMV of the tickets (retail) was $2,220. Turner declared only $520, subjective valuation. Income is an economic benefit. The court found that $1,400 was an appropriate valuation of the economic benefit here. How the court reached this number is unclear… perhaps it averaged the two estimates. Note that there is some discretion in determining income.
    7. Imputed income – The value that one obtains from owning property or from providing services to oneself or anyone else in one's household. Examples are property ownership and self-supplied services. Not taxed.
    8. Barter transactions – They don't eliminate the tax consequences of compensation for services. Compare to imputed income from spouse as homemaker: We view families as a single unit, so we don't recognize transactions that take place inside the family unit. But we do recognize barter transactions between two (or more) units.
  B. Windfalls and Gifts, Basis.
    1. Exclusion, § 102 – Gifts and inheritances.
    2. Glenshaw Glass (p.69) – Punitive damages held to be taxable. Compensatory damages for lost profits (general rule is taxable, although there are exceptions) and punitives shouldn't be treated differently.
    3. Duberstein (p.74) – To constitute a gift, a transfer must proceed from "detached and disinterested generosity." The intention with which the gift was made controls. Two companies did a lot of business with each other; Duberstein given a Cadillac for providing the names of potential customers to Mohawk. Ct. held that the Cadillac should be treated as income, not as a gift.
    4. Harris (p.82) – Wealthy widower gave money to two mistresses, and issue was whether they had to pay income tax. "[A] person is entitled to treat cash and property received from a lover as gifts, as long as the relationship consists of something more than specific payments for specific sessions of sex."
    5. Gains from dealings in property, § 61(a)(3) – § 1001 provides that gain = excess of amount realized (sum of cash plus FMV of any property received in the transaction) over adjusted basis (see below).
    6. Basis of property = cost, § 1012. General rule, like when the taxpayer purchased the property or received property as compensation for services rendered (i.e., not as a gift).

Basis is a tracking mechanism, to make sure that something is taxed once and only once.

7. Basis of property acquired by gifts and transfers in trust, § 1015. For property acquired by gift, the general rule is that the donee must take the donor's adjusted basis (called "carryover basis," or "substituted basis"). But exception: If (1) the FMV of the property at the time of the gift was lower than the donor's original-cost basis, and (2) the FMV upon sale/transfer by the donee is lower than what the FMV was at the time of the gift, then, for the purpose of taxing the donee/seller, the basis is what the property's FMV was at the time of the gift. The exception limits losses, reflecting the concern over taxpayers taking big losses (or giving losses as gifts) in order to offset gains for capital-gain tax purposes.
8. Basis of property acquired from decedent, § 1014 – The basis of property in the hands of a person acquiring property from a decedent (i.e., by inheritance) is the FMV of the property on the date of the decedent's death. This is the highest basis – of the 1012, 1015, and 1014 – that we've looked at, assuming that property has appreciated in value. Encourages people to hold onto appreciated property until death in order to completely avoid payment of income tax.
9. § 1016 provides that taxpayer must adjust basis when taking deductions for losses, depreciation, amortization, depletion. The taxpayer wants the highest basis possible; the higher the basis, the lower the gain that has to be reported.
10. <u>Taft</u> (p.95) – A purchases for $1,000. A transfers to B as gift when FMV is $2,000. B then sells for $5,000. The issue: What's B's gain? $4,000. B isn't getting cheated out of anything; she's still receiving a gift. She's able to pay, because of the gift. Wouldn't make sense to make A pay some of the tax because A no longer has the property, has no control over when B decides to sell, plus difficult to track A down when B does finally sell… The current rule allows A to cash out.

C. Recovery of Capital.

1. Suppose taxpayer purchases 10 shares of stock at $10 a share ($100 total). Then sells 5 shares for $500. Shares have increased in value from $10/share to $100/share. Amount realized upon sale is $500. Subtract basis of $50 – that's the value of 5 shares, at original purchase price per share. Basis allocated proportionately, easy here because shares are homogeneous. Income = $450.
2. <u>Inaja</u> (p.106) – The taxpayer was the owner of some land that included a river. The City of LA diverted "foreign waters" into the river, which adversely affected the value of the taxpayer's property. After the taxpayer threatened legal action against the city, the city settled for $50,000 to release itself from liability for the diversion and to purchase a easement in perpetuity to continue the diversion. The issue was whether the $49,000 ($50,000 - $1,000 in legal fees) received by the taxpayer in 1939 should have been included in his gross income for that year. Held: Don't treat what he received as income. When it's really difficult to figure out what was sold and to allocate for the purpose of basis, don't worry, just treat as return of capital and reduce basis by amount of payment. Taxpayer gets to defer taxation now, but will recognize higher gain later, upon sale/transfer.
3. Annuities, § 72 – Apply exclusion ratio (investment in the contract divided by the expected return) to each payment received under the annuity; that portion is treated as a non-taxable recovery of capital investment, and the remaining portion is treated as income. To determine the expected return of an annuity, see Table V, p.921 Supp. (Multiply annual payment under annuity contract by the applicable multiple in the table.) Note that after you exclude up to your basis, you can't exclude anymore.

4. For special exclusion rule for pensions, see § 72(d).
5. Clark (p.121) – Taxpayer received compensatory payment from tax counsel for error counsel made. Holding that payment shouldn't be treated as income is no longer good law because of *Glenshaw Glass*, but the case still illustrates the problem of what to do when there is the "Tom, Dick, and Harry" relativity problem (comparing taxpayer in *Clark* to other taxpayers). The court in *Clark* decided to under-tax via exclusion of the recovery, rather than over-tax via inclusion.

D. Annual Accounting and Its Consequences.
1. Sanford & Brooks (p.125) – Respondent was a subcontractor for the Atlantic Dredging Company, which was carrying out a river-dredging contract for the U.S. government. The court ruled that our income tax system uses annual, as opposed to transactional, accounting. More administratively feasible, but Congress overturned with enactment of § 172.
2. Deduction for net operating losses, § 172 – The rule enables a corporate taxpayer to be taxed only on profits and avoid taxation on revenue in a given year when that revenue fails to cover a loss. § 172(b)(2) – As soon as you can carry over a loss, you have to. Take your losses in the earliest year possible, and continue to use it to offset income year after year until the loss runs out.
3. North American Oil (p.130) – Dispute over profits from oil-producing property. The 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, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." (Conversely, if taxpayer receives money but has an unequivocal, contractual, statutory, or regulatory duty to repay it, so that the taxpayer is really just a custodian of the money, then the taxpayer is allowed to exclude that money from gross income.)
4. Lewis (p.133) – Taxpayer's employer improperly calculated his bonus, so that the taxpayer had to return it. Ct. said no refund of tax paid on bonus in earlier year, but taxpayer could take deduction for loss in current year. After *Lewis*, Congress apparently thought rule was inequitable and provided relief in § 1341.
5. Computation of tax where taxpayer restores substantial amount held under claim of right, § 1341 – Taxpayer gets deduction. But if deduction would exceed $3,000, then taxpayer gets to either claim the deduction in the ordinary manner OR forego the deduction and claim a credit in the current year for the tax that would have been saved by excluding the item in the earlier year (i.e., the amount of tax overpaid) – whichever is better for the taxpayer. Note that taxpayer still loses interest on overpayment.
6. The tax benefit rule, § 111 – Suppose taxpayer makes donation to charity in 1995 and takes a deduction. In 2000, taxpayer gets the donation back. What about that deduction? Taxpayer must include an item in this year's gross income if the deduction yielded a tax benefit in the earlier year. An inclusionary rule. Can exclude the item in this year if the deduction didn't give any tax benefit in the earlier year. Like if tax liability in the earlier year was 0 anyway. An exclusionary rule.

E. Recoveries for Personal and Business Injuries. (See pp. 140-144.)

F. Cancellation of Indebtedness and Other Enhancements of Worth.
1. Loan proceeds are not included in gross income, and loan repayments are not deductible. This is the rule for both recourse and non-recourse loans. Not in Code.
2. Kirby Lumber (p.146) – Discharge of indebtedness (company repurchased bonds from bondholders for less than the bondholders originally paid) was held to constitute income.

3. Discharge of indebtedness counts as income, § 61(A)(12); indebtedness defined, § 108(d)(1).
4. Zarin (p.149) – Gambler disputed debt with casino. Under the contested liability (a/k/a disputed debt) doctrine, if there's a good-faith dispute as to the amount of a debt, a settlement of the dispute determines the amount of debt-discharge that's cognizable for income-tax purposes.
5. Diedrich (p.158) – A couple gave stock as a gift to their three children, with the stipulation that the children were to pay the resulting federal and state gift taxes. The S. Ct. held that the parents realized taxable income (an economic benefit) from the children paying those taxes. 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 exceed the donor's adjusted basis in the property. Donor's total tax liability = (tax rate)*(value of the gifted property – adjusted basis in property).
7. Crane (p.164) – The taxpayer inherited land and a building from her spouse; FMV at time of death was $250,000. The property was subject to a non-recourse mortgage, or one that she wasn't personally liable to repay, with an unpaid balance of $250,000. For several years, she claimed depreciation deductions totaling $25,000 for the building. Then, she transferred the property to a third party for a cash payment of $2,500. How much taxable income did she realize from the transfer? (1) The basis of the property upon transfer to Mrs. Crane was the FMV value of just the land and buildings themselves. The basis/cost of property includes amounts paid with borrowings; the court rejected her argument that she should've been able to subtract the value of the unpaid balance of the mortgage (i.e., that "property" = equity). [$250,000] (2) The basis of the property upon transfer to the third party was the basis from step (1) minus the depreciation deductions that Mrs. Crane claimed. [$250,000 - $25,000 = $225,000] (3) Gain = amount realized (cash/property consideration, unpaid balance of the mortgage as discharge of indebtedness) – adjusted basis. [($2,500 + $250,000] - $225,000 = $27,500]
8. Depreciation deduction, § 167 – Allowed for wear and tear of property used in the taxpayer's trade or business, or property held for the production of income.
9. Tufts (p.172) – The S. Ct. held that the *Crane* rule applies even when the value of the mortgage exceeds the fair market value of the property sold. See the symmetry: If a non-recourse debt is treated as cash for the purposes of determining basis, then it should be treated as cash for the purposes of determining amount realized upon sale. So… Amount realized = Cash consideration from the transfer + the value of the loan debt that the purchaser assumed (even if debt was non-recourse because taxpayer is still discharged from liability, and even if loan debt far exceeds FMV of property). Adjusted basis = the invested loan proceeds (used to purchase the property) + the partners' capital contributions – the total amount of the depreciation deductions the partnership took over the years.
10. Gilbert (p.179) – Gilbert was an executive at the E. L. Bruce Co. He made unauthorized withdrawals from corporate funds in an attempt to purchase stock in another company, Celotex, intending eventually to effectuate a merger of the two companies. The stock market declined, and he was unable to repay Bruce some $1,953,000. The issue in the case was whether Gilbert should been treated as a borrower (in which case, no taxable income) or an embezzler (in which case, taxable income). Ct. found that he really wasn't an embezzler. "Although Gilbert undoubtedly realized that he lacked the necessary authorization, he thought he was serving the best interests of the corporation and he expected his decision to be ratified shortly thereafter. … In signing immediately

payable promissory notes secured by most of his assets, Gilbert's clear intent was to ensure that Bruce would obtain full restitution." His equity in Bruce was worth way more than the amount he withdrew. Pretty gray-area – lots of embezzlers intend to pay back what they embezzle. Note that we can view a criminal conviction for embezzlement as evidence of embezzlement for tax purposes… or not, as the court here didn't.

II. Problems of Timing.

A. The Classics of Realization and Basis.

1. Deduction allowed for losses, § 165(a) – Taxpayer can claim deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Limitation on losses of individuals, § 165(c).
2. Determination of amount of and recognition of gain or loss in value of property, § 1001 – To realize a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of the property."
3. <u>Macomber</u> (p.192) – The issue was whether the taxpayer should have been taxed at the moment she received a stock dividend, which didn't change her ownership rights at all and didn't significantly alter her wealth, or at the time she sold her stock. Held, if you receive a stock dividend that doesn't change your ownership rights at all, it's tax-free. If the stock dividend *does* change ownership rights, then it's taxable. This was like dividing the same pie into more slices. Side note: Cash dividends extraordinary in amount and dividends paid in stock of another company do constitute taxable income.
4. <u>Bruun</u> (p.204) – The taxpayer was a landlord who owned a piece of land with a building. He entered a long-term lease with a tenant who demolished the building and built a new one, worth $51,000 more. Then, within four years, the tenant abandoned, and the landlord repossessed the property. The issue was whether the increased value of the property should be recognized as taxable income at the time the landlord repossessed the property, or at the time when he perhaps later would sell the property. The court held that he should have been taxed at the time he repossessed the property. (The basis would then be adjusted upwards to reflect that taxes had already been paid on the gain.) Congress subsequently overturned *Bruun* with sections 109 and 1019. Section 109 says that the lessee's improvements don't constitute a taxable gain for the landlord when the landlord repossesses. Section 1019 says that the lessee's improvements don't change the basis of the property. Under these provisions, the tax liability is the same, but the taxpayer gets the benefit of deferral.
5. <u>Woodsam</u> (p.209) – Wood bought property for $296,400 using a mortgage. She refinanced her mortgage, borrowing more, so that she had a $400,000 non-recourse mortgage debt, secured by the property. She transferred the property to a partnership that she and her husband had (in return for an interest in the partnership). The issue was whether her second mortgage consolidation, whereby her borrowed amount exceeded her adjusted basis in the property, was a taxable event. The partnership wanted this to be a taxable event because then it would have had a higher basis in the property. Wood didn't care because the statute of limitations had expired with respect to her tax liability for the year she secured the second mortgage consolidation. Held, she never "disposed" of the property within the meaning of § 1001(a), so this wasn't a taxable event. She still had the ability to charge rent, sell the property, etc.
6. The usual rationales for not taxing unrealized appreciation are threefold: it's hard to measure; the taxpayer may not have the cash in hand to pay the tax; and the taxpayer still faces a risk of loss if the property subsequently declines in value.

7. Cottage Savings (p.213) – Cottage Savings traded partial interests in mortgages with other savings and loan associations. The issue was whether it could report a loss under § 165(a) and, specifically, whether there had been a "disposition" of property within the meaning of § 1001(a). Under the "material difference" test in the Treasury Regulations, an exchange involves a disposition of property if there's a material difference between the thing exchanged and the thing received. The court found that there was a material difference here because the partial mortgage interests "embodied legally distinct entitlements."

B. Non-recognition Exchanges.

1. The realization requirement can create a tax incentive for a taxpayer to sell (or be deemed to sell) an asset that's worth less than the asset's basis, in order to claim a loss. Example: A family farm. For an appreciated asset (worth more than its basis), the realization requirement creates an opposite version of the same problem: the "lock-in" effect, or a tax disincentive to sell. Example: PNC stock.
2. The realization inquiry involves asking (as in *Cottage Savings*) whether something of tax significance happened in the first place. The recognition question involves asking whether a specific, generally statutory "non-recognition" rule applies to mandate disregard of the realization event.
3. Exchange of property held for productive use or investment, § 1031 – Not all barter transactions are taxable events. Policy: A partial solution to the lock-in problem in that it promotes efficient transactions; non-taxation is easier on taxpayers if all their cash is tied up in the property (that is, avoids liquidity problem); and avoids administrative problems associated with valuation.
   § 1031(a) – If (1) there's an exchange of property (2) held for productive use in the taxpayer's trade or business (3) solely (4) for property of like kind (5) which is also to be held by the taxpayer either for productive use in a trade or business or for investment, then no gain or loss shall be recognized (i.e., not a taxable event). Exceptions for certain types of property, § 1031(a)(2).
   § 1031(b) – If you exchange property for property of like kind plus other property (not of like kind) and/or money ("boot"), and you realize a gain, then you have to recognize the gain, but only to the extent of the value of the boot.
   § 1031(c) – If you exchange property for property of like kind plus other property (not of like kind) and/or money ("boot"), and you realize a loss, you can't recognize any loss.
   § 1031(d) – The basis in the property of like kind that you receive is (1) the basis in the property of like kind that you exchanged, (2) minus any cash you received in the transaction or plus any cash you paid, (3) plus any gain or minus any loss you realized as a result of the transaction.
4. Revenue Ruling 82-166 (p.224) – The IRS held that a taxpayer's exchange of gold bullion for silver bullion doesn't qualify for non-recognition of gain under § 1031(a). "Although the metals have some similar qualities and uses, silver and gold are intrinsically different metals and are used primarily in different ways. Silver is essentially an industrial commodity. Gold is primarily utilized as an investment in itself. An investment in one of the metals is fundamentally different from an investment in the other metal. Therefore, the silver bullion and the gold bullion aren't property of like kind." Determination based on objective factors, not subjective factors. Doesn't matter what the parties were using the property for. Result: 1031 didn't control, and the parties were back in 1001 territory. The parties had to look at the FMVs for each property and recognize the gain/loss (determined by subtracting adjusted basis of property exchanged

from FMV of property received).

5. Jordan Marsh Co. (p.225) – The taxpayer entered a sale-and-leaseback transaction; he sold property for $2.3mm in cash and simultaneously entered a long-term lease with and received a cash payment from the purchasers of the property. He claimed to the IRS that the transaction was a sale under § 1001 and tried to deduct the difference between his adjusted basis in the property and the cash he received ($4.8mm - $2.3mm = $2.5mm) as a loss. The IRS disallowed the deduction, taking the position that the transaction represented an exchange of property for other property of like kind, so under § 1031(c) the taxpayer couldn't claim any loss. Held, the transaction was a sale. The court found dispositive the fact that the taxpayer was exchanging property for a lesser interest in that property plus cash. He came away with a different set of property rights. Some scholars view transaction as a loan transaction; note that the same transaction may be characterized in different ways.
6. What is boot? – Boot is cash and/or property that, under a provision like § 1031, is transferred as part of the like-kind exchange but is not like-kind property. The transfer of boot will affect basis and may result in the recognition of gain. See § 1031 above.
7. Revenue Ruling 84-145 (p.236) – The Airline Deregulation Act of 1978 made airline route authorities (which airlines were required to treat as capital assets) a lot less exclusive so that the costs of entry into the market decreased substantially. The taxpayer here, an airline, wanted to deduct a loss under § 165(a) for the diminution in value of its route authorities. The IRS held that the taxpayer couldn't claim the deduction because no recognizable event. The reasoning was "the mere diminution in value of the operating rights does not constitute the elimination or abandonment of a completely worthless asset. In addition, there was no closed and completed transaction fixed by identifiable events because the taxpayer's operating rights remained unchanged even though more competition was introduced."

C. Open Transactions, Installment Sales, and Constructive Receipt.

1. Logan (p.244) – The taxpayer had 1,000 shares of stock. Her basis in the shares was $180,000. In 1916, another company came along and bought the company in which she had stock. The second company gave her $120,000 for her shares and promised to make additional payments based on future profits. The IRS estimated that she'd receive future payments of $9,000 per year for 25 years, with a present value of $100,000. It claimed that the transaction was a closed transaction, she'd have a basis of $100,000 in the right to receive future payments, and she'd be allowed to recover the $100,000 basis at the rate of $4,000 per year over the 25 years she expected to receive payments. She argued for open-transaction treatment. She argued that the present value of the promise to make future payments was not ascertainable in 1916, and that she should be allowed to recover her entire basis before reporting any gain. She wanted to not report any gain in 1916, since she received $120,000 in cash and her basis in her stock was $180,000, and then not treat any future payments from the takeover-company until the total of the payments exceeded her remaining basis ($60,000). The S. Ct. held for the taxpayer. The case stands for the open-transaction doctrine – "the notion that where the total value of the consideration to be received by a taxpayer is sufficiently uncertain (not equivalent to cash because of no ascertainable fair market value), gain is not recognized until the payments actually received exceed the loss." Note that most rational actors want to know what they're getting in a transaction. The basis-first approach (a/k/a "open transaction," or "wait and see") isn't routine.
2. Consider three possible approaches to recognition of gain or loss and recovery of basis where property has been sold in return for the right to a series of cash payments

(installments) to be received in the future. (1) Basis-first approach from *Logan*. (2) Determine the present value of the expected payments and treat this sum as if it were cash received on the date of the sale. Gain or loss is then determined by comparing this amount with basis. This is the closed transaction approach. (3) Installment method, § 453, the present rule.

3. Installment method, § 453 – If the FMV received in an exchange can be ascertained, use § 1001. If it can't, then gain or loss is reported as payments are received, like with an annuity. Suppose you sell property with a basis of $100,000 for $400,000. Suppose you're going to get paid $100,000 every year for the next four years. Your gross profit is $300,000. So each year for the next four years you recognize $75,000 per year.
4. The doctrine of constructive receipt – Income is treated as constructively received if it has been credited or set apart for the taxpayer without any substantial limitation or restriction as to the time or manner of payment or contingency upon which payment is to be made, even if it's not reduced to the taxpayer's actual possession that year.
5. <u>Amend</u> (p.251) – Contract for the sale of wheat. Just because the taxpayer could have contracted differently doesn't mean that we should force him to. This was a bona fide, arms-length contract, for legitimate business reasons, not for the purpose of tax avoidance.
6. The economic-benefit doctrine – Even if there is no actual or constructive receipt, a taxpayer is currently taxable on the economic 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. That is, the payor's promise to pay may itself constitute a taxable economic benefit if the present value of the promise can be ascribed an appraised value.
7. <u>Pulsifer</u> (p.256) – Pulsifer purchased a winning sweepstakes ticket in his name and the names of his three minor children. The issue was whether the kids should have recognized their winnings as income in 1969, the year they won and obtained the money, or later when the funds would be released to them. The kids had an absolute right to their winnings; the money had been irrevocably set aside for their sole benefit. All they needed to do was have their legal representative apply for the money, which he did. Held, under the economic benefit doctrine, they had to recognize the income in 1969.
8. <u>Drescher</u> (p.257) – A company purchased two annuities for its high-ranking executive (the taxpayer). Held, the taxpayer was taxable on some amount in the years the company purchased them for him. The amount for each annuity would be treated as the taxpayer's investment in the policy, and the taxpayer would then be taxed on the annuity payments to the extent they exceeded the return on his investment. The court reasoned that the non-assignability and non-accelerability clauses in the contracts didn't make them non-taxable before the taxpayer started receiving the monthly payments. The taxpayer had contended that because of these restrictions the contracts had no present value when they were purchased. The court found that the taxpayer did receive an economic benefit in the pre-monthly-payment years – namely, the assurance that he'd receive monthly payments from the insurance company in the future. Nevertheless, the court found that the restrictions did lower the value of the contracts somewhat. He was treated as though he had received in cash the amount he should have included in income, and had used the cash to purchase the policy. (Credibility: If the present value really was $0, and he knew he'd have to include as gross income the full price, then he wouldn't have allowed the company to purchase them for him. He was in a position to demand any sort of executive compensation he wanted.)

9. <u>Minor</u> (p.266) – A physician entered a voluntary deferred compensation plan with a medical group (Snohomish Physicians) whereby he agreed to receive a portion of his fees (a percentage which he designated) and apply the balance to a deferred compensation fund. The issue was whether he should have included in his gross income that portion of the fees that he applied to the fund for his future benefit. Held, because the deferred compensation plan was unsecured from SP's creditors, the present value of the taxpayer's future benefits from the fund was incapable of valuation. Cases like this fall into two categories – constructive receipt and economic benefit. The IRS conceded that the constructive receipt doctrine didn't apply in this case (strategic mistake). The court found that the economic benefit doctrine didn't apply, either. "The economic benefit doctrine is applicable only if the employer's promise is capable of valuation." The court went on: "In cases where courts or the IRS have found a current economic benefit to have been conferred, the employer's contribution has always been secured or the employee's interest has been non-forfeitable." In this case, the employer's contribution to the fund wasn't secured because SP had total control over the assets of the trust, and the assets were subject to the claims of SP's general creditors. Also, the conditions on the taxpayer's receipt of the benefits under the plan amounted to a risk of forfeiture.
10. <u>Al-Hakim</u> (p.272) – In 1978, Al-Hakim negotiated a contract for a professional baseball player. In the fee-payment arrangement, Al-Hakim received his fee payments in equal installments totaling $112,500 over the course of 10 years. Simultaneously, he paid off a 1978 loan from Bostock of $112,500 in installments equal to his "fee payments." In other words, not a penny changed hands over the course of the ten years; the taxpayer just received the $112,500 upfront. The Tax Court's holding that the $112,500 payment in 1978 was a loan, as opposed to a fee payment, meant that he had access to the full amount of his fee in 1978, but he got taxed as though he had received the fee in installments. Outlier case, widely criticized, not much of a precedent. Form truly triumphed over substance. Horizontal equity problem: taxpayers who can't structure their agreements his way pay more in taxes. Maybe the court reasoned that if the taxpayer followed the letter of the law, then the court should affirm. Let Congress change the law. Another possible justification: If the court went the other way, then would we have to investigate every loan and repayment arrangement? Push-back – auditors are supposed to delve into these kinds of details.
11. <u>Olmsted</u> (p.274) – Olmsted (taxpayer) and Peoples Life Insurance cancelled their old insurance agency contract and entered a new one. Peoples wanted to get out of its exclusive agreement with Olmsted so that it could pay lower commissions. Miller (worked for Olmsted), nearing retirement, wanted to change the method and rate of the commission payments. In 1956, the year the new contract took effect, Olmsted reported as § 61 income just the amount of the payments ($5,500) actually received that year pursuant to the new contract. The IRS argued that cancellation of the old contract and the formation of the new one constituted a "disposition" within the meaning of § 1001 and that therefore Olmsted should have reported the entire fair market value (about $68,000; basis in rights to renewal commissions would've been $0) of the new contract, whereby Olmsted gave up its rights to future renewal commissions and received instead a fixed income from a Peoples annuity over a period of fifteen years. Held, there was no disposition within the meaning of § 1001. "All that has occurred is the exchange of one contract for another, the principal change therein being the rate of payment." The court distinguished *Drescher* on the grounds that Peoples didn't deduct the cost of the annuity, and the annuity didn't constitute new compensation for Miller –just a change in

the rate of payment. Taxpayer achieved the same outcome. He still would be taxed over time (before the annuity, he was taxed on the commissions; after the annuity, he would be taxed on the annuity benefits payments). Looked less like a tax-avoidance effort.

D. Transfers Incident to Marriage and Divorce.

1. Davis (p.298) – The taxpayer and his then wife agreed before they divorced that the taxpayer would pay child support and transfer property to the wife. The wife received, among other things, 1,000 shares of stock. Two issues: (1) whether the stock transfer was a taxable event; and (2) if so, how much taxable gain resulted. Held, the transfer was a taxable event – it resembled a taxable transfer of property in exchange for the release of an independent legal obligation more than it resembled a non-taxable division of property between two co-owners. The court worked from the assumption that the parties acted at arm's length and judged the marital rights to be equal in value to the stock for which they were exchanged. So the wife's tax basis for the stock was the market value of the stock at the time of the transfer. Easier to do it this way than to try to value the marital rights that she gave up. Note that under § 1041 (enacted subsequently), wife would have taken husband's basis for the stock and husband would have had no taxable gain.
2. Transfers of property between spouses or incident to divorce, § 1041 – No gain or loss recognized by either spouse; substituted-basis approach.
3. Alimony and child support, § 71– Only cash transfers are considered alimony. Alimony is deductible by the payor and included in the income of the payee; other transfers (child support, "property settlements") incident to divorce are not deductible by the payor or included in the income of the payee.
4. Farid-Es-Sultaneh (p.303) – The IRS argued the stock transfer was a gift, so therefore § 1015(a) applied and the taxpayer's basis was her ex-husband's adjusted basis at the time of the transfer. Held, the transfer was not a gift but rather more like a purchase. There was a change in the tax law to the effect that recipients of gifts under the new law had to take the donor's basis at the time that the property was transferred as a gift (the law today), as opposed to using the fair market value of the property at the time of the transfer as the basis. Because Congress was closing a loophole, the court found that a transfer that would be classified as a gift under the old gift tax law was not necessarily to be treated as a gift income-tax-wise. "In our opinion the income tax provisions are not to be construed as though they were *in pari materia* with either the estate tax law or the gift tax statutes."
5. Diez-Arguelles (p.311) – The taxpayer's ex-husband didn't pay child support. She tried to treat the amount he owed her in a particular year as a non-business bad debt and deduct it from her gross income as a short-term capital loss. Under § 166(d), a non-corporate taxpayer may deduct non-business bad debts as a short-term capital loss in the year such debts become completely worthless. But the non-business bad debts are deductible only to the extent of the taxpayer's basis in the debts. See § 166(b). The Tax Court found that she wasn't "out of pocket" anything as a result of the ex-husband's failure to pay the support obligation, so really she had no basis in the debt. She wasn't allowed the deduction. Many people think the case was wrongly decided.

III. Deductions, Exemptions, and Credits.

A. Casualty Losses, Expenses, Contributions, and Interest.

1. GENERAL RULE: No deduction allowed for personal, living, or family expenses, § 262(a).
2. Exception: Deduction for medical, dental expenses, § 213 – Medical expenses are

deductible to the extent they exceed 7.5% of adjusted gross income. An issue in this area is what constitutes "medical care" under section 213(e).

3. Exception: Deduction for casualty losses, § 165(c)(3). Deduction for losses from "fire, storm, shipwreck, or other casualty, or from theft." Limited to losses that in total exceed 10% of gross income ($100 floor per loss).
4. Exception: Deduction for donation to charity, § 170(a). Can only deduct up to a certain percentage of adjusted gross income. Also, when a taxpayer makes a gift of property whose sale would produce long-term capital gain, the amount allowed as a deduction is the full fair market value of the property. (So gift of appreciated property can be more advantageous than sale followed by gift of proceeds b/c taxpayer pays no capital-gain tax.)
5. Exception: Deduction allowed for expenses related to activities not engaged in for profit, § 183 – Like hobbies. Can deduct expenses but only to the extent that the taxpayer receives income from the hobby.
6. Exception: Deduction allowed for expenses related to the production of income, § 212. § 67 – These deductions in the aggregate must exceed 2% of adjusted gross income.
7. Exception: Deduction allowed for trade or business expenses, § 162 – Salaries, travel expenses, rents. § 67 – 2% floor. Note that trade-or-business (162) is something higher than production of income (212) – the two aren't the same. If you argue trade-or-business (162), you can also argue for a home-office deduction under 280A and for a business-entertainment expense deduction under 274(a)(1)(A), both of which would be harder to get if you argued production-of-income 212. Also: § 274 prevents abuse by disallowing certain deductions for entertainment expenses which would otherwise be properly deductible under § 162. The entertainment expense must be "directly related to" or "associated with" the active conduct of the taxpayer's trade or business, and, in the latter situation, must directly precede or follow a substantial and bona fide business discussion. Also, 50% limit on meal and entertainment deduction, and substantiation requirement.
8. Exception: Home office, § 280A(c)(1). Principal place of business for any trade or business of the taxpayer. Stringent limitations.
9. <u>Dyer</u> (p.339) – Cat has a neurotic fit and breaks a vase. Taxpayer wants to deduct $100 under § 165(c)(3), but loses; this isn't a casualty loss - isn't in any way similar to a "fire, storm or shipwreck." Ejusdem generis.
10. <u>Chamales</u> (p.341) – Taxpayers open escrow on house next to O.J.'s. O.J. murders occur during escrow period, and taxpayers are advised that they can't get out of escrow without liability. According to broker, the value of the house decreased by 20-40% as a result of the O.J. situation. Taxpayers want to take a casualty loss deduction under § 165(c)(3). In order for a taxpayer to be able to claim a deduction for a casualty loss within the meaning of § 165(c)(3), (1) "the nature of the occurrence precipitating the damage to the property must qualify as a casualty," AND (2) "the nature of the damage sustained must be such that it is deductible for purposes of § 165." The court found that prong (1) doesn't contemplate the kind of the ongoing public attention, occurring over a period of years, upon which the taxpayers based their claim. Even with sudden and unpredictable events, if it looks like the market value will rebound, courts won't allow a deduction. Here, people were still buying in the neighborhood when the taxpayers brought their case. As for prong (2), the court found that the temporary decline in property value wasn't enough; "only physical damage to or permanent abandonment of property will be recognized as deductible under § 165." The taxpayers weren't liable for negligence or disregard of the rules/regs under § 6662. Most important factor here is the

"taxpayer's effort to assess proper liability," and this taxpayer took sufficient effort by talking to several real estate brokers and an accountant.

11. Blackman (p.348) – Taxpayer started a fire, was charged with arson/malicious destruction and had to serve 24 mos. probation without verdict. He wanted to deduct the loss under § 165(c)(3), though! Public policy reasoning: negligence will not bar a 165 claim, but gross negligence will. This was at least gross negligence.
12. Taylor (p.353) – a taxpayer was not entitled to a medical-expense deduction under § 213 for the $178 he paid to have his lawn mowed; he allegedly paid to have his lawn mowed because he had a severe allergy and his doctor instructed him not to mow his lawn himself. The court interpreted "medical care" strictly, citing an earlier case in which golfing expenses weren't deductible, even where a doctor had instructed the taxpayer to play golf for therapeutic reasons. It's not the seriousness of the condition, it's the medical nature of the expense. To what extent is the expense incurred exclusively for medical reasons? Have to separate out personal, family, and living expenses.
13. Henderson (p.353) – The Tax Court held that the taxpayers were not entitled to a depreciation deduction under § 213 for the van and wheelchair lift they purchased for their son, who suffered from spina bifida. The IRS allowed the taxpayers to take a deduction for their modification of the van (they modified the van to suit the son's medical needs – added a wheelchair ramp, etc.), but they weren't allowed to deduct the cost of the van itself. How closely related is the expense to the person who has the medical problem. Critics argue that § 213 offers deductions for medical expenses that only wealthy people can afford.
14. Ochs (p.355) – Doctor recommended the separation of taxpayer's wife from taxpayer's children for illness reasons, and taxpayer attempted to deduct the cost of boarding school for his children. No deduction under § 213; these are nondeductible personal expenses under § 262.
15. Ottawa Silica (p.363) – Taxpayer donated land to a school district, knowing that the donation would cause the school district to build roads beneficial to taxpayer. Held, transfer wasn't a charitable donation because it looked like a quid pro quo. If it's not a charitable donation, and it's not a sale, then it's just a gift. Taxpayer had to retain basis of transferred property and treat as a capital improvement on the other portion (keeping the basis somewhat higher, allocating throughout, is better than losing the basis altogether). Also, taxpayer could deduct the excess of the donation over the value of the benefit. If you can locate a substantial direct benefit to the taxpayer, then you can say it's an Ottawa situation. Opens the door for lots of charitable donations to be investigated, subjectivity.
16. More on charitable contributions – § 170 governs the donor's deduction. § 501(c)(3) governs the organization's status as a charitable organization. Under § 501(c)(3), an entity must be (1) a corp., community chest, fund, or foundation, (2) organized for one of the eight enumerated purposes, (3) operated on a nonprofit basis, and (4) free from involvement in lobbying activities and political campaigns. Under Bob Jones University (p.371), the entity must ALSO "demonstrably serve and be in harmony with the public interest," must have a purpose that comports with the "common community conscience," and must not act in a manner affirmatively at odds with the declared position of the whole government." If an organization loses its tax-exempt status, then taxpayer can't claim deduction.

B. Business and Investment Deductions along the Personal/Business Boundary. [See list of deductions above.]

1. Nickerson (p.391) – The taxpayer purchased a farm with the intention of switching careers – leaving his advertising job in the city and becoming a dairy farmer. For the first few years, he incurred only losses. Under § 183, can deduct only to the extent one receives income from hobby (and here taxpayer had earned nothing from farm yet), whereas under § 162 can deduct without limit, so long as 2% floor is met. How do you distinguish between an activity engaged in for business or profit and an activity that's really just a hobby? Activity undertaken in a routine or methodical way, formal records kept, clients, other signs of professionalism… these are indicia, not requirements. Held, taxpayer got § 162 deduction. Sure, he was inexperienced as a farmer, but he was making a bona fide effort to lay the groundwork for a contemplated career change. These were start-up costs, not vacation-home expenses.
2. Popov (p.401) – Held, a professional violinist was allowed to deduct the portion of her rent and electricity bills that was associated with her living room on the grounds that that room was her principal place of business, within the meaning of the home-office deduction in § 280A(c)(1)(A). Consider the relative importance of the activities performed at the location (in terms of taxpayer's trade or business) and the time spent there.
3. Moller (p.406) – Taxpayers used home offices for full time personal investment management, and tried to deduct expenses under § 280A. The case turned on whether the taxpayers were engaged in a "trade or business." Courts distinguish between traders and investors – the former qualify under § 280A, while the latter don't. Here, "taxpayers weren't engaged in a trade or business. They were active investors in that their investment activities were continuous, regular, and extensive. However, that's not the correct test. What is determinative is the fact that the taxpayers' return was that of an investor: they derived the vast majority of their income in the form of dividends and interest; their income was derived from the long-term holding of securities, not from short-term trading; and they were interested in the capital appreciation of their stocks, not short-term profits. That they spent a lot of time managing their own sizable investments doesn't mean that they were engaged in a trade or business."
4. Whitten (p.413) – After appearing on "Wheel of Fortune," taxpayer tried to offset against his game-show winnings the travel-related expenses he incurred from participating as a contestant. He argued that the travel-related expenses amounted to "gambling losses" within the meaning of § 165(d). The IRS contended that the expenses were either non-deductible personal expenses under § 262 or miscellaneous itemized deductions that may only be deducted subject to the 2% floor prescribed by § 67(b). The taxpayer conceded that he wasn't in the trade or business of either gambling or appearing as a contestant on game shows (a strategic mistake – could've related to his crossword job). Held, the expenses weren't wagering losses within the meaning of § 165(d), but maybe he could claim a miscellaneous itemized deduction under § 67. The court distinguished another case, Kozma, on the grounds that, although Kozma was allowed to deduct similar expenses under § 162(a) ("ordinary and necessary business expenses") to the extent of his gambling winnings, Kozma was a professional gambler, unlike the taxpayer here.
5. Henderson (p.416) – Taxpayer wanted to deduct office decorations and parking fee under § 162(a) as "ordinary and necessary business expenses." Court disallowed deduction – where both sections may apply, § 262 takes priority over § 162(a). Expenses must be necessary to do the job, or at least significantly aid job performance, in order to qualify under § 162(a). Court distinguished similar case in which a pediatrician purchased for his office paintings and decorations that appealed to children.

6. Rudolph (p.420) – Taxpayer tried to deduct NYC trip provided by insurance company for a group of agents and their wives as an "ordinary and necessary business expense" under § 162. The trip was voluntary, and the company, and insurance company, paid most of the taxpayer's expenses. Held, the "primary purpose" of the trip wasn't business. Taxpayer had to recognize the employer-paid portion as income under § 61 and wasn't entitled to deduction for miscellaneous travel expenses (meals, etc.) under § 162. The dissenters contended that this kind of social interaction can further business purposes (like what Posner said in Moss). Also, they contended that the wives' expenses should have been deductible because the presence of the wives on the trip aided the wives in their role as supporters of their husbands' work and kept a lid on the men's debauchery.
7. Moss (p.427) – Held, a lawyer was not allowed to deduct under § 162(a) the cost of his daily lunches at a café with the other attorneys at his firm. Although the attorneys discussed cases over lunch, the restaurant was cheap and conveniently located, and lunchtime was the most convenient time for everyone to meet, the meal itself wasn't sufficiently related to the business purpose, wasn't "an organic part of the meeting," and wasn't even attended by all of the attorneys. "It is all a matter of degree and circumstance (the expense of a testimonial dinner, for example, would be deductible on a morale-building rationale); and particularly of frequency." This looked like a bunch of friends from the office just meeting for lunch regularly, even though it may in fact have furthered their business activities. Staudt thinks this case came down to the frequency of the lunches, the fact that they took place on a daily basis.
8. Danville Plywood (p.430) – Held, company couldn't deduct under § 162 for a weekend trip for 120 people to the Super Bowl. Even though the company invited some of its customers along, the court found that it wasn't an "ordinary and necessary" business expense. Pretty extravagant, no business conversations at all, spouses were brought along… Looked more like creating goodwill, and goodwill expenses aren't deductible. Didn't get over the hurdle of § 162, so didn't even get to § 274.
9. Smith (p.437) – Taxpayers, a two-income family, tried to deduct the cost of child care under § 162 as an "ordinary and necessary business expense." Held, child care is a personal concern that falls in the non-deductible § 262 category. Have to distinguish between expenses that directly accompany business pursuits and expenses that are of a personal nature and apply to human beings generally. Congress responded by allowing a child care credit in § 21. Also see § 129. [Read p.439.]
10. Flowers (p.440) – Application of predecessor to § 162(a)(2) which allowed deduction for "traveling expenses while away from home in pursuit of a trade or business," as well as for associated meals and lodging. Taxpayer's travel expense must be (1) reasonable and necessary, (2) incurred while away from home, AND (3) incurred in the pursuit of business (also, necessary and appropriate to the development and pursuit of the business or trade). "The exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors. Such was not the case here." Can't deduct the cost of commuting.
11. Hantzis (p.446) – Lawyer tried to deduct under § 162 commuting expenses from Boston to NYC, including the cost of a small apartment in NYC and meals. Held, the expenses were not incurred while away from home ((2) in Flowers). "Section 162(a)(2) seeks to mitigate the burden of the taxpayer who, *because of the exigencies of his or her trade or business*, *must* maintain two places of abode and thereby incur additional and duplicate living expenses. … Hantzis' decision to keep two homes was a choice dictated by personal, albeit wholly reasonable, considerations and not a business or occupational

necessity. We therefore hold that her home for purposes of 162(a)(2) was NYC and that the expenses at issue in this case weren't incurred 'while away from home.'"

12. Pevsner (p.456) – Yves St. Laurent case. Taxpayer tried to deduct clothing and dry cleaning expenses under § 162. But clothing must be "unadaptable to general usage as ordinary clothing" to fall under § 162. Three-part test: (1) specifically required as a condition of employment (2) objectively unadaptable to general usage as ordinary clothing (3) not worn by the taxpayer as ordinary clothing. Objectivity of (2) provides administrative feasibility and horizontal equity.
13. Gilmore (p.459) – Taxpayer tried to deduct under § 212 his litigation expenses from his divorce proceeding against his ex-wife, who brought claims against him that would have damaged his career if she had won. "The characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It doesn't depend on the *consequences* that might result to a taxpayer's income-producing property from a failure to defeat the claim – that would go too far." Here, the wife's claims stemmed from the marital relationship, not from income-producing activity
14. Carroll (p.465) – Cost of college education is generally a § 262 non-deductible personal expense. Here, the police officer failed to demonstrate a direct relationship between the general liberal-arts courses he was taking and the particular duties and job skills required by his employment.

C. Deductions for the Cost of Earning Income.

1. Current vs. capital expenditures. § 162 permits taxpayers to currently deduct the full costs of ordinary and necessary expenses (including incidental repairs) that neither materially add to the value of the property nor appreciably prolong its life but keep the property in an ordinarily efficient operating condition. In contrast, § 263 requires taxpayers to capitalize costs incurred for permanent improvements, remodeling, or restorations to property, even if the costs might otherwise be ordinary/necessary business expenses under § 162. In general, these costs include expenditures that add to the value or substantially prolong the life of the property or adapt such property to a new or different use. Taxpayer can't take full-cost deduction initially, but instead can take depreciation deductions over time. The uniform capitalization (UNICAP) rules, § 236A – The direct and indirect costs of producing a self-created asset must be capitalized. Exception to capitalization requirement: R&D expenditures can be treated as ordinary/necessary business expenses and deducted, § 174.
2. Deduction for depreciation, § 167 – The depreciation has to be warranted, but the general policy is to allow taxpayer to understate taxable income (overstate decline in value of business property) to encourage investment.
3. Encyclopedia Britannica (p.471) – Taxpayer paid an unrelated publishing company to prepare a manuscript for publication, which included content, editing, and research. Taxpayer wanted to deduct these expenses as "ordinary and necessary" business expenses under § 162(a). Held, under § 263(a) taxpayer had to capitalize cost of manuscript and amortize against sales. In this case, Posner reasoned that the expense fell under § 263(a) since taxpayer was essentially "buying a completed manuscript" as a "turn-key project." Distinguished between recurring (162) and non-recurring (263) business expenses. The court noted, however, that the in-house costs of producing such a manuscript would be currently deductible.
4. INDOPCO (p.481) – Supreme Court tackled the capitalization vs. expense issue. Legal and investment banking fees incident to a merger must be capitalized. Why? Expenses don't have to create distinguishable assets to be capitalized. § 263A "envisions an

inquiry into the duration and extent of the [taxpayer's benefits]." The benefits of the merger were for longer than a year. If the companies didn't think that, then they wouldn't have engaged in the merger. The holding has been limited to the facts and circumstances of the case, as a result of lobbying against the result of the case. Note Ct. of Appeals cases following INDOPCO: bank was permitted to expense regularly incurred loan processing costs (PNC); bank was permitted to expense salaries of corporate officers working on a takeover since they were "of common and frequent occurrence in the business world" (Wells Fargo). And Bush Administration wants to go further.

5. Revenue Ruling 85-82 (p.478) – Taxpayer tried to deduct under § 162(a) the portion of the purchase price of farmland that was allocable to growing crops. Taxpayer would be able to immediately deduct, under Treasury regs, costs for "seeds and young plants purchased for further development." But taxpayer lost here and had to capitalize the growing crops.
6. Midland Empire Packing Co. (p.483) – Taxpayer was allowed to deduct under § 162(a) an expenditure for a concrete lining in his basement to protect it against an oil nuisance created by a neighbor. The expenditure enabled the taxpayer to use the space not on any new or improved scale, but on the same scale and, so far as possible, as efficiently as it had used the space before. Note § 165(a) attempt by taxpayer to deduct for a loss. Losses must be "realized" for § 165(a) to apply and taxpayer can't take a "double 162/165 deduction" (e.g. deducting the loss of value of a business building due to hurricane and then also deducting the cost of repairing the building).
7. Revenue Ruling 94-38 (p.486) – Taxpayer contaminated land and water with hazardous waste and tried to deduct the cost of cleanup under § 162(a). Soil remediation and ongoing groundwater treatment expenditures were allowed to be deducted under § 162(a) because they didn't provide "permanent improvements" to taxpayer's land or "otherwise provide significant future benefits." But groundwater treatment facilities constructed by taxpayer had a "useful life beyond the taxable year" and should therefore be capitalized under § 263(a); their construction constituted "production" within meaning of § 263A(g)(1). Many scholars have criticized this outcome.
8. Norwest (p.489) – Taxpayer tried to deduct under § 162(a) cost of removing asbestos-containing materials from its bank building. IRS said must be capitalized under § 263(a). Court's test: inquiry into the "duration and extent" of taxpayer's benefits, and the Plainfield-Union test which looks at the value/strength/use/etc. of the property before and after the expenditure. Court ruled that the asbestos removal should be capitalized under § 263(a) because the removal was part of "one interwined [remodeling] project" that would provide long-term benefits to taxpayer.
9. Starr's Estate (p.499) – Held, a contract for the installation of a sprinkler system looked more like an installment purchase than a lease in substance, even though the parties called it a lease. Deducting rental expenses annually vs. deducting depreciation expenses over the life of an asset. Taxpayer wanted to take larger (rental) deductions in a shorter period of time. This was about timing – how quickly could the taxpayer deduct the full cost of the payment. The case serves as authority to re-characterize a transaction differently from the way a taxpayer has characterized it. Look to the type of transaction that you would normally see in the market, question whether the terms of the transaction reflect reality.
10. Welch (p.503) – The taxpayer tried to deduct expenses incurred when he paid the some of the debts of his former, bankrupt company in order to solidify his credit and standing and to be able to resume some of the relationships he had with customers of the former

company. Held, he couldn't deduct under § 162 because these payments weren't ordinary within the meaning of the statute. They amounted to a capital outlay to acquire goodwill for a new business. Note that paying off debts unrelated to getting new business can be expensed (Dunn). In particular, when debts are paid to preserve existing business, § 163(a) applies. At the time of this case, there was no depreciation deduction (§ 167) allowed. But the taxpayer could apply the goodwill amount to the cost-basis of his new business (§ 1012) and get a benefit that way. Having a high basis reduces the amount of tax he'd pay when he sold his business. This is about keeping track of costs incurred.

11. Amortization of goodwill and other intangibles, § 197. Know this provision generally.
12. Gilliam (p.508) – An artist was traveling on an airplane to teach for a week at the Memphis Academy of Arts. He had mental problems, and while he was on the airplane he struck another passenger and incurred legal expenses. He tried to deduct his legal expenses under § 162 as "ordinary and necessary" incurred through his trade or business. Held, no deduction. Think about how closely related the expense is to your actual business activities. The farther you get away, the harder it will be to claim a deduction. (Note also that negligence isn't enough to throw you out of § 162, but gross negligence, criminal behavior – these are enough. But just because you're not grossly negligent doesn't mean that you deserve the deduction.)
13. Deduction for reasonable compensation, § 162(a)(1) – Courts have busted people who tried to deduct massive "salaries" to employees (often family members) who were also shareholders (these were really dividends, not salaries). Look for substance over form here.
14. Stephens (p.518) – Stephens, along with others, was convicted of a scheme to defraud a company called Raytheon. It looked like the charges were RICO charges. He was taxed on the amount he embezzled in 1976. The issue in this case was whether he could claim a deduction for his restitution payment – or whether allowing such a deduction would frustrate public policy. He was allowed the deduction under § 165(c)(2). In § 162 there's language to the effect that it can't be used for fines and penalties. The question here was whether the same public-policy restriction applied to the § 165 context. The court got around the question on factual grounds, finding that the restitution payment wasn't a fine or penalty, so § 162 wouldn't apply here anyway.

D. Tax Avoidance and Tax Shelters.

1. Knetsch (p.534) – Taxpayer borrowed $4mm from insurance company at 3.5% and invested that $4mm right back with the insurance company's tax-free 2.5% annuity. The net before-tax effect was a 40K loss, but taxpayer sought to deduct the 140K yearly interest as "interest paid on indebtedness" under § 163(a). Held, substance over form, there was no "actual indebtedness" here and taxpayer lost. Note that without court's ruling it would make sense to borrow 4 billion dollars this way... or 4 googleplex dollars. Congress followed up with § 264, which expressly denies deductions for interest on debt of the sort involved in this case. Purpose, substance, and utility – it has to appear to the IRS that you're entering into the transaction for some legitimate reason besides (perhaps in addition to) tax avoidance.
2. Goldstein (p.539) – Taxpayer won 140K in sweepstakes. She then borrowed 465K from a bank at 4%, prepaid 52K in interest and used the loan proceeds to buy (for 465K) 3 year US T-notes with face value 500K. She expects to receive tax savings from (1) deferral, since 52K interest deduction would lower immediate taxes and (2) conversion, since the interest deduction would be an ordinary loss offsetting the sweepstakes' ordinary income while the T-note return would be a capital gain. Taxpayer loses – even

though these transactions aren't shams, court holds that § 163 doesn't allow interest deductions when the loan doesn't have purpose/utility apart from tax consequences. (Questionable holding - what about muni bonds and taxpayer motive?)

3. Estate of Franklin (p.542) – Romneys "sold" property to Associates for $1.25 mm. Associates paid 75K in "prepaid interest" and were responsible for monthly payments, but Associates' obligation was non-recourse (if Associates defaulted, Romneys' only remedy was forfeiture of the property). The sale was combined with a leaseback; Associates never took physical possession and weren't responsible for any of the costs of ownership. The mortgage was constructed with a huge balloon payment at the end. Basically, Associates paid 75K for the opportunity to take (1) massive depreciation deductions off of the artificially high $1.25 million price and (2) interest deductions. They lost. "Depreciation is not predicated on ownership but rather upon an investment in property." The Associated didn't have any equity in this real estate transaction. Similarly, interest deduction disallowed. [Notes from class: They were really just buying the right to depreciation deductions. The Romneys got 75K, nothing else changed hands for 10 years, and then there was a balloon payment at the end. Could the Associates walk out before the balloon payment? Yes, and the Romneys would get to keep their property. But, now the Associates have income from discharge of indebtedness – the $1.25mm that they never paid back. BUT, not a problem really because the Associates get the benefit of deferral.]

IV. Splitting of Income.

A. Income from Services.

1. Lucas v. Earl (p.575) – Husband entered into contract with wife – half of everything I own is yours. They filed separate returns, decreasing their tax costs significantly by avoiding what would otherwise have been the husband's relatively high marginal tax rate. The case arose at a time when there was only one rate schedule used by all taxpayers and when husband and wife were treated as separate taxpayers. The S. Ct. held, you can keep your contractual arrangement, and we don't care what your motivations for entering into it were, but the husband has to pay tax according to his marginal rate, as if he were the sole earner (because he really was). Can't undermine the progressive tax rates.

2. Poe v. Seaborn (p.577) – Same facts as in *Earl*, except that the couple split their income pursuant to Washington's community property rules (providing that half of couple's income is owned by each spouse) instead of a private contract. The S. Ct. held that they were entitled to file separate returns, each treating one-half of the community income as his or her respective income. The Ct. distinguished *Earl* on the grounds that "here, by law, the earnings are never the property of the husband, but that of the community." Note that after Seaborn, couples in community property states had an advantage over other couples. In 1948 Congress allowed all married couples to file jointly and compute tax by computing tax on half the total and then doubling that amount. Then singles complained – rates on singles were reduced and income shifting within marriage was limited. The net effect was that couples with one wage earner did better with marriage, but two-earner couples were generally worse off (and especially worse off when both earned comparable incomes). This is a simplified explanation of the terms "marriage bonus" and "marriage penalty."

3. Armantrout (p.583) – Each top employee at Hamlin received an Educo plan that provided money to employees' children through a trust to defray college expenses. IRS argued that the distributions from the Educo trust to the employees' children were in the

nature of deferred compensation to the employees and therefore includable in the employees' gross income, and won. Although the taxpayers in this case did not have "dominion and control" over the money, the court distinguished First Security Bank and Teschner by emphasizing employees' ability to bargain with Hamlin; also, the court cited Holmes' famous line from Earl that income should be "attributed to the tree upon which it grew," and substance over form.

B. Income From Property.

1. Blair, Horst (p.592) – These two cases are about people who try to split income by giving away income interests in property to less wealthy family members. In Blair, a taxpayer gave away a portion of the income of his life estate for the estate's entire duration, and won. In Horst, the taxpayer gave away a "carved out" income interest of a bond (a bond coupon, or interest income for a brief period of time), and lost. "If one, entitled to receive at a future date interest in a bond or compensation for services, makes a grant of it by anticipatory assignment, he realizes taxable income just as if he had collected the interest or received the salary and then paid it over."

3. Hypo: Suppose client invests salary, investment appreciates by $1,000 and pays cash dividend of $1,000, and the cash dividend is paid to the son. Who gets taxed on the cash dividend? Client wants son to get taxed because son is in lower marginal tax rate. Is this a gift of income from property (then client taxed) or is it a gift of property (then son taxed)? Horizontal slice or vertical slice? Horizontal slice – transfer of ownership rights. Property rights segmented for the full duration of the rights. Vertical slice – you give away some of your rights for years 1 through year x, but you keep a reversionary interest and therefore retain some ability to manipulate the property. Temporal limit to the interest.

4. Eubank (p.599) – Life insurance agent assigned renewal commissions to some other entity. The S. Ct. held, along the lines of *Horst*, that the commissions were taxable as income of the assignor in the year when paid. Renewal commissions – whenever customers renew contracts that he originally sold to them, he gets a small slice of their renewal payments. The Court must have reasoned that renewal commissions were traceable enough to the services that the agent rendered. Counterargument from class: Not clear how long the commissions will continued to be renewed for, not clear how much money will come in because of this right. Doesn't this look more like property than income from property? The agent's work and the customers' renewal of their commissions down the road are attenuated, so that the renewal payments aren't a direct result of the agent's work. Response from Staudt: This case has been accepted.

5. Heim (p.600) – Inventor entered into an agreement with his family-owned company in which he partly assigned his patents in return for periodic payments along the lines of royalties. He then assigned interests in the agreement to his wife and kids. Held, the assignments to the wife and kids were sufficiently substantial to justify the view that their interests were income-producing property, and not income from property. Why were the interests sufficiently substantial? Because under the terms of the agreement between Heim and his company, he retained the power to bargain for the fixing of royalties, and he retained a reversionary interest in his invention and patents by reason of his option to cancel the agreement if certain conditions weren't fulfilled. These rights were transferred to the wife and kids with their interests.

V. Capital Gains and Losses.

A. Statutory Requirements.

1. Capital asset defined, § 1221(a) – A capital asset is, generally, "property" (whether or

not connected with the taxpayer's trade or business), but (first exception) doesn't include inventory (that is, property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business). "Property" has been interpreted narrowly (and, therefore, the exceptions interpreted broadly) in order to avoid extending capital gain treatment too far.

2. Capital gains and losses, § 1222 – Short-term means asset wasn't held for longer than a year. Concept of basketing.
3. Capital losses, § 1211 – A corporation has to report a net capital gain/loss (basketing). An individual has to do the same, but, if the individual has a capital loss, the individual may offset up to $3,000 of that loss against ordinary income.
4. Why do we care about the distinction between ordinary income and capital income? Two reasons: (1) The tax rate for ordinary gain is 0-39%. The tax rate for capital gain is 20%. (2) An ordinary loss can be used to offset any amount of ordinary gain, plus (if excess) a capital gain. A capital loss, in turn, can be used to offset a capital gain, plus (if excess and if taxpayer is an individual) an ordinary gain but, as to the latter, only up to $3,000. (§ 1211) Note that § 61 discusses income generally and doesn't distinguish ordinary from capital.
5. Policy rationales for favorable treatment of capital gains, *inter alia*: (1) avoid bunching small gains into one year which would be unfair, (2) avoid lock-in effect which leads to inefficient use of capital, (3) generally encourage investment.
6. <u>Bielfeldt</u> (p.645) – The taxpayer was a trader of Treasury bonds, and he took a big loss. Held, he wasn't a specialist, didn't provide (or get paid by customers for) a service – he was a speculator – so his loss should have been treated as a capital loss.
7. <u>Biedenharn Realty Co.</u> (p.649) – Subdivision sales from family estate held to yield ordinary income. Clearly property – question was whether the property was held by Biedenhorn "primarily for sale to customers in the ordinary course of [his] trade or business." Use <u>Winthrop</u> factors: the nature and purpose of the acquisition of the property and the duration of its ownership; the extent and nature of the taxpayer's efforts to sell the property; the number, extent, continuity, and substantiality of the sales; the extent of subdividing, developing, and advertising to increase sales; the use of a business office for the sale of property; the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and the time and effort the taxpayer habitually devoted to the sales. Prior investment intent is relevant only to the extent that "the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continued preexisting use of the realty… like acts of God… Once an investment doesn't mean always an investment."

C. The Taxpayer's Regular Course of Business.

1. <u>Corn Products Refining Co.</u> (p.659) – Corn futures gains held to be ordinary income under § 1221 because the futures were so closely related to the company's inventory (as narrowed by Marshall in <u>Arkansas Best</u> – the <u>CP</u> court is more vague, reasoning that the transactions were "vitally important to the company's business"). Court wanted to avoid the loophole that would result if the sale of the future created a capital transaction while the delivery of the commodity under the same future created an ordinary transaction. "To hold otherwise would permit those engaged in hedging transactions to transmute ordinary income into capital gain at will. The hedger may either sell the future and purchase in the spot market or take delivery under the future contract itself." Also note that many of the policy arguments for favorable treatment of capital gains – avoiding "bunching," avoiding lock-in, generally incentivizing investment, supporting new

industries which tend to generate large capital gains – didn't apply here.

2. Arkansas Best (p.663) – Diversified holding company sold Bank stock and wanted to use Corn Products to argue that the resulting loss was an ordinary loss because the stock was purchased and held for a business purpose w/o substantial investment motive. Sorry – the stock was a capital asset. The 1221 exceptions are exhaustive, not illustrative, even though those exceptions are admittedly construed broadly. Bank stock, regardless of motive (which, as Marshall points out, is an easily abused test) doesn't fall into one of the exceptions.

D. Substitutes for Ordinary Income.

1. Hort (p.669) – Hort received 140K payment in consideration for his agreement to cancel a realty lease, but reported a 21K loss, arguing that (1) the 140K was 21K less than the difference of the PV of the "unmatured rental payments" and the fair mkt rental value of the space for the lease's remainder and (2) even if (1) fails, the 140K income was capital. To (1), court analogizes to Hort receiving a discounted payment of rent upfront (which would be income under 61(a)) and concludes that it's income. To (2), court concedes that the lease was property but argues that since the amount was a substitute for rental payments that were clearly ordinary income, that it's ordinary income. (Staudt's argument would be that (1) it's property but (2) Hort didn't sell all his rights so therefore ordinary income.)
2. McAllister (p.675) – Taxpayer sold her life interest in a trust to the trust's remainderman. Remainderman paid her 55K in exchange for her release of all interest in the trust and consent to the trust's termination and cancellation. This interest is treated as a capital interest because taxpayer sold, permanently, all of her rights pertaining to the property. Note that this makes a life estate a capital asset within 1221 and that a life tenant has a "basis" in the life estate. This creates tax avoidance opportunity to doubly use part of this basis, so 1001 was adopted. 1001: when life tenant sells life interest to remainder holder, basis in life estate is zero unless remainder holder sells at the same time. Note Congressional response to this case: see class notes.
3. Note for Hort and Lake that although those courts used "substitutability for ordinary income" as justifications for their holdings, Staudt pointed out that the real test is twofold: first, is the interest property under 1221, and, second, did the taxpayer sell the entirety of her interest.
4. P.G. Lake (p.679) – A company agreed to repay a loan from its president by assigning to him a percentage interest in two oil leases, payable over time until the loan was fully repaid (estimated at two years). The company reported the oil payment assignment as a sale of property producing a profit in the amount of the outstanding loan and taxable as long-term capital gain. The court compared the situation to *Horst* and held that the company should have reported ordinary income. This was a loan repayment, not a sale, and the transfer of a carved-out interest, not a full interest.
5. Brown (p.682) – Circular transaction between Clay Brown Co., a cancer institute (non-profit, tax-exempt), and attorneys for Clay Brown – CB Co. sought capital-gain treatment for profits from its own sawmill/lumber business. In the transaction, CB Co. stock was transferred for a price payable on the installment basis but payable from the earnings of the company. Interpreting "sale" broadly, the Ct. held that there was one, given that the price paid was within reasonable limits based on the earnings and net worth of the company. The Ct. rejected the IRS' argument that there is no sale if the purchase price is to be paid from the earnings of the asset that's sold.

E. Contractual Rights and Other Claims.

1. Baker (p.693) – The taxpayer sold insurance policies for State Farm. Upon retirement,

he entered a non-compete covenant, returned all property belonging to State Farm, and received a termination payment. The issue was whether the termination payment was ordinary income (thinking of him as just a State Farm rep) or capital gain (thinking of him as selling his insurance business as though it were a franchise). The court looked at the things that he transferred to his successor agent – the State Farm books and customer lists, the phone number he used, the people who worked under him who were employed by the agency – and found that he didn't own or sell any capital assets. To qualify as the sale of goodwill, there has to be the sale of a business or a business segment, to which the goodwill attaches (not the case here). As for whatever remaining portion of the termination payment he received for entering the non-compete covenant, that, too, was taxable as ordinary income. How could the taxpayer have avoided this outcome? Could've structured his employment contract with State Farm differently, more like a franchise agreement.

2. Ferrer (p.701) – Moulin Rouge. The taxpayer sold the following rights under one contract in order to enter into another contract: lease of a play; the right to prevent for a time the disposition of the movie, TV, and radio rights; and a 40% share of the proceeds of the movie and other rights if he produced the play. The court found that the first two were capital assets and the third was ordinary income. As to the first, he didn't "create" the play within the meaning of the capital-asset exception, and, as to the second, it's sort of like a tenant's relinquishment of a right to prevent his landlord from leasing to another tenant in the same business, held to be the sale or exchange of a capital asset. People have criticized the characterization of the third as ordinary income. The court looked at the three components of the transaction separately and allocated. [Notes from class: Staudt says to ask the following. Property? If yes, sale? If yes, exception applicable? If no, then capital asset.]

Techniques of statutory interpretation:
plain meaning
public policy (the "intentionalist" approach, deference to the enacting legislature)
defer to the expertise of the administrative agency (deference to the executive)
dynamic approach – look at text, contemporary politics, virtually anything that would guide decision
(many people say courts use this approach, even if they don't say so explicitly)