Federal Income Tax Outline

I. Introduction

Statutory Interpretation and Tax Policy

- Problem Set 1, #1, language at issue is “every individual.”
- §7701(a): what is the difference btw “person” and “individual”? Why is this not defined anywhere in the tax code? How do we know Congress intent by “individual”? Congress could have used “every individual” in a more restrictive sense by limiting age, etc; by not defining “individual” more restrictively, Congress probably meant to define the word by common usage or in a broad sense;
- A problem exists: each word in a definition requires a definition which also requires a definition, etc, etc. Ultimately, one must come down to undefined terms or the IRC never ends
- Statutory interpretation
  1. Follow all cross references
  2. Look for definitions locally and globally
  3. If no definition exists, then legislature probably intended to adopt common usage.
- After establishing Baby Keisha is an individual, does interest income count as taxable income? Compare §61(a)(4) (includes federal bond interest) with §103(a) (excludes state & local bond interest).
- Most of immense tax code boils down to definition of “taxable income”
- After determining 1) Keisha is an individual and 2) Interest is taxable, 3) it is also assumed that the word “of” connotes ownership and Congress intends “of” to mean common usage.
- Problem Set 1, #1b, what is the difference btw Keisha and her parents’ liability? b/c of rate schedules, Keisha liable for $450, parents liable for $980.
- Problem Set 1, #1c: Strategic to put money in the name of lower income dependents; §1(g) makes §1(c) conditional; §1(g) applies to Keisha, defined by §1(g)(2); What limit does IRC place on “spreading around income to low income dependents?"
  Computing of unearned income (earned income=compensation for svs; unearned income=income from property) of minor treated as parent’s income under §1(g)(1)(B):
  §1(g)(1)(A) tax = greater of $450 (per §1(c)) or sum of:
    (i) tax on taxable income, reduced by net unearned income ($3500-1000=2500 in this case)) =$2500*15%=375
    plus
    (ii) Child’s share of allowable parental tax (excess of tax on parent’s taxable income, including child’s net unearned income over tax on parents w/o regard to §1(g))=700
    =$775;
  $775 is greater than initial 15% rate if §1(g) did not exist but still less than if parents were fully liable for tax on Keisha’s interest income ($980).

- §1(g) only applies to unearned income; once child has wages from working, then the “money hiding limit does not apply to wages; Congress assumed that young children do not have control over bonds they hold, so parents cannot get away with hiding money that
parents effectively control in their children’s names; once a child is 14, §1(g) no longer applies and the parents can hide $$ in the kids’ names

- Is ownership defined per the IRC or per property law? Congress intended to align tax with beneficial ownership

- All numerical answers to Prob Set #1, Q1 are wrong but the analysis is correct; §1(f) provides: by 12/15/93, Sec’y shall prescribe $ amounts in accordance with C.O.L.A. for each year; Treasury increases limits on brackets per inflation rates; keeps tax liability constant with buying power; §1(i)(1) creates a rate reduction bracket for low income taxpayers, so Keisha is only taxed @ 10% as of 12/31/00; as of 6/30/01, Dubya also reduced rates for higher tax brackets

- Problem Set 1, #2: Joe misunderstands the progressive rate schedule like many people; current rate schedule is different from historical norms; until 1981, there were dozens of brackets, even as high as 92.5%; Kennedy dropped from 70% to 50%; Reagan dropped from 50% to 28%, then it went back up to 35-40%;

- The principle of fairness is involved in §1: everybody should be forced to support the government; tax rates are not proportional but progressive.

- Tax Rates and Policy
  1. Economic Neutrality: Tax law should interfere as little as possible with economic decision-making, i.e. work vs. leisure, spend vs. save, consume vs. invest.
  2. Fairness or Vertical Equity: Persons in different situations should be treated differently; possibilities of regression/proportionality/progression

Other Choices: Flat Rate-reverse of progressive-reward hard work (in the form of high income); tax people based on labor versus leisure-this could reduce distortion. Flat rate may increase economic neutrality.

The only tax that is completely neutral would be total government costs divided by population=$23,000/person-this is a flat dollar or head tax. This is not used because it would create lots of unwilling criminal tax cheats-this system was adopted in the UK by local govt’s in the 1980’s; vertical equity rules out the head tax;

Congress believes that tax rate should increase with income, known as a progressive tax rate. Congress has always adopted progression as a standard of vertical equity. Scholars have debated the merits of flat versus progressive tax rates in recent times. Progressive may be a way of distribution of benefits. The economy is built upon a progressive system (IRS bureaucracy, tax accountants, etc.) and progressive taxes are popular with constituents-this makes up for state and local taxes that are not progressive.

Regressive system: lower income people pay a higher proportion of income; still has the effect of increasing tax burden as income increases, but at a lower percentage; even the most conservative republicans still choose between proportionality or regression; if lower income people pay a higher or flat rate, they may have trouble meeting basic needs.

Because lower income people spend higher % of income on goods/svcs, state & local sales tax actually serves as a regressive income tax. Social security is also regressive.

Benefit based taxation, people pay for sewers & roads based on usage as opposed to income

- The ability to pay should be accounted for; reflects an intuitive notion that at some point, additional income is less valuable; some economists (not all) believe in decreasing returns with goods & svcs, but is money subject to declining utility? Notion of equal sacrifice.
• Problem Set 1, #3a: Does the city pay tax under §1? No b/c it’s not an individual. The city pays tax under §11, provided the city is a corporation; §7701(a)(3) defines corporation, but not sure if local govt’s are included; §7701(a)(3) is bizarre b/c it gives 3 definitions of corporation (joint stock co. with no share holder limited liability is no longer relevant). What do we know for sure? §7701(a)(3) “includes but is not limited to association, joint stock co. and insurance co.” This is an open definition, not complete and exhaustive (Compare w/ §7701(a)(4) “means” limits the definition.) Congress’s silence about for-profit corporations does not mean they’re not liable—This is due to common usage. What is the city’s status? Cities are incorporated §115(1) limits city/state income definition: (i) Public Utility; (ii) Exercise of essential functions-no statutory defn. of a public utility exists; definition of essential function does not mean investment in an interest bearing account.

• Problem Set 1, #3c: Under socialist government, the city is still not exempt from tax b/c the function is not essential

• IRS-common usage of “essential”; “city” is ambiguous; Can be resolved with precedent cases or legislative history.

• In a case of first impression, look to other places in tax code: (i) legislative history; (ii) intent is problematic-rather than looking at subjective intent, it may be better to look at advisory committee notes; (iii) The best purpose is underlying tax policy in §115(1) exempting state/local gov’t on public utility income; the policy/purpose of this exemption is NOT WANTING FEDERAL TAX COLLECTORS TO INTERFERE WITH STATE/LOCAL GOV’T PROVIDING SERVICES-INTERGOVERNMENTAL TAX IMMUNITY; §115(1) is an embodiment of federalist principles—there is no need for legislative history b/c the constitution made this necessary.

• No municipality has actually tried to expropriate a bank for tax immunity; how could a college town earn $ w/o paying taxes on the revenue? Expropriate pizza joints/bars and operate them at a profit-effectively tax transient students and relieve residents of tax liability. The town is a municipal corporation-issue of whether pizza & beer are essential government functions? Not essential, but competing corporations outside city limits would be subject to tax unlike city owned restaurants—this creates unfair competition with taxable businesses; principle of economic neutrality versus exploitation of outsiders.

• Problem Set 1, Q4a: dividends are included in gross income, TP is liable

• Problem Set 1, Q4b: if dividends are paid by a French Corporation, §61(a)(4) makes this irrelevant b/c of “including but not limited to” clause, TP still liable.

• Problem Set 1, Q4c: What if TP is no longer a U.S. resident? This does not matter, b/c TP is a U.S. citizen, so TP pays tax on worldwide income, regardless of residence.

• Problem Set 1, Q4d: “Every individual” → French Citizen taxable on French Corp. dividends while residing in U.S. §2(d) applies to non-resident aliens, but TP is a resident alien.

• When Congress said “individual” in §1 and the only qualification was §2(d), then resident aliens also pay tax on their worldwide income; so by “individual”, Congress means every human being everywhere is potentially subject.

• Problem Set 1, Q4e: Now dealing w/ nonresident alien, but still may be subject to U.S. tax; the analysis is very nasty:

§2(d): Non-resident aliens only taxable under §871 (§877)
§871(a): Tax of 30% on amount received from sources within U.S. by non-resident alien as all types of income in §871(a)(1)(A), but only to extent that amount received is not connected with trade or business within United States.

§871(a): 30% tax or “gross withholding tax”:
(1) Sources within U.S.
(2) Periodical Income
(3) Not effectively connected with U.S. trade or business.

§871(b): non-resident alien engaged in U.S. trade or business is taxable under §1 or §55 on income effectively connected with U.S. trade or business (progressive tax).

What if income is not effectively connected? §871(b) does not apply, but §871(a) might apply if within U.S. and periodical income.

Only if a person does not fall under §871(a) or (b) are they not subject to tax: Not effectively connected and (1) not from U.S. sources; or (2) periodical income.

- Problem Set 1, Q4f: §864(c)(1)(b) → Non resident alien not engaged in trade/business within U.S. → No income shall be treated as effectively connected with trade/business within U.S. → boils down to §861(a) and (b) → dividends are income from within U.S. if corporation is domestic under §7701(a)(4).

GM is obligated to not pay full dividends to non-resident aliens and pay the 30% cut to IRS; §1441 requires this even if full dividends are paid, GM still must pay 30% to IRS.

GM cannot circumvent by reincorporating a subsidiary in France.

→ §861(a)(2): dividends = amount received from a domestic corporation or a foreign corporation.

Unless less than 25% of the gross income from all sources of such foreign corporation are effectively connected with U.S. trade/business.

Must know what % of Panamanian corporation’s income is from U.S. trade/business

§862 defines income from sources without United States

§862(a)(2) → dividends other than those derived from sources within U.S. provided in §861(a)(2).

- 3 Jurisdictional bases of U.S. Fed Income Tax
  (1) Citizens pay tax from worldwide income (U.S. and Liberia are the only countries that have citizenship-based taxation)
  (2) Residents pay tax from U.S. Income
  (3) Source: Non-resident aliens with income connected to U.S.; §871 “source”

- Fairness? Taxes paid produce benefits in terms of governmental services. Do people in these 3 categories get sufficient benefits?
- Fair to tax residents? They do get benefits of most services (nat’l defense, security, etc.- everything exc. The right to vote)
- Fair to tax non-resident aliens? They receive the benefit of exploiting an economy that is protected by the U.S. government.
- Expatriates: What benefits accrue to citizenship standing alone? No on-site protection, no domestic income, but right of repatriation, right to use embassies abroad; also, becoming a citizen may be voluntary, but expatriates have a right to renounce citizenship.
- Even if there is a benefit, expatriates and non-resident aliens have a much smaller benefit than residents; many countries think U.S. taxation is dubious at best.
- Even broader, §877: expatriation to avoid tax → people who renounce citizenship principally to avoid tax are still liable for U.S. taxes on worldwide income (only for a 10
year period); §877(f): people must show evidence to the contrary if the IRS reasonably believes a person is renouncing to avoid taxes; wealthy U.S. citizens, descending from robber barons, receiving passive income from investments, could move abroad, renounce citizenship and only be liable for 30% tax under §871(a)(1); more historically relevant due to much higher top tax brackets in the past.

- What about U.S. citizen, residing in Canada, receiving income from France? The cascading effect of international income would stifle the global economy. Adjustments are made by (1) International agreements (2) If U.S. relations are not good w/ a certain country, unilateral statutory rules are made.

Overview of Tax Computation

- Problem Set 2
  §63: Taxable income defined
  §61(a): Definition of gross income
  Why have a tax base so complicated?
  Why not subject all receipts to tax? It would be less costly for the IRS to administer and less costly for taxpayers to comply?
  If TP is a solo practitioner, they should not be taxed on all monthly fees, b/c much of the fees go toward expenses (rent, LEXIS, secretary salary, etc.)
  Not fair to tax on gross receipts, because not all of that money can be freely spent.
  The tax system is based on fairness/ability to pay.

- What is the value of a deduction paid to an employee as wages? This is dependent upon the taxpayers bracket; the higher the bracket, the greater value of a deduction.

2 types of deductions in the code
(1) Non-itemized (difference between gross income and adjusted gross income)
(2) Itemized deductions (alternative to standard deduction); explicit in §63(b), every taxpayer has a choice between standard or itemized deduction.

Why give a taxpayer the choice btw standard or itemized deductions? Taxpayers can minimize their liability by choosing either option.

For each non-itemized deduction, a person saves (their tax bracket) cents on the dollar.
For each itemized deduction, a person will save nothing unless standard < itemized.
Taxpayers, in their self-interest, would prefer to have every deduction classified as non-itemized so they can be assured a tax break.
Administrative necessity requires minimizing workload of auditing itemized returns→easier to give a standard deduction that is high enough for most people.

- Problem Set 2, #4: A credit s a direct offset to tax liability, while a deduction offsets tax base.

- Problem Set 2, #3: Difference between deduction and exclusion? No functional difference; the actual difference is that exclusions appear at different points; exclusions are a part of gross income; exclusions are the functional equivalent of a non-itemized deduction.

- Why did Congress make a distinction between exclusions and non-itemized deductions?
  Usually, an exclusion is an untaxed receipt, while deductions refer to outgoing expenses; typically, if something was an exclusion, it did not have to be reported at all, while a deduction must be reported; difference in privacy rights.
General rule: Partial tax credits benefit people in lower tax brackets more than those in higher tax brackets. (If you are at a tax rate that is less than the credit amount, then you benefit from a credit rather than a deduction.)

Itemized deductions benefit those in higher tax brackets than those in lower tax brackets.

<table>
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<th>No Contribution</th>
<th>Gross income</th>
<th>Amt. Contrib</th>
<th>Ded'n</th>
<th>Tax</th>
<th>Credit</th>
<th>After-tax funds</th>
<th>Cost of contrib</th>
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<td>72</td>
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<tr>
<td>TPB</td>
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<td>0</td>
<td>15</td>
<td>0</td>
<td>85</td>
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**Contrib. Deductible**

| TPA             | 100          | 100          | 100   | 0   | 0      | 0              | 72             |
| TPB             | 100          | 100          | 100   | 0   | 0      | 0              | 85             |

**Contrib. 25% credit**

| TPA             | 100          | 100          | 0     | 28  | 25     | -3             | 75 = 72 - - 3  |
| TPB             | 100          | 100          | 0     | 15  | 25     | 10             | 75 (=85-10)    |

Wash U. would probably want the Code to offer a deduction, whereas a local church would want a credit system.

Who gets the taxes in a multinational situation? Treaties: If you pay foreign taxes, you get a 100% credit toward foreign taxes that you pay.

This promotes foreign commerce because you can never pay more in taxes than the highest foreign tax rate as a result of paying US taxes.

*Old Colony Trust v. Commissioner* (CB p.35)

Does taxable income include a payment made on a taxpayer's behalf? "The answer must be 'Yes.'"

"The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."

Economically equivalent transactions must be taxed identically.

Wood's argument (according to Wiedenbeck): "It cannot be income because it never came in: GO TO HELL!!!!"
August 29, 2002 (Hillary’s notes)

A. Noncash Receipts in General

-Most income is received in the form of cash (including checks)- salaries, wages, dividends, interest, sales proceeds, etc. The value of money is what it will buy. Money may be viewed as a symbol for the real goods and services it will buy; real income, then, is real goods and services consumed, or accumulated rights to such goods and services, whether they are purchased w/ money income or received in kind.

-There are practical difficulties and some theoretical problems in taxing non-money income.

Comments in class on Old Colony:

-Employer agrees to pay the employee's income tax on his salary. In 1910, there was no federal income tax. In 1913, Congress enacts the modern income tax. These people are used to having 100% of their salary. In the early years, the rate of tax was minimal. But in 1918 and 1919 the rates went very high to finance WWI. Rates went up to about 77%. This didn't affect many people, except for people like William Wood, the president of the company who is making $1 million in salary in 1918 (this guy is like the Bill Gates of 1918). This high tax rate would result in a massive change in lifestyle if all the salary is majorly taxed. The motivation for the employer is that keep the President.

-The employer pays the IRS for about $700,000.

-The IRS is happy to get the money, but they think that this amount should be included in the President's additional income. Employer's tax payment = additional income to the Employee

-What supports the IRS opinion? The SC doesn't cite statutory authority. Tax is the first enumerated power of Congress- they have the power to lay and collect taxes- and this by negative implication says that the executive and judiciary should NOT lay taxes. The IRS saying you owe this money is not good enough. We are resisting this opinion without authority. §1 says "hereby imposes tax on taxable income" → does Wood's income include just his salary or his salary and the amount paid by his company?

-Turn to §61 (a)(1) Gross income definition→ gross income includes income from whatever source derived, compensation from services. Compensation for services is expressly included in gross income.

-The issue is the status of the $700,000 paid to the IRS directly from the employer. Normally compensation for services is reflected as salary-something you receive. The employee didn't receive the $700,000-it was sent directly to the IRS. The taxpayer argument comes down to saying this is not gross income b/c not compensation for services because I never got my hands on any of that money. May be some question as to whether this is "compensation". However, §61(a) says in general gross income means ALL income from WHATEVER SOURCE DERIVED, and then lists some examples and says it is not limited to the list. We have only
specifically listed examples that are CLEARLY in gross income, but Congress provided us with a "means" definition. Gross income means ALL income from whatever source derived. This is circular definition. We have an item that is not specifically listed, but Congress meant something broader because of the "including but not limited to". The general principle set out by Congress is circular. This is like no definition at all. So we fall back on common usage. Does the term income have a core meaning or commonly accepted definition?

-What does "income" normally connote? In-come. Usually means something coming in, something received.

-Court's argument

Æ-But, he received some BENEFIT. Something may have come in that wasn't a check of $, but was a benefit. **The discharge by a 3rd person (employer) of an obligation to him is equivalent to receipt by they person taxed. The one-step direct tax payment is equivalent to the two-step process of receipt by the person taxed and then him using it to pay the tax. We know in the two-step transaction would be definition "income" and would be subject to tax. So, the court says the one-step = two-step, so the taxation should be the same. Principle of Economic neutrality. Economically equivalent transactions must be taxed equally.

-Issue #1: are the 2 transactions really equivalent? Issue #2: why?

-Wood's argument is if I actually got an extra $700,000, I would have used it to buy a new house or done something to benefit me. I wouldn't spend it on taxes. Actually receiving that money would mean that I could spend it anyway I wanted to and would have benefited-rather than the employer making the decision for me. But, the next argument is that the IRS would seize the vacation home. This is a legal obligation, and you have to pay your creditor (the IRS). It isn't up to you if you pay. Creditors have rights to enforce liability, and could repossess the vacation home he bought. The individual has to pay that amount regardless of voluntariness.

-When your employer pays off you MasterCard, it is equivalent to the employer giving you the money and you pay it off. If the employee didn't use the money to pay off his MasterCard, then MasterCard could repossess his home, car, etc.

-They are economically equivalent because it is a legally enforceable obligation** It is a question of pay it now or we will make sure you pay it later. If it wasn't a legally enforceable obligation, then the employee's argument that he would spend the $ however he wanted to is persuasive.

-What if the result had gone the other way? What would have been the message? The response would be people trying to reduce their taxable income. They would arrange by contract to have the employer pay tax liability. Would also have the employer buy their home, pay for their food. Hideous unfairness to the taxpayer in a position to arrange this kind of a deal, and those that are not. The people in the position to have this arranged are the executives of the company, and won't do this for the secretaries and the janitors. The result will be those taxpayers that can't arrange this dodge will have to pay a lot more taxes. Unfairness is the result.

-We are also refusing common-usage of the term "income".
• *Old Colony*: Discharge by a 3rd person of an obligation is equivalent to receipt by the person taxed. How so? One must reject the argument that direct payment to creditors is less valuable that receiving the payment oneself.

If Wood’s argument in *Old Colony* was valid, all employees could reduce their tax burden by arranging direct tax payment from employer to IRS.

This would distort: (1) Economic Neutrality, because this would not minimize the impact of taxes on economic decision making and most employees are not in the position to rearrange their own compensation; (2) Horizontal Equity b/c this would result in different treatment of individuals in the same circumstances; the Supreme Court principle must hold b/c of economic neutrality and horizontal equity.

• No comprehensive definition of “income” exists, per §61(a)-circular reference; Supreme Court rejects the common understanding despite not having a statutory definition. Why? Absent statutory defn probably means common usage. But, if common usage conflicts with legislative purpose, then common usage must also be rejected.

• **Supreme Court understands that Congress did not want a tax system so unfair as to depend on actual receipt of money to incur tax liability.**

• 2 additional arguments made on Wood’s behalf to avoid tax obligation
  (1) The tax payment was a gift b/c gifts are not specifically enumerated in §61(a) definition of income; substance over form; this argument is irrelevant b/c §61(a) reads: “including but not limited to”
  Income must involve some sort of gain or enrichment-requires receipt (direct or indirect);
  §61(a) prefaced by “Except as otherwise provided”;
  §102(a): gross income does not include gift, bequest, devise or inheritance (Wood’s argument); **BUT** no definition of “gift” is given in the tax code; payment for services, even if voluntary is still income; why did Congress grant exclusion for gifts when they are pure enrichment?
  (2) Wood shouldn’t have to pay a tax on a tax-tax on tax is an infinite series, but it converges as an algebraic limit of a series (in Wood’s case) to $2,333,333; argument rejected b/c everyone pays tax on tax; dollars withheld for taxes are subject to tax liability; the federal income tax obligation is not deductible;

• §275(a)(1)(A), (C): no deduction allowed for fed income taxes, incl. FICA and tax withheld @ source on wages.
  §164(a): Except as otherwise provided, certain taxes are deductible (state/local taxes, real/personal property taxes, foreign taxes)-exact opposite of §275
  On principle, federal taxes should be deducted also b/c they can’t be saved or spent, **BUT** to keep things fair in light of different state/local tax rates, §164(a) makes state/local taxes deductible in contrast to uniform fed rates where a deduction is irrelevant in terms of fairness

• Wood’s total tax liability is $2.33 mln, b/c at 70% rate:

\[
\text{Ratio} = \frac{30\% \text{ (take home pay)}}{\$1 \text{ million}} = \frac{100\% \text{ (total pay)}}{\$3.33 \text{ million}}
\]
II. Scope of Gross Income

In-Kind and Imputed Income

- **Benaglia**: BTA (board of tax appeals—predecessor to U.S. Tax Court)
  Benaglia managed hotels; received free room & board; salary was fixed; wife also rec’d free room & board.

**Issue**: Whether free room and board were included in definition of gross income?
This was a receipt and a valuable gain/enrichment; IRS thought this was worth $7800/yr (fair mkt. value of rooms/meals—possibly retail price)
Benaglia argued that his job made it necessary to live/eat at hotel.
BTA finds the room & board to be tax-free despite the enrichment b/c this is **incidental to performance of duties**.

What is the meaning of “for convenience of employer”? Why is this relevant?
Benaglia had to be on premises 24 hrs/day

Possible valuation standards for room & board
1. Retail Price = $7,800
2. Employee’s subjective value = $4,600
3. Cost of alternative arrangements = $3,600
4. Employer cost = ???
5. Zero

Zero is probably the wrong choice, b/c it is doubtful that the accommodations were really no advantage to Benaglia;
However, it may not have been Benaglia’s choice AND the price of housing/meals > Benaglia’s salary
Therefore, b/c Benaglia did not choose voluntarily to eat/sleep at the hotel, the value of room & board to Benaglia may not have been as great as the retail price.
Incidental advantage: b/c it was imposed on Benaglia, incidental advantage was the amount Bengalia would have to spend for his own room & board

- **Benaglia** dissent has 3 arguments
  1. Legal standard should be focused on benefit to employee, not employer’s purposes; dissent would have taxed on alternative cost; convenience of employer is irrelevant, but inclusion should not be retail; without meals/lodging, Benaglia would have to pay for his own and one cannot be sure what Ben would choose on his own “restrained consumption”—focus on extent of employee enrichment as opposed to retail price
  2. Lodging was included in the original contract, so it was included as compensation; if bargained for in compensation, maybe full retail price is appropriate
  3. Eating/sleeping @ hotel was not necessary—convenience of employer was not a factual matter

- Benaglia is much better off than others @ same salary who must purchase their own room/board (principles of **fairness**)
  IRS implied Bengalia should be taxed on the retail price of room & board; zero tax is Benaglia’s position and the result of the majority decision.

- A number of plausible intermediate rates
  If Bengaglia is taxed at $13,600 salary, he is equivalent to a person paying $3,600 room & board out of pocket and still has $10,000 left over.
  As a matter of **horizontal equity**, best to tax @ approximate value of room & board.
Even so, the margin, hotel mgr. @ $10,000 is better off than other job @ $13,600 b/c there is lower tax liability @ $10,000 salary. If many people choose hotel manager as a job b/c of tax advantage, salary goes down, people pay an “implicit tax” on the higher demand for the jobs

1. Horizontal Inequity
2. Economic Non-Neutrality
Possibility that being on call 24/7 made Benaglia entitled to higher compensation

- Do we want the market to adjust—spend more on hotels b/c of their tax advantage, resulting in lower salaries and lower prices?
- A large portion of hotel employee compensation is tax free, leading to lower salaries, lower prices and higher consumption; hotels can also deduct employee benefits as business expenses.
- Whenever there’s a disparity in tax treatment between people who seem to be similarly situated, we first see an inequity, but then the market will adjust; this will distort prices between alternatives
- Hotels & restaurants are the biggest employer and lobbyist for minimum wage in the USA b/c of the tax treatment in Benaglia fallout.
- Why not tax Benaglia on the subjective value of room & board? Was Benaglia indifferent between renting a home and buying groceries or staying at a nice hotel? Was it only worth the cost of alternatives or does Benaglia most likely feel better off with room & board at a fancy hotel?
- May need to know the substance of the contract negotiations btw Benaglia and hotel.
- Could be determined by the amount of salary Benaglia was willing to forego, but this is unfair b/c different people value free room and board at different prices.
- If we could learn personal subjective valuations of free room & board, it would be the best way to determine tax fairness.
- Another way to determine could be to look at Benaglia’s expenses for room & board prior to receiving a free benefit—this may be a good determinant
- Could also look at employer’s cost of giving free room & board. Possibly low, b/c the hotel isn’t necessarily foregoing a paying customer to give a free room to Benaglia; also, no markup cost on meals, only labor and overhead.

- Reginald Turner: How to measure income from goods and services rec’d in kind? Minimum enrichment = net resale value
- If non-transferable, then how is enrichment to be addressed?

Radio caller won free cruise to South America
- IRS says retail cost of tickets is $2,200 but this is income from the steamboat.
- Taxpayer states $520.
- The only reason it ended up in court was b/c the taxpayer told the IRS about it
- Court valued tickets @ $1,400; rationale is that Turner would not have paid for 1st Class price, but his family got the benefit of a vacation; the total may have been reached by averaging the two amounts; Turner could have sold the tickets but they were non-transferable; value would be FMV minus cost of sale; b/c Turner went on the cruise, the personal valuation may have been greater than the sale value.

- Benaglia does not apply b/c no employment relationship exists in this case; the benefit in Benaglia was incidental to the employer making money.
How is this applied in *Turner*? Turner won the ticket as part of the radio station’s effort to promote itself; still could be incidental to the radio station; factual distinction b/c/ no employment relationship, but still the same on principle.

- Tax Court did not accept IRS retail valuation or Turner’s valuation @ $520; why go with $1400? Why not include $0? What if it can be shown that Turner would buy tickets to S. America (he did, in fact); Turner’s actions show he would go; best valuation (p.42) factors in retail minus cost of sale; also factors in the fact that they did take a cruise w/ free board, savings in expenses, pleasure of trip; free room not factored in b/c could not forego paying for home mortgage or rent while on the cruise.

- Can it be assumed that Turner would take a different vacation if he had not won a cruise? *Turner* is basically adopting the *Benaglia* dissent; neither refused nor can it be shown the ticket would actually be bought; best to use “expenses avoided” standard.

- *Haverly*: School principal got free books from publisher, gave to school library, tried to write off as a charitable contribution; under §170, FMV = $400, but books were never reported as income.
  
  What is the value of the books? Resale price? The books are transferable goods, how much can they be sold for? What should inclusion be on principle?
  
  Value of enrichment is probably only 50 cents/book, but Haverly tried to claim $400 for a deduction; if charged w/ $400 of income, the deduction gets wiped out.
  
  What does IRS do w/ free samples? Ignore b/c that’s nearly accurate. A free sample enriches very little, so IRS thinks strategically to limit taxpayer outrage.
  
  IRS knows it’s not worth the political backlash of demanding inclusion of free samples in gross income, UNLESS people’s conduct is like Haverly’s.
  
  The purpose of a charitable contribution deduction is reflective of the fact that taxpayers are not charged for enrichment not actually gained.
  
  Gross income should have been enrichment, tax deduction should be actual enrichment. If a deduction is too high, gross income can be adjusted accordingly.

- *Kowalski*: NJ state troopers receive cash meal allowance; there is obvious enrichment and no questioning about whether allowances are spent on meals; are these allowances gross income under §61(a)? No limitations on source of receipts except those specifically exempted.

  3 part definition in *Glenshaw Glass*

  1. Accessions of wealth
  2. Clearly defined
  3. Complete dominion

  Tax base is not gross income, but taxable income

  §119(a) meals and lodging furnished are an exclusion; this is a problem in *Kowalski* b/c troopers received cash payments; *Kowalski* gives long history of “convenience of employer” doctrine;

  CB p. 55: §119 comprehensively modified prior law-intended to replace prior law and end the inclusion

  §61(a) gives Congress the exclusive authority to determine the definition of gross income: “except as otherwise provided in this subtitle” means that Congress repealed all judge-made exceptions to tax liability.
• Even if *Benaglia* standard survived, the judge made exclusion does not cover troopers b/c business necessity standard is not met; eating is essential, but nothing necessitates the state of NJ providing meal money to troopers.

• *Sibla*: meal costs of LA firefighters; ff’s had to participate in meal plan at fire stations; by making requirements and paying cook’s salary, city’s participation was considerable. CB p 58: what’s the problem w/ applying §119(a)? Applies to “meals furnished in kind by employer”

• *Kowalski* never applied to cash-hard to reconcile w/ *Sibla*
  B/c of employer compulsion element, enrichment is not what it seems to be
  Family-like discussion of food; Kennedy dissent said this was factually indistinguishable

• Problem Set 3, #1
  2 conditions for meals being an exclusion
  1. Convenience of Employer
  2. On business premises
  3 conditions for lodging
  1. Convenience of Employer
  2. On business premises
  3. Employee is required to accept
  Convenience of employer means *substantial non-compensatory business reason*
  Business premises means *place of employment*
  Condition of employment means *employee is required to accept*, i.e. household servants need business premises definition to qualify
  Why did Congress give more conditions for lodging than for meals? Congress meant to be more restrictive-at odds with apparent objective; Congress must have meant not to follow traditional judicial understanding; Supreme Court in *Kowalski* interprets §119 to mean “convenience of employer” means *business necessity*, thus rejecting treasury’s regulation; treasury defers to Congress, but the Supreme Court does not.
  Congress added §119(b)(3) *immediately* after *Kowalski*, allowing cash payments to be excluded b/c Congress disagreed w/ cash vs. in-kind dichotomy in *Kowalski*.

  §119(b)(3) is not applicable to the facts in *Sibla*. (1) Employees collaborate on menus, payments are dependent on content of meals; (2) 119(b)(3) does not apply to *Sibla* b/c the charge was *not* fixed *nor* was it furnished for the employer’s convenience
  There were not significant elements of constrained consumption

• Problem Set 3, #2b: Employee A has $10K salary, pays employer $1K for meals; Employee B has $9K salary and receives $1K in free meals at convenience of employer
  In the end, both A ans B have the same total benefits, i.e. **horizontal equity**
  But in the case of B, §119 grants an exclusion b/c the meals are in kind; A cannot exclude b/c there’s a cash payment under §119(a); under §119(b)(3), A can exclude cash payment
  Congress believes Supreme Ct. undercut cash vs. in-kind exclusion-wants economically equivalent decisions treated the same-made 1978-enacted law retroactive to 1954 to keep IRS from going after all people in employee A’s case from 1954-1978
• Problem Set 3, Q3: Qualified campus housing in §119(d)(3) only applies if meals/lodging exclusion in §119(a) does not apply
   §119(d)(2)(A)(i) makes 5% of the value of the housing included in gross income
   Also, a college president is not likely entitled to the exclusion under §119(a)
   Aside from §119, there may be a business necessity to have an official residence—gives surroundings to create “psychological oppression”
   Inherently, the Benaglia rule is very fact sensitive

• Problem Set 3, Q4a: Does minister have to pay taxes on the value of a home? No.
   Why does §107 cause lee concern than §119? It’s an older statute that predates Benaglia.
   Begs the question why Congress did not make §119 and §107 consistent—maybe Congress does not want to mess with ministers
   Even if it’s fair to take away these benefits from religious entities, Congress doesn’t b/c it’s afraid of the ramifications of changing-religious institutions have the influence to keep from fixing the mistake
   Definition of “minister of the gospel” is common usage, not defined in §7701
   IRS realizes Congress’s shortsightedness and applies §107 to all religions

• Problem Set 3, Q4b: If TP gets cash payment to rent a farm, §107 does not distinguish btw cash or in-kind; IRS would argue that renting a farm does not mean renting a “home” under §107; §107(2): rental allowance may exceed fair rental value; suggestion of Congress that rent should be excluded but mortgage is not excluded.

• Problem Set 3, Q5: TP earns $50K salary, donates $25K to church where he is minister and receives back a $25K parsonage allowance, used for living expenses.
   Normally, no deduction allowed for personal consumption expenditures under §262(a)
   BUT, gift to church is a charitable contribution w/ a deduction under §170(a),(c) and gift comes back as a tax exempt parsonage allowance under §107
   Maybe this is not laundering $ if the church is real; the court may not want to question legitimacy of church b/c of 1st Amendment problems
   Televangelist ministers get HUGE parsonage allowances, tax-free b/c of §107-historical source of abuse
   The main test is whether a minister actually performs religious functions (regardless of nature of doctrine); then the allowance is valid under §107
   If TP has another full-time job and nobody else belongs to the church, §107 exclusion is questionable; religious function must be significant and substantial.
   §170(c)(2)(B): church is a charitable organization
   §170(c)(2)(C): no part of net earnings which inures to the benefit of any private shareholder or individual

• Problem Set 3, Q6a: Are employer furnished cars an exclusion? This is a factual inquiry.
   After 1954, §119 enacted to cover meals/lodging; still does not apply to cars
   Cars are still a benefit that enrich a family
   §61(a) “except as otherwise provided in this subtitle” (meaning the entire Fed Income Tax Code), gain and enrichment are taxable
   §61(a)(1) includes “fringe benefits and similar items”
Congress expressly intended to tax this unless the TAX CODE grants an exclusion
§132 gives 7 exclusions
Is use of a good a “good” or “service”? For tax purposes, this is a service;
§132(a)(1): No add’l cost service?
§132(b)(1): No add’l cost service defined; even if use of cars is a service, it is not offered
for sale to customers or in the line of business of the employer in which the employee is
performing services.
§132(c): qualified employee discount defined-not eligible
§132(d): Working condition fringe?
§132(e): not a de minimis fringe
§132(f): not a qualified transportation fringe
Message: If employer gives you something, it is tax free if it would be a deductible
business expense if paid out of pocket.
In this problem, TP’s use of a car is clearly an employer benefit, but personal living
expenses are not deductible under §262.
This is a problem of mixed business/personal expense-§162 mixed standard; the test is all
or nothing; what is primary purpose?
Congress explicitly saw this situation when passing working condition fringe exclusions;
workers should be familiar with products for quality control; See Treas. Reg §1.132-5(n)
6 conditions for working condition fringe
1. Ordinary/necessary business expense of employer
2. Business reasons necessitate product be tested off of employer’s premises
3. ?
4. Make available no longer than necessary to test
5. Employer imposes limits on employee’s use
6. Employee must submit detailed reports on testing
Family use generally restricted; this is problematic; but a car is generally conducive to
family use.
On these facts, the expenses avoided test amount is very low (cheap 5 year old car)
FMV test: new lease value-this is what Congress prescribed

- Problem Set 3, Q7: Meals/cab fare provided by law firm are not deductible b/c of
  personal consumption, but possibly a de minimis fringe, based upon frequency of use and
  benefit being afforded to all people in the company
  This may be accounted for by company on W-2 form-not tax-deductible.

- Problem Set 3, Q8: Qualified Employee Discount (QED)-course of dealing requirements
  8a: Clerks w/ 4+ years get 20% discount; only 15% is tax free b/c of gross profit
  percentage limitation in §132
  Does president’s discount (10 yrs service, 50% discount) fit under non-discrimination
  rule? (1) Substantially same terms; (2) Belonging to a group w/ reasonable class
  distinction that does not discriminate in favor of highly compensated employees (HCE).
  §132(j) only applies to §132(a)(1) and §132(a)(2) – special rules; looking behind terms,
  §132 is facially neutral but what if HCE is the only one w/ long enough tenure to receive
  a discount.
§414(q) defines HCE: (1) substantial ownership of employer; (2) receive more than $80,000 total compensation
Non-discrimination rules have: (1) Formal/org component; (2) Operational (procedural) component.
Applied on specific facts, if §132(j)(1) is violated, the entire president’s discount is taxable; special conditions for any exclusions id HCE motive is irrelevant.
8b: 4+ years requirement-only president and one clerk are eligible; president and clerk receive substantially the same conditions in regards to the amount of benefit received, but this is still discriminatory in terms of overall coverage/eligibility; ratio of the % of non-HCE’s receiving benefit to the % of HCE’s receiving benefit must be at least .70 (standard normally used by Congress); in this case the ratio of 1 of 4 non-HCE’s to 1 of 1 HCE’s is only .25, so the discount is not tax free in this case
Without non-discrimination rule, there would be:
1. Disparity in who gets discount
2. Disparity in amount of discount
3. Unfairness to taxpayers (perception)
IRS depends on perception of fairness to ensure greater compliance (CB p. 67)
If president is sole owner of a corporation, §132 applies; may not apply to sole proprietorships or partnerships; also depends on process of inventory procurement when considering pres/owner’s benefit

- Problem Set 4, Q1a: TP2 invests $200K in corporate bonds @ 10% interest, earns $20K interest/yr, taxable at 30%, leaving $14K after tax to rent a home; rent expenditures are not deductible
TP1 buys house with $20K annual rental value, foregoing $20K/yr in rent by living there herself; if TP1 rented house out for $20K/yr, the rental income is taxable under §61(a)(5); by moving there herself, TP gains benefit worth $20K/yr that is not within definition of gross income under §61(a)
Message to taxpayers: BUY HOUSES b/c there is a major preference for owner occupied housing in regards to tax treatment.
Tax free status of imputed income for owner-occupied housing violates fairness issues; economists believe this leads to over-investment in housing as opposed to productive industries.
- §132(n)–“Sec’y shall prescribe regulations” this means the legislature delegates lawmaking authority to the secretary of the treasury
- A partner in a partnership is treated as an employee for tax free discounts; retraction: sole proprietors – owner of unincorporated business; not an employee under §132; employees of sole proprietorships can get tax free discounts, but not owners

Imputed Income
- Set 4, #1: Owner occupied housing; high level of investment in U.S. partially b/c of tax free status, tax free status also a partial contributor to suburban sprawl
  1. If imputed rental income was taxable, it would require owners to estimate-difficult to assume
  2. If rent payments were deductible, income problem for government would result; people would rent more, buy less, resulting in lower investment in owner occupied
housing; even more American wealth is invested in both kinds of housing b.c of tax preferred status

2 bad alternatives to current situation (1) administrative problems; (2) unacceptable

- Set 4, #2: Not worth it for TP to take $30K/yr job @ 50% tax bracket if $18K/yr in home and childcare services is not deductible under §262(a)

Result of this disparity: Market tells them they are more valuable at work than at home, but after taxes, it is not worth it, resulting in HORRENDOUS MISALLOCATION of labor/capital resources

In this case, a job must pay twice the value of home services to justify accepting it

How to remedy:

1. Child care credit, much better solution
2. Tax the imputed value of home production-“damn near impossible”

If home/childcare services are deductible, it makes sense for TP to take any job that pays $18K/yr or more; no tax on income to the extent it is replacing homemaker’s services

Congress acknowledges this concern, but there are privacy issues

Earned Income Tax Credit (EITC) benefits low income people, but not spouses in high income tax brackets.

- Set 4, #3: Payment for services with other services (bartering) is taxable, §1.61-1(d)(1); if neighbors make arrangement to cut each others lawns on alternative weeks and the cost to pay for weekly lawn mowing is $1000/yr, the tax consequences of the barter arrangement are $500/yr in additional income for each neighbor; self-performance of services and performance of services by another member of the same household is tax free, that’s why the arrangement is $500 add’l income per person and not $1000. Any exchange arranges outside of the household is taxable gross income; barter exchanges are traditionally sources of noncompliance; most incentive was based on assumption of being tax free; IRS has not shut them down b/c of general misunderstanding; Is there a de minimis limit?

Carpools are a swap of services, but the IRS excluded carpools from barter tax 30 years ago as a matter of prosecutorial discretion and also b/c of environmental benefits; barter of services also helps increase free time; the IRS only enforces when there is significant abuse b/c it doesn’t want to be silly; it’s a law of principle but not heavily enforced b/c of potential taxpayer backlash; more official barter exchanges are taxed; IRS requires barter exchanges to report their membership; doctor’s professional courtesy situation not really a barter

Compensatory Receipts

- Edward Clark, CB p. 78, 40 B.T.A. 333 (1939)

Tax advisor admitted to making an error, paid $20K (presumably settlement of malpractice); error was about deduction of capital losses §1211(b); §1211(b) limits deductions from capital losses only against capital gains and only up to $3,000 ($1,500 for married individuals filing separate returns); the married/separate returns parenthetical was not in there in the 1930’s; tax adviser admitted to error and compensated taxpayer;

Issue of whether taxpayer should be tax on settlement:

IRS: 3rd party tax payment is taxable

Clark: Compensation for a loss is not income
Rule Derived From Clark: 3rd Party payment of TP’s liability is income (Old Colony) unless 3rd party caused the liability (Clark)
Why not file amended return to fix mistake? §6013(b) gives SOL of 3 years
If Clark prepared his own return and made the same mistake, same tax liability incurred, Clark & client get reimbursed, self-prepared return; if filing joint return, cannot switch to individual; violation of vertical equity
When Clark settles. No add’l taxes; if someone prepares their own return, they get a loss deduction, creates vertical equity.
What if all fed income tax payments were deductible and all refunds were income? Isn’t this the right treatment on principle? Deductions are supposed to account for perceived $$ that is not income; refunds of state and local taxes are income; why not treat federal the same way, when it would eliminate inequity? B/c “doing the right thing” makes no difference; it only makes a difference in the event of mistakes
§165(c)(3) allows theft loss deduction; why not do the same thing w/ taxes? B/c taxes are indirectly consumed by society thru gov’t expenditures; but then why allow deduction for state/local tax? B/c municipal/local taxes are collectivized consumption; schools, fire, police, street repairs are more direct civilian consumption than fed income tax paying for war in Afghanistan.

• Raytheon 144 F.2d 110 (1st cir), cert denied 323 U.S. 779 (1944) CB p.81: Single most important authority on tax treatment of damages; RCA had claim against Raytheon for unpaid royalties; Raytheon stopped paying royalties as leverage for its claim against RCA; $410K settlement, $60K was related to value of patents; parties agreed to stop paying each other in both directions; why was Raytheon liable for tax on $350K it never received? B/c an obligation was lifted
CB p.82: remaining $350K was “realization from a chose in action” (right to sue); therefore it’s not taxable under Clark rule; top of p.83: all damages recovered are not necessarily non-taxable; if damages are for lost profits, damages are taxable.
Raytheon argument: but for RCA’s conduct, sales would have continued; but had sales profit occurred, Raytheon would incur tax liability.
This is like Old Colony; no difference between 1 or 2 steps in earning or paying of taxable income.
Good will is an intangible asset of most businesses; having an established set of customers is a psychological advantage, even if product & services are identical
In this case, Raytheon had a lock on market for the radio tubes; after RCA came on the scene, Raytheon lost its market to RCA
Goodwill (customer lists, trademarks, trade name, location) is typically transferable only with sale of an entire business; goodwill is often the single largest asset in the transfer of a service business;
What if Raytheon had voluntarily sold out of the Radio tube business? How would this be treated for tax purposes? How would the sale of a tube be treated for taxes? Profit (sale price minus cost) is taxable; income is viewed as gain only under §1001(a)
On the sale of property, gain or loss is computed; amount realized minus adjusted basis (§1012 = cost; §1016) of property sold is definition of gain/loss
However, RCA did not buy from Raytheon, but it stole business; principle of “you break you buy”

If RCA is guilty of anti-trust, they’re forced to buy the business (involuntarily); proceeds of any business sale should be taxed the same, even if involuntary.

Amount realized on good will = $350K minus adjusted basis of property sold = ? = gain/(loss)

Despite realizing that Raytheon is only liable for the gain, IRS still taxes on full $350K because it believes all $350 is gain and there was no cost to the business (the business was not bought; it was started from scratch and all startup costs would have been deductible business expenses)

**Taxpayer has burden of proof to show costs** under §7491; Raytheon was not able to show evidence of any basis; historically, the burden of proof was on the taxpayer in all civil controversies except for fraud; recently modified by §7491, shifts burden to IRS, provided initial burden of production is still on taxpayer; then persuasion burden goes to IRS.

Damages for lost profit = income

Damage for destruction of goodwill is treated like proceeds of a voluntary sale; under §61(a)(3), gross income includes “gains derived from dealings in property”

Purchased goodwill versus self-constructed goodwill? Difference between lost profits and compensation for goodwill? Why would Raytheon be unable to prove cost of good will?

B/c it was not bought, but created from scratch

- §1001(a)
  - Amount realized §1001(b) = sale proceeds
  - Adjusted basis §1011 = basis +/- adjustments
  - Gain/(loss) under §1012

- Raytheon is taxed on all $350K b/c all of it is either income or self-constructed goodwill; but the cost of self-constructed goodwill is deductible; lost income = ordinary income; destruction of goodwill = capital gain

Raytheon could argue it is unfair to tax on destruction of goodwill profits b/c but for RCA’s conduct, Raytheon would not have had an “involuntary sale”

W/o jury award (b/c it’s a settlement), where did they look?

1. Antitrust allegations
2. There was a prolonged process before reaching settlement; RCA contested and counterclaimed for non-payment of royalties, needed fact finding; finally RCA settled before decision of special master came down
3. How to draw conclusions based on conflicting allegations? Business could not resume by being simply compensated; this business was permanently injured; more of a conversion than a tort

All profits are gone; on such facts that business was destroyed, court can say that the business was destroyed – not lost profits

Raytheon test: what is being replaced, per Old Colony principle that 2 economically equivalent transactions are to be taxed the same?

What happens if there was earlier settlement? Must look to best available factual evidence; there must have been a conflict of interest/basis for the settlement

**Costs of generating goodwill had already been generated in earlier years; basis for the goodwill was zero; education expenses are disallowed as personal but damages**
for loss of earning capacity are not taxed; deductibility of expenses may explain opposite result in Raytheon.

- Set 5, #1: Damages in lieu of salary are taxable
- Set 5, #2: $300,000 damages for recovery of landlord’s burnt down building represents destroyed property; value of building, “you break you buy”
- Tenant being forced to buy is an involuntary sale that is treated like sale of property for tax purposes; the amount of gain/(loss) is taxable/(deductible); because landlord paid $200K for building, $100K gain is taxable
- Set 5, #3: In Clark, what was compensation for overpayment of taxes replacing? About $20K of additional $32 that was paid; damages are replacing after-tax dollars, so these damages are tax free
- Set 5, #4: Compensation for breach of promise to marry? Why would court award damages here? For emotional harm/suffering/loss of consortium (FMV of sex, help around the house), it is tax-free imputed income. What about lost wedding expenses if stood up at the altar? This is replacement of after-tax dollars, so also tax free, just like Clark.
- Set 5, #5a: Car wreck medical expenses? Not taxable, b/c this is after-tax dollar replacement
- Set 5, #5b: Damages for pain and suffering are imputed tax-free income
- Set 5, #5c: Damages for lost wages are taxable, §61(a)(1) compensation for services
- Set 5, #5d: Damages for lost earning capacity (future wages): taxable, no difference if received as a lump sum for lost future earnings, same as wages received in normal course of dealing
- Set 5, #5e: Punitive damages: not substantively replacing rights of plaintiff; Raytheon does not apply; windfalls are taxable under Glenshaw Glass.
- Glenshaw question: What is tax treatment of a windfall? Always taxed as enrichment; when Congress enacted §61, was it trying to be circular? No Congress intended to use the full measure of its taxing power; unallocated awards are problematic for tax purposes
- Set 5, #6: §104(a)(2): Gross Income does not include amount of damages (other than punitive) received (by suit or agreement, lump sum or periodic) on account of personal physical injuries or physical sickness; compensatory damages are tax free even though Congress acknowledges that some of them replace taxable wages; this eliminates confusion over unallocated compensatory damages.

Raytheon replacement rule or §104(a)(2) exclusion, which controls?

Why not tax unallocated damages?
1. Jury could sympathize for tax treatment
2. Automatic mistrial to speak to jury about tax treatment of damages
3. Attorneys frame their arguments differently
4. Federalism: state/federal relations should not be constricted for tax purposes; bad politics; deters Congress from applying federal income tax laws to state tort laws; to try the same case twice in federal tax court is horribly inefficient; §104(a)(2) allows certain incomes to go tax free for lack of easy solution; Congress is unwilling to impose on states or retry in federal court system

Why not tax the whole thing? Fairness issue; would be double taxation on lost wages/out of pocket med expenses; also fairness issues from not taxing; also a product of lobbying
efforts of plaintiff’s lawyers; political unpopularity would result from imposing the taxes on tort victims; muckraking journalism was feared.

Difference between lump sum and annuity (for lost wages)? Greater tax liability w/ lump sum, higher average rate of tax; income bunching of taxes as well as allocation problem.

§104(a)(2): personal physical injuries/sickness other than punitive damages; Congress gives a break but not to windfalls; this exception is only a few years old; special standards of review on appeal for punitive damages; this is nearly universal on the part of state tort laws; also only applies to injuries and sickness; does not apply to property or commercial damages; for general treatment of damages apply Raytheon; last sentences of §104(a) excludes emotional distress.

• Hypo: assume TP, a pedestrian, witnesses her 4 year old daughter being run over by a drunk driver; damages include: pain, suffering, medical expenses, lost wages, punitive, etc. Apply Raytheon or §104(a)? The damages are taxable b/c they are not physical, despite not being enrichment under Raytheon. What if TP develops physical manifestations of her emotional distress? Still not excludible b/c its emotional distress.

• *Burnet v. Sanford & Brooks*, 282 U.S. 359 (1931), CB p.89: TP had huge cost overruns in trying to perform the construction contract; “net operating losses”-more expenditures than fees received from the corps of engineers; loss = $175,000, claim made against corps of engineers, won claim in court b/c corps of engineers misrepresented difficulty of work/fees for work; breach of warranty claim; *issue of whether contractor’s jgmt is taxable*

Different meanings of Loss
1. Net operating loss – excess of cost over revenues
2. Loss on sale of property §1001(a)
3. Casualty loss-destruction of property (negative windfall) §165(c)(3)

In the end, contractor broke even after hemorrhaging money in earlier years; held taxable on $ to make them whole

Court of Appeals argued that if contractor does not deduct all expenses from those years, then it can get the settlement tax free; **problem: cannot shield deductible expensing from negative income in all of those years**

Who won? Court of Appeals was reversed

Statute mandates calculating taxable income on a year by year basis, not on a transactional basis, §441(a), year by year basis

Supreme Court holdings
1. Cannot leave tax consequences open for years and years
2. Benefit of income tax; fairness in distribution of income; any other revenue collection is less fair

Constitutional Arguments
1. Practical resource
2. Framers’ intent-civil war union states had income tax; tax policy is correct

Despite unfair consequences of multiple year transactions, other earlier income tax jurisdictions had annual accounting.

What really galls TP in Sanford?

1913-16: TP makes good faith effort to dredge river; fraud by corps of engineers; 1920: corps of engineers forced to pay for breach
All expenses in earlier years were deductible; get payment in 1920, taxing payment should be a wash b/c of earlier deductions, but there were no taxes saved in 1913-16 b/c no income was earned; b/c of annual accounting, TP is taking a net loss on the multi-year transaction; on top of that, from 1913-16, maximum income tax rate is 7%, but by 1920, the tax rate was 77%

Supreme Court: The decision to increase the burdens of administration by requiring prior tax returns to be revived or re-audited should be legislative, not a judicial initiative
Congress was responsive to this unfairness, enacted §172(b) which allowed deductions of net operating losses to carry forward 15 years and carry back 3 years; §172 overrides §441 for cases like Sanford & Brooks
Irony: §172 was already on the books; enacted in 1918, but not effective until 1920 and not retroactive to 1913-16
What was $175K payment in Sanford & Brooks? Breach of contract damages
What is normal tax treatment of damages? Taxable, per Raytheon.

- Dobson, 320 U.S. 489 (1943) CB p.94: Loss on sale of property
  1929: TP buys 300 shares of stock
  1930: TP sells 100 shares of stock @ $42K loss
  1931: TP sells 100 shares of stock @ $28K loss
  1936: TP sues issuer for securities fraud
  1939: TP receives $45K settlement

  Issue: What is the tax consequence of the settlement?
  Is this a refund of purchase price or loss of earnings damages? Under Raytheon, the partial refund of a purchase price is a refund of after tax income that is not taxable.
  Core of Dobson: judicial review of administrative decisions; what weight does court give to administrative decision-making?
  From tax standpoint, under Raytheon, refund of purchase price should be tax free as to 1/3 of stock still owned in 1939
  What about portion of settlement proceeds attributable to portion already sold? Still getting a refund of the purchase price.
  Losses in 1930-31 sales are deductible per §165(a) and (c)
  Why allow deduction for losses? B/c gains are taxable enrichment under §61(a)(3), so losses should be deductible disenrichment; the losses are deductible: (1) saves taxes in 1930-31; (2) refund from seller
  Deduction was allowed for dis-enrichment, now the re-enrichment should be taxed; proceeds of settlement prove he was not dis-enriched, yet he had taken a deduction so the settlement is taxable; inclusionary side of tax benefit rule-error correction; inclusion offsets erroneous deduction (error correction device)
  Even though under Raytheon, the settlement is tax-free, the intervening deduction makes settlement taxable; actual facts: 1930-31 deductions were not enrichment; by taking 1930 deduction, there was still no tax savings (harmless error); exclusionary side of tax benefit rule says: “don’t correct harmless error”; it is ludicrous to tax a settlement when taxes were not saved by earlier deduction; really the “no tax benefit” rule; earlier deductions being erroneous is irrelevant; §172(d)-special carry over provision is basically only
available for business deductions; therefore §441 applies (annual accounting); §212(b) now allows for corporate taxpayers to carry over capital losses
1930-31 losses were incurred for multiple reasons (fraud and stock market crash); causation problem: some, but not all dis-enrichment attributable to fraud (also an issue of bargaining power)

- §111 is Congress’s response to Dobson: codification of exclusion side of Dobson rule; §111(a), as interpreted, only applies to recoveries; always assumed that it applies to errors only
- §111 exclusionary tax benefit rule versus §172 Net operating loss deduction; on Sanford facts, §111 would not be triggered b/c there was no mistake; money comes back in the form of refund to payee; if deduction didn’t save money, invoke exclusion
- §172 allows excess deduction from past/future against past/future returns
- §111 is limited; §172 is more general-look to §172 first
What if company losing money overpays judgment to employee in lawsuit? What happens if overpayment is returned? Always apply §172-carry back or forward; §111 does not apply later on if $ comes back; if dealing with overpayment of bonus, §111 would apply to refund of overpaid bonus
TP in Sanford was screwed by horrendous change in tax rates; if tax rate change intervenes, taxpayer is not left whole b/c tax payments are not equalized when applying them to different years; if rates go down, the treasury is similarly hurt by erroneous underfiling;
Inclusionary Tax Benefit Rule versus Amended Return; filing amended returns for earlier year? Should not be allowed to go back unless there is any error; don’t file amended return; fix it when it comes back
***§441 is still the law; tax on annual year basis unless Congress makes an explicit exception under §172

Health Care Costs
- §106: equal tax treatment of employer directly paying health insurance premiums or employee paying premiums out of salary rec’d from employer; high salary employee paying premiums are entitled to same benefit as employer paying health insurance co.; tax exempt status of employer provided insurance coverage is $69 billion/yr; the only larger tax exemption is employer-provided retirement benefits
- §105(a) amounts received under tax-free coverage are includable in gross income if:
  1. attributable to contribution by employer not includible in gross income
  2. paid by employer
- §105(b) conditions §105(a) and still exempts proceeds that are applied to medical care costs from gross income
- §213(d) defines medical care costs
Employer provided group coverage:
  1. Premium is tax-free under §106
  2. Proceeds of medical care are tax free under §105(b)
§104(a)(3) grants exclusion for health insurance proceeds of self-insurance
Employee purchased Insurance
  1. Premiums are deductible under §213(d)(1)(D)
  2. Proceeds excludable under §104(a)(3)
§213(a) creates non-deductible floor of med costs of 7.5% of adjusted gross income. Why did Congress do this? Tax based incentive to get employer-provided health insurance; promotes good social policy of health care coverage by using tax code for non-tax purposed; Ted Kennedy is correct in saying we’ve had national health insurance since 1954 (it’s hidden in IRC) but this screws people in low-paying jobs who also tend to be uninsured (or unemployed); employer can shift costs to employees and still exclude. Third Possibility is to not purchase insurance or receive from employer, but just pay your own bills; this could be beneficial over paying for insurance b/c in event of huge bills in a given year, one is much more likely to exceed 7.5% of GI in a single year than by paying insurance premiums every year. Another possibility is to get tax-free coverage but tie it to a dollar amount, thereby creating disincentive of getting 2nd, 3rd, 4th opinions and overabusing coverage; continuing proposals to cap dollar value of employer coverage; this would give catastrophic coverage to more people rather than gold-plated coverage to fewer. Sick pay from employer is taxable income, so are sick pay premiums, but if sick pay premium is paid with taxable income, the proceeds are tax free; employers give employee the option of participating in employer-provided sick pay insurance or they can purchase themselves; it is better to let employer pay for disability insurance and then pay tax on proceeds in the unlikely event of needing this

- *Ochs*, 195 F.2d 692 (2d Cir), cert denied, 344 U.S. 827 (1952), CB p.112
  Mother recovering from throat cancer compelled to send kids to boarding school to aid recovery & minimize vocal strain
  Note breadth of §213(d) definition of medical care; problem of §213 versus §262
  How to handle dual-purpose expenditures?
  Possibilities suggested:
  1. Direct versus Indirect test: Is boarding school a cure for cancer? *Old Colony* applies
  2. Doctor’s orders; *Ochs* dissent—this rule could be subject to abuse
  3. But/For causation: taxpayer’s purpose; *Ochs* dissent: never would spend w/o health problem
  4. Custom or convention: *Ochs* majority
  5. Sort out relative benefits/effects: divide out portions related to medical care versus consumption; costs of boarding versus education that only benefits kids.
  §213(d)(1)(A) mitigation of disease (children @ boarding school) versus §262 (no deductions allowed for personal/family expenses)
  How to sort out deductions? *Ochs* is an endemic problem of single expenditures creating multiple benefits; §213(d)(1)(C), qualified long term expenses defined in §7702(B) requires doctors orders.

III. Timing of Income

Annuities
- Annuity problem: fixed number of installments, $1000/yr for 5 years; TP pays $3,790 in premiums, gain = $1,210; not an issue of how much is gain, but question of when to tax gain; timing is the issue; problem of how to allocate receipts btw income and return of capital;
- Why not tax annuity payments until the full investment is returned? ROC First Method
• Why not tax the income first, since ROC is guaranteed? **ROC Last Method**; this treats annuity premium payment like a purchase of stock; TP does not get capital (tax-free) investment back until stock is sold;

• Why not use ratio of premiums paid to total annuity premiums = 3790:5000 = 75% to determine tax free amounts in annuity payments? This is the Pro-Rata ROC method

• Why not treat annuity premiums/payments like TP giving loan to a company and receiving repayment in installments? This is a mortgage amortization; assume $3,790 loan @10% borrowing rate
  - Year 1: Payment = $1000; 10% of payment = $379 interest; therefore principal payment = $621 tax free
  - Year 2: Remaining principal = $3790 - $621 = $3169 * 10% = $317 interest
  - Therefore, $683 tax-free return of capital

This is the **Back Loaded ROC/Mortgage Amortization Method**

• What about **Front Loaded ROC Method**? This assumes loaning @ 10% interest rate each year, but breaking it into 5 separate loans w/ $1000 due in each of the next 5 years; this is the purchase of 5 separate endowment contracts from an insurance company

• **Congress uses all 5 methods for tax treatment of return of capital** ROC Last is not a practical alternative for an annuity b/c we don’t know when “last” will be; most others are plausible candidates; Congress chose Pro-Rata ROC method §72
  §72(b)(1): Exclusion ratio = investment in capital/expected return; this proportion of each payment is excluded tax-free
  §72(c)(1): Investment in annuity contract is aggregate amount of premiums minus amount received before annuity starting date
  §72(c)(4): annuity starting date is 1st day of 1st payment year
  §72(c)(3): Expected return; if dependent on life expectancy, use actuarial tables prescribed in Reg §1.72-9; expected return = annuity payment*life expectancy in years

• Set 6, #1: TP, age 70, pays $50K for immediate straight life annuity of $5K/year; how much of each annuity payment is subject to tax?
  - Expected return = (16.0 years (multiple on Reg §1.72-9))($5K/yr) = $80K
  - Exclusion ratio = $50K investment/$80K expected return = 62.5% in year 1, so $3125 is excludable.

  This is limited by §72(b)(2): Amount received as excludable annuity shall not exceed total investment

• Set 6, #2: TP buys straight life annuity of $5K/year at age 45 to commence at age 70 and pays in installments of $900/yr until the annuity starting date. How much of each annuity payment is subject to tax?
  - ($900/yr*25 yrs)/($5K/yr*16.0 year multiple on Reg §1.72-9) = $22.5K/$80K = 28.125%, so $1,406.25 is excludable

In problem 2, TP has more use of more $ for a longer amount of time; more is true income and less can be excluded

What if $900/yr was placed in a savings account? A person is taxed on interest, interest on interest, etc., even if it is not withdrawn, but if a person deposits into an annuity, they get a tax break on the annual interest, not only while the $$ is in the account accumulating, but also after it is withdrawn.

In both problems, once entire tax-paid investment is recovered tax-free, all future annuity payments are taxable income; if one dies before full recovery, a deduction is recoverable
Notes on annuities

1. Actuarial Table in Reg §1.72-9 was changed in 1986; Table I was gender specific, Table V was unisex and implemented in 1986; women would prefer using unisex table, men would prefer gender specific, denominator is at issue; litigation over whether government can use gender specific table; treasury eventually decided on unisex table despite fact that men live shorter lives than women on average; the move from Table I to Table V accounts for life expectancies going up.

2. §72(b)(2) was new in 1986: before 1986, the same exclusion applied every year but there were no deductions for early deaths; the 1986 change better reflects enrichment; Who buys annuity contracts in general? A person may need tax-free benefits once they’re old and sick and the benefits are exhausted. Why did Congress formerly keep the same exclusion ratio? Reliance interest of elderly in terms of financial planning. Why have a change? When baby boomers begin to receive annuities, Congress could change back to pre-1986 annuity rule.

3. Accumulation period tax deferral: economic neutrality
Who is biggest advocate of tax treatment of annuities? Insurance companies b/c they are entitled to a tax benefit that banks and stocks do not have.

4. Pre-start date withdrawals
CB p. 124: TP pays $100K for deferred annuity to begin on 95th birthday, cash surrender = $99K and it goes up $7K per year; at end of each year, TP takes out $7K; §72(b)(1): Gross income exclusion ratio applies to amount received as an annuity but does not apply here b/c $7K/yr is not received as an annuity; §72(e) applies to amount received not as an annuity; ROC first is tax treatment of non-annuities prior to 1982; TP in this case probably intends to die before age 95
Investment in contract = aggregate premiums minus any amount received tax free
How was this pre-1982 abuse treated? By switching to ROC last method, under §72(e)(3)(A); old treatment (grandfather clause) under §72(e)(5)(A)

- History of Annuity tax treatment:
  Prior to 1934: Not taxed until annuitant had rec’d an aggregate amt equal to his entire investment in the contract, ROC First method
  1934-1956: Under “3% rule,” 3% of the cost of annuity included in income each year; the remainder was regarded as return of capital until cost was recovered; problem w/ this rule b/c it overstated the income component;
  Hypo: TP, age 45 pays $100K to receive $5K/yr for life, has life expectancy of 28 more years; under 3% rule, $3K/yr included in income, $2K yr excluded as ROC until $100K recovered; this would require TP to live another 50 years to recover his total investment tax-free
  1954-1986: §72, imputes the contractual rate of interest to annuitant instead of fixing a statutory rate; cost recovery factor determined by dividing investment in contract by expected lifetime payments and using this as an exclusion ratio; there was unfairness here b/c people outliving their life expectancy continued to exclude a portion of annual payments even though cost was already recovered; likewise, people who died early were denied a deductible loss
§72 amended, §72(b) allows annuitant that dies prematurely to deduct unrecovered cost from final tax return and requires annuitants who outlive their expectancy to include the entire amount rec’d in subsequent years.

**Life Insurance**

1. Pure Insurance Component (Term Insurance)-protection from early death
2. Savings/Investment Component (Whole Life Insurance)-option to stop paying premium and cash in face value upon maturity

An Insurance Contract purchases term and whole life; when a policy matures and the face amount is paid, where does the money come from?

Premiums pay for:
1. Term Insurance @ given ages
2. Deposit in savings account (higher amount); savings account deposits plus interest earned thereon

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![Investment Account Balance](image1)

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![Decreasing Term Insurance](image2)

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0 yrs 20 yrs

Savings account balance increases as value of pure term insurance decreases

Hypo: TP purchases $100K insurance policy @ age 45, premium = $3,500/yr (whole life) stays constant w/ age

Yr1: $500 goes to 1 yr term insurance for $100K/$3K investment deposit
Yr2: $500 goes to 1 yr term insurance for $97K/$3K investment deposit
Yr3: $500 goes to 1 yr term insurance for $94K/$3K investment deposit

After 20 years, no more premium and willing to pay out b/c the $100K is already in the account.

**Distinguishing true insurance from savings component**

**Term Insurance (wage substitute)**

Premiums: Deductible, §162(a)
Proceeds: Taxable, replaces lost wages/salary, $100K

**Lost Homemaker Services**

Premiums: non-deductible, §265
Proceeds: Tax-free

People my buy insurance as a substitute for making a bequest

**Bequest**

Proceeds: Compare §102(a), §1014 death time transfers are not treated as income; Congress declined to include despite being a windfall

Premiums in this case are not deductible

How to sort out? Look at motivations for purchase of policy at given amount

Very common to combine wages, imputed household income and bequests for purposes of life insurance; difficult or impossible to administer/sort out motivations

How to keep simpler? Don’t sort it out, make it all or nothing.

Majority of life insurance ‘s purpose is to replace wages;
Fair result: tax the proceeds, make the premiums deductible
Actual tax policy: Exclude from gross income if paid by reason of death of insured, but premiums are not deductible.

Set 6, #2: $100K life insurance, $60K of premiums deposited for 20 yrs, $3K/yr
When check is received, $60K should be tax-free ROC, $40K should be accumulated interest; problem w/ tax deferral: life insurance salesmen have advantage of selling tax deferred policy—violation of equity/neutrality principle compared to C.O.D., stocks, bonds, etc.; TP’s response: invest in insurance accounts; massive misallocation of resources into life insurance policies.

What if insured dies the day before maturity under §101(a)? Zero tax.

How much is really insurance? $0.37 (one day of term insurance)
If insured dies after maturity, only interest amounts are taxed; if payment is not b/c of death of insured, look at §72(e)

§72(e)(5)(A): exclude ROC, tax interest income
§72(e)(6): definition of investment = amount of premiums minus aggregate amount received under the contract

By virtue of statute, term insurance and whole insurance premiums are returned tax free; 20 yrs * $3500 = $70K, not $60K ROC; life insurance is still very tax preferred over other investments

§72(e) generally applies whenever death is not the cause of life insurance payout; if life insurance policy is survived, insured has lump sum or annuity option
§101 governs payments b/c of death of insured, §72 governs the rest

What about sale of life insurance contract as opposed to cash surrender?
Seller: §1001(a), adjusted basis, pay tax on gain
Buyer: §101(a)(2), limits exclusion

§101(g)(1)(A): terminally/chronically ill individual’s payout treated as death of insured, triggers §101(a)(1); §101(g) is Congress’ approach to the AIDS crisis, treats terminally ill sale of life insurance like a death benefit; §101(g)(2): proceeds of sale also tax free

§101(d) applies to annuity payments of death benefits, taxes interest but not ROC on each payment

**Realization and Recognition**

  4 options in disposition of corporate profits
  1. Retain/invest in business
  2. Retain/invest in business/issue stock dividend
  3. Issue optional stock or cash dividend
  4. Distribute to shareholders as cash dividend

Question of how to show corporate profits: Standard Oil decided to issue stock dividends
Brandeis Analogy: 2 and 3 are too similar; stock taken as additional compensation is often discounted; functional equivalence between 2 and 3
Macomber’s argument: 2 should not be taxed but 3 can be taxed

Pitney’s response

TP (Mrs. Macomber) was a stockholder of Standard Oil; received involuntary stock dividend

Pitney syllogism (major premise): Income = “gain derived from capital” CB p.210
(minor premise): Shareholder derives nothing from corporation via stock dividend. CB p. 212-13
Reasons that a shareholder derives nothing from the corporation on receipt of a stock dividend is b/c it’s a purely formal transaction w/o any difference in substance b/c corporation has still kept the cash profits; w/o deriving from corporation, no income is received, therefore, stock dividend is not income
Is there gain or enrichment from dividend payout? Mrs. Macomber argues that tax of stock dividend is unconstitutional b/c despite being defined as income, it is not income under the 16th Amendment
Pitney response to Brandeis: when corporation announces stock dividend/split, the value of each share drops, market adjusts immediately; all that is going on is a paper change in Macomber’s ownership of Standard Oil, no change in % of Macomber’s ownership; no shareholder has any change of wealth; as a matter of substance over form, no difference between 1 and 2; cannot let Congress draw the line between 1 and 2, p.207
Brandeis’s response to Pitney: Because similarity between 1 and 2 is so strong, Congress should not draw the line between 1 and 2, but Congress should be able to tax 1 if it chooses to; but when differences are so slight, as a matter of constitutional law, defer to Congress to define income.
Brandeis: Could Congress tax #1 (undistributed) corporate profits? If so, leave it to Congress to draw the line
Sticking point between majority and dissent: Despite agreeing that difference between 1 and 2 is minute, Brandeis believes Congress can tax 1, so 2 can be taxed
BUT, Pitney believes Congress cannot tax 1, so 2 cannot be taxed either
Partnership versus corporation: Pitney believes there is a fundamental difference in substance between these 2 organizations
p.211: short of liquidation, stockholders have no rights to withdraw, only to persist
p.214: stockholders have no right to partition the corporate assets; corporation deserves different treatment than its shareholders
Corporations have no obligation to return shareholders’ investments (shareholder can sell a stock share to another person who effectively returns the investment, but not returned by the corporation); conversely, a partner at a law firm has the right to get out (dissolution on demand); selling a stock is not getting your own money out of a corporation; it is getting someone else’s $ who chooses to invest (crux of Pitney’s argument)
This case is about “derive” clause in 16th amendment

LEXIS Summary of Macomber
Dividends paid in the form of additional shares of stock were found to not be income; Defendant United States treated those shares as income, and plaintiff paid a tax under protest on the same. Plaintiff brought an action against defendant to recover the tax contending that in imposing such a tax, the Revenue Act of September 8, 1916, ch. 463, 39 Stat. 756, et seq. (the Act), violated U.S. Const. art. I, § 9, cl. 4, and art. I, § 2, cl. 3, which required direct taxes to be apportioned according to population. The district court held in favor of plaintiff and defendant sought the court's review. The court held that by treating the dividends as income, defendant failed to appraise correctly the force of the term "income" as used in U.S. Const. amend. XVI, as the mere issue of a stock dividend
made plaintiff no richer than before. Therefore, under neither amend. XVI or any other authority did Congress have the power to tax without apportionment a stock dividend made lawfully and in good faith, as income of the stockholder, and the Act failed as a contravention of U.S. Const. art. I.

Brandeis Dissent (6 reasons)
1. Common understanding of income included returns rec’d by stockholders from gains/earnings of a corporation.
2. Segregation of assets in a physical sense is not an essential of income; a year’s gains of a partner are taxable as income although no segregation of his share of gains from that of the partners is obtained
3. No reason that Congress in levying a comprehensive income tax should be limited by the particular view of the relation of the stockholder to the corporation and its property
4. The equivalency of all dividends representing profits (in either cash or stock) is so complete that the taxability of stock dividends would never be questioned if Congress only tried to tax profits earned during the year in which the dividend was paid.
5. To not tax dividends is an “exceedingly narrow construction” of the 16th amendment is in sharp contrast to Supreme Court’s previously liberal construction of the amendment.
6. Making dividends tax exempt will allow large corporate shareholders to escape taxation on a large part of what is actually their income.

- Implications of Macomber
1. Tax deferral or tax forgiveness?
   Macomber held 2200 shares and received 1100 shares of stock as tax free dividend
   What happens when Macomber sells? Taxed on capital gains, §1001(a) (proceeds - cost)
   If Macomber is not taxed now, she will be taxed later; an issue of timing not forgiveness
2. Unrealized appreciation from increases in property value? Not taxable CB 214-15
   Congress lacks the power to tax this increase; Macomber has broader implications than stock dividends; CB p.210: “mere growth in value is not taxable”
3. Business Income Taxation
   a. Classical Corporate Income Tax system (treats corporation and shareholder as separate entities): §11 taxed profits to corporation as earned income; corporation later distributes the already taxed profits to shareholders, who are taxed under §61(a)(7); this is a double tax on distribution of corporate earnings; corporation gets no deduction for dividends paid
   b. Pass through business taxation-General or Limited Partnerships and LLC’s
      §701: Partnerships not subject to income tax
      §702: Partnership’s profits are computed, but taxed directly to taxpayer
      §731(a)(1): distribution of profits to partners are tax-free if already taxed to partners @ time of earning

- 2 Completely different approaches to business taxation in Macomber decision; the double taxation on corporations creates a disincentive to distribute earnings as dividends; however, corporations are legal fictions as opposed to human beings and they cannot consume anything, so the profits can be taxed to owners as is done in a partnership U.S. is one of the few holdouts using a classical tax system; most countries are concerned with double tax on corporate earnings and misallocation of resources/investments

Western Europe has moved to integration of the corporate and individual tax systems
Corporations pay double tax on profits under §11 then §61 (dividends), but corporations also have deductible expenses (salary, rent, interest)

• How do small businesses avoid double taxation?
  1. Own all stock
  2. Pay salary to stockholders (deduct)
  3. Own real estate and pay rent on their own real estate (deduct)
  4. Never pay dividends (related to owning all stock)
  5. Take out loans and pay interest on loans (deductible)

Massive problem of misallocation results from realization requirement of Macomber

• Tax Policy Considerations of Macomber
  1. Enrichment actually occurs from a stock dividend (could borrow against the enriched market value, but must take risk that increased market value may disappear)
  2. Difficulty of appraising value of all investments at the end of each year. TPs and IRS would always have different assessments; would always be an issue of fact; courts would overflow; small non-publicly traded assets are hard to assess value for
  3. Federalism Problem (states’ rats)
  4. Liquidity problem posed by paying cash taxes on real property; tax obligation no longer tied to the sale; forced sales to pay tax could distort behavior; politically unfeasible even if theoretically feasible

• Arguments against realization requirement
  1. For stocks/bonds (most important asset in U.S.) their value is easily calculated (publicly traded stocks); for small businesses, cannot assess the value of assets like publicly traded stocks, but profits and retained earnings can be measured
  2. For real estate (next most important asset in U.S.), almost every state has a property tax system based on value not cost; traditionally out of whack with real market values, but it’s getting better
  3. Hypo: TPA has $100 in A corp stock, $10/share profit
     TPB has $100 in B corp stock, $10/share profit

A corp distributes dividends §61(a)(7); B corp reinvests earnings

Despite same economic position (TPA has 100 stock + 10 dividend; TPB has 110 stock), TPA and TPB have different tax treatment

Fairness concern: encourages investment in companies that don’t pay dividends; investing in dividend paying stocks accelerates taxation; investing in non-paying stocks defers taxation; in reality, the people who can afford to invest in non-paying stocks are wealthy, not dependent on annual dividends

This horizontal inequity is not horizontal, but actually a vertical inequity

Wealthy get a tax deferral, non-wealthy do not; this “matter of practicality” is actually an inequity (Brandeis, p.228)

When dividends are distributed, the value of a share goes down by the amount of the dividend; no additional enrichment from receiving dividends

Mistake in Pitney Opinion: concern about forced sale of capital to pay taxes is a legitimate policy concern but not a constitutional violation of the definition of income

Issue of substance over form of receipt

Congressional responses to Macomber
  1. Realization in general, §61(a)(3), gains derived from dealings in property
  2. §1001 defines gain from “sale or other disposition”
3. §305(a): excludes stock dividends from definition of gross income (codification of Macomber), but only if change is strictly in form w/o substance; §305(b) provides a “buttload” of exceptions; not an exclusion if receipt of stock dividends is elective; only if stock dividends are involuntary are they excluded; §305(b) disallows exclusion of stock dividends if change is one of substance or an alteration of proportionate ownership of shareholders

- Chirelstein: Pitney was right when he said that stock dividends add nothing to shareholders’ interests, but neither do cash dividends; therefore the question in Macomber is not whether the shareholder had an economic gain but whether stock dividends are a taxable event in legal/accounting terms; however, the aim of the tax law is to impose a tax on “dividends” when assets representing corporate earnings are transferred to the shareholders-stock dividends merely give add’l pieces of paper to represent the same equitable interest.

- Helvering v. Bruun, 309 U.S. 461 (1940), CB p.244
  1913: Landlord/Tenant sign 99-year lease
  1929: Tenant tears down old building and constructs new building of $50K greater value
  1933: Tenant defaults on lease, landlord repossesses
  IRS: Tax in 1933; enrichment
  TP position: p. 246, relies on Macomber; no new capital is available that is severable from the old investment, should not be taxed; nothing with separate use is available
  Supreme Court: Tax the landlord in 1933
  p.246: “We hold petitioner was right in assessing the gain as realized in 1933”
  Land could be sold or rented at higher value than before; tenant gets benefit of new bldg in 1931 when building is erected (despite landlord owning); when lease terminates in 1933, landlord can realize gain; p.247 “other profit realized from computation of a transaction”
  IRS argument to the court: gain has been severed from risk of lease transaction while in tenant’s possession, it could still be subject to risk of loss due to tenant’s actions; now in 1933, tenant is gone, value is increased, landlord can realize gain
  Per Macomber, a cash dividend is taxable b/c it is spendable and separate from underlying stock investments; Macomber is not repudiated in Bruun, only reinterpreted

Different alternatives were tried by courts
1. Post paid rent option: Landlord has income on termination of lease in amount = to FMV of building (1917 treasury position)
2. Prepaid rent: landlord has income in year building completed in amount = to predicted FMV of building on lease termination discounted to present value (Miller v. Gearin codified)
3. Pro-Rata rent: Landlord has income each year from time building is complete until end of lease term, in an amount = to FMV on lease termination divided by # of years the lease had to run (IRS position in Blatt)
4. No rent: Landlord has no income at any time during the lease transaction (2d Cir in Hewitt Realty)

§61(a)(5): rent is gross income, but taxable income = gross income minus deductions; deductions typically equal the cost of producing income; when property wears out, cost of producing rent decreases in value
Supreme Court: Tax the landlord on 1933 value ($50K);
rent = gross income; depreciation = adj. basis in property/period of use = $50K/50 years;
pro-rata straight line depreciation, pro-rata ROC
If not taxed in 1933, what happens to basis? **The point of basis is to keep track of what TP has been taxed on:** if basis has not gone up, TP would not get depreciation on building, so $50K increase is taxable; either the building sold and gain on sale is taxed or future rent income is not entitled to depreciation deduction.
Also, a deferral if LL occupies the building himself; no deduction allowed for rent payments and no depreciation allowed if not included in income.
This was the most inconvenient possible time for TP in *Bruun* to pay taxes on the property: (1) just lost a rent paying tenant; (2) wouldn’t be able to find a buyer in 1933 b/c of the great depression
§109 (Congress response to *Bruun*): GI does not include income (other than rent) by a lessor on termination of lease representing value of such property attributable to buildings erected or improvements made by lessee; **statutory exclusion for realized gain**
Congress responded to political reality of a very inconvenient time in history; Congress could allow IRS to repossess everything that incurred tax liability but couldn’t be sold; this was just not feasible politically
§1019: If not taxed on termination, no basis increase; this is deferral, not relief; if no increase in adjusted basis, no future depreciation, deductions or no basis offset on sale; What if building erected by tenant 15 years into 99-year lease is only supposed to last for 15 years? The income to the landlord in *Bruun* was a windfall.
§109 exception: tenant improves as part of lease payment; Congress unclear of scope and timing; IRS applies exception as soon as buildings are placed on the land
• Problem Set 7, #1a: TP1 swaps piece of land $60K cost/$70K FMV with TP2 for piece of land $30K cost/$70K FMV
  §1001(a): Amount realized-adjusted basis (of property disposed of) = gain
  Amount realized = $ received + FMV of property = $0 + $70K = $70K
  Adjusted basis = cost under §1012 = $60K
  Realized gain = $70K - $60K = $10K
  Congress can tax this gain under *Bruun* if it wants but it doesn’t have to
• Problem Set 7, #1b: §1031(a)(1) has 5 requirements:
  1. exchange of property
  2. used for business/investment
  3. solely
  4. like kind
  5. property received must be used for business/investment; non-recognition of gain/loss
  Congress turns a blind eye to realized gains that satisfy conditions of §1031(a)(1); it looks like TP1 has satisfied all 5 conditions, assuming that exchange of 2 parcels of unimproved land are a “like kind exchange” (by common usage);
  §1031 defines what is “like kind exchange”
  Treas. Reg. §1-1031.1 includes exchange of real estate in like kind exchanges
• Problem Set 7, #1c: §1031(d): Basis of property received = basis of property given up ($60K) minus money received ($0) minus recognized gain ($0) minus recognized loss ($0) = $60K
Simple question to ask: what would happen if after non-recognition, TP1 changed his mind and sold the lot? $70K amount realized minus $60K adjusted basis = $10K This gain is both realized and recognized

- Problem Set 7, #1d: TP2 must recognize his gain from the exchange b/c he is using his newly received property as a residence
- Problem Set 7, #1e: suppose TP3 and TP4 make this stock trade:

<table>
<thead>
<tr>
<th></th>
<th>TP3</th>
<th>TP4</th>
</tr>
</thead>
<tbody>
<tr>
<td>GM Stock</td>
<td>Cost = $60K</td>
<td>GE Stock</td>
</tr>
<tr>
<td></td>
<td>FMV = $70K</td>
<td></td>
</tr>
<tr>
<td>$10K realized gain</td>
<td>All of it taxed</td>
<td>$40K realized gain</td>
</tr>
<tr>
<td></td>
<td>All of it taxed</td>
<td></td>
</tr>
</tbody>
</table>

Why tax gain from exchange of stocks but not from exchange of land? Stocks are more liquid. Administrative inefficiency of selling land received in a land exchange for the sole purpose of paying taxes; taxes in this scenario force people out of investments they just made. §1031 grants additional tax deferral

If wealthy investors don’t have to pay tax on exchange of stocks, the tax deferral could effectively become infinite tax forgiveness; the wealthiest 2% are the ones who would benefit the most from this deferral if it existed (extension of Brandeis dissent in Macomber).

Also, is exchange of stocks a “like kind” exchange? Not really.

If 2 stores exchange inventory, all 5 conditions in §1031(a)(1) are satisfied, but inventory never qualifies for the non-recognition of gain b/c the merchandise is more liquid than land.

- Policies of §1031
  1. Administrative Convenience: Avoids valuation controversies, i.e. “what is the true value of exchange”? It is unproductive to value; instead, of going through inefficiencies, tax later when property received in swap is actually sold (temporary deferral)
  2. Taxpayer Compliance: TP may not have the $ to pay taxes @ time of exchange—this could force a tax sale to pay taxes-motivated Congress to delay, despite having the power to tax immediately-wait until TP chooses to sell for cash and tax liquid resources
  3. Horizontal Equity: Compare continued ownership of property w/ continued exchange for very similar property; §1031 concedes certain equity problems; realization puts unilateral tax deferral opportunities on property owners; sometimes there isn’t enough difference btw continuing to hold property and exchanging it for something different; realization is substantively the same as selling and immediately sinking $ into something very similar.
  4. Economic Neutrality: Perhaps the true motivating factor

Assume TP owns land; cost/basis = $50K; FMV = $100K; appreciates 10K/yr TP has investment opportunity to sell old land and buy new land that will appreciate at 11%/yr; TP should trade investments; if TP sells land for $100K, has a taxable/realized $50K gain; capital gain taxed @20% rate = $10K of tax, $90K after-tax proceeds of sale; 90K investment @ 11% = 99K < 100K; TP doesn’t get into better investment opportunity, stays in worse investment; Realization doctrine will deter investors from choosing more lucrative investments and not responding to market signals; realized gains will trigger tax obligation; may result in investors...
staying put; Congress is always concerned with tax policies that deter investment; this concept is known as “capital lock-in”; Realization doctrine forces people into less productive investments; some combination of reasons 1-4 above is the policy justification for §1031; no single reason explains §1031 in full

- §1031(a)(2)(A): non-recognition is not available for exchange of stock in trade or property held primarily for sale; What if Walmart wants to trade 10 extra shoes to Target across the street for 5 extra jackets? Valuation here is not hard b/c prices are set by stores; liquidity not a concern; horizontal equity probably not a problem; economic neutrality? If object is to turn over inventory as quickly as possible? None of the §1031 policy concerns apply

- Problem Set 7, #2a: TP trades apt bldg he purchased for $100K for a tract of unimproved land valued at 85K and equipment worth 25K; Congress does have the power to tax, so must figure out amount realized:
  Amount realized = $0 cash plus $110K land & equipment = $110K
  Minus adjusted basis of property sold = $100K *
  =$10K gain
  *If apartment building has depreciation, adjusted basis is less under §1016(a)(2)

- §1031(a): exchange must be solely for property of like kind; was apartment building a trade or business? Yes

- Apartment building and land are a like kind exchange; treasury regulations have always been lenient with real estate; but what about apartment building exchange for equipment? Could it be argued that construction equipment will be used to build a building on vacant land? Then maybe this exchange has functional similarity.

- The question is what is the definition of like kind? Congress did not give a real definition. This is up to treasury and courts to decide: (1) Real estate for real estate is like kind, regardless of whether it’s developed or not; (2) Real estate for personal property is never like kind, unless personal property is a 30-plus year lease on real estate; (3) personal property for personal property has no traditional rule; must make fact-based evaluation case-by-case; new treasury regulation: §1.1031-2: Treasury will treat as like kind exchange if property is the same depreciation class or same product class (safe harbor, i.e. desk for chair is like kind exchange) BUT gold bullion coins for gold collectible coins is NOT like kind exchange

- §1031(b): not solely like-kind, but like-kind in part, tax consequence: gain, if any, should be recognized, but not in excess of FMV of other property or money; additional excess property is the “boot” in a partly like kind exchange; in this case, all $10K of gain is recognized b/c it is not in excess of the FMV of other property or $ Result: $10K of gain is realized, not the boot, only the gain, it is court’s discretion to recognize and tax or not tax

- Problem Set 7, #2b: Basis in unimproved land and equipment?
  Basis of property received = basis of property given up = $100K
  Minus amount of money received = $0
  Plus amount of gain recognized = $10K
  Minus amount of loss recognized = $0
  $110K total basis

First, assign $25K basis to the boot
Next, assign remainder as basis of land $85K

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What if TP changes his mind and wants to sell the land the next day? He will sell it for FMV of $85K, basis is $85K; b/c of boot, all enrichment was taxed, $10K; therefore, TP should not be taxed for subsequent sale of land or equipment.

- Problem Set 7, #2c: Why tax up to the amount of boot received? To the extent that a person “bails out” of real estate by receiving boot, they should be taxed.
- Problem Set 7, #2d: TP trades apt bldg he purchased for $100K for a tract of unimproved land valued at 85K and equipment worth 10K: Not a §1031(a) transaction b/c of boot; §5K realized loss; under §1031(c), loss is not solely in kind; no loss recognized in boot, so recognized loss = $0
  
  Amount realized = $85K FMV + $10K FMV equipment = $95K
  
  Realized loss= 5K
  
  Recognized loss = 0, §1031(c)

Basis of property received = basis of property given up = 100K

Minus cash received = 0

Plus recognized gain = 0

Minus recognized loss = 0

100K

$100K is basis, but how to divide among multiple items? 10K equipment basis/$90K land basis; but if TP sold his land the next day and could only sell for $85K FMV, then the loss = $85K FMV minus $90K adjusted basis

= $5K realized/recognized loss, §1001(c)

- What is the consequence of §1031(c)? Not a complete disallowance of all losses in exchanges, only in exchanges for goods; §1031(c) realized loss is not recognized, TP not entitled to deduction at that point; this only defers the loss-it does not disallow altogether; TP must end up with a basis > value

§165: loss deduction; non-recognition of gains is good, non-recognition of losses is bad

Implicit saying: any deferred gain/loss is locked into the basis of like-kind property received in the exchange

- Why is there a difference between §1031(b) and (c)?

§1031(b): every penny of gain taxed up to FMV of boot

§1031(c): loss not deductible in a like-kind exchange

- Taxpayers are advised to sell property at the end of the year so losses can be deducted while deferring gains; §1031(c) is Congress response to TP’s deferring gains and accelerating losses; only the boot is taxes and losses are not recognized until a cash sale occurs; deferral of losses in §1031(a),(c) does not affect TPs because they will never make a like kind exchange at a loss because no deduction is available

- Can you manufacture an exchange to qualify for a tax deferral?

Hypo: TP owns apartment building with $100K cost and FMV of $110K; wants to trade it for land; someone is willing to buy the apartment building for $110K; buyer should be instructed to purchase land, then swap the building with buyer;

Alderson allows this kind of tax deferred exchange; consequence of Alderson: deferred exchanges; buyer can wait to purchase property to swap with seller after sale;

§1031(a)(3): property received in exchange shall not get tax deferral, unless identified within 45 days and relinquished within 180 days

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• Problem Set 7, #3a:
  Sale proceeds = $1 million, deposited with court (1998)
    Plus $500K in 2000 (just compensation)
  $1.5 million amount realized
  minus $1.0 million cost
  $500K realized gain

Does TP qualify for deferral under like-kind exchange provision?

Why can’t TP qualify under §1031? B/c the land was sold for cash; despite being involuntary, sale for cash is not an exchange

Even if it was an exchange, what’s the problem? Under §1031(a)(2)(A), this is property held primarily for sale b/c TP is a real estate developer.

§1033(a)(1): No gain is recognized if converted into property similar or related in service or use; if converted to cash, it’s a sale.

§1031(a)(2)(A): gain recognized only if amount realized on conversion exceeds the cost of replacement property; this limits recognized gain;

TP spent $1.2 million of the $1.5 million realization; therefore, TP is only liable for tax on $300K of $500K enrichment.

§1033(a)(2)(B): if 1994 is 1st date of “threat” of condemnation, tax exemption is granted for up to 2 years from close of tax year of gain being realized?

Is imminence of threat defined as published plans? No definition of “imminent threat” in the tax code, so common usage applies.

IRS position: If local authorities are in on it, and make a solid determination, imminent threat period begins

If land is bought in 10/02, realized gain is not until 2000: 10/02 is still within 2 years of close of $2000 tax year

§1001(a): gain = excess of sales proceeds over basis

No gain for TP’s 1998 forced sale b/c of price not giving any enrichment

• Problem Set 7, #3b: What if TP buys $1.6 million piece of land in 2002, ½ used for golf, ½ used for residential development?
  Timeliness is not an issue, but service and use is an issue; Congress wants some function of replacement property; the ½ used for golf would not qualify; if golf is not a similar use, how much should be taxed?

Compare §1031 “like kind” with §1033 “similar or related service”; §1033 is more stringent than §1031, why different? (1) Valuation/administrative convenience; (2) liquidity; (3) preservation of capital lock-ins; none of these reason support tax deferral in involuntary transactions; the only policy concern to support is FAIRNESS

Do golf course and residential development have similar uses? Courts have been strict about construing §1033, require functional similarity

Amount realized on conversion = $1.5 million

Minus cost of other such property = $800K (only ½ used for similar/related purpose)

=$700K
This is a limit on what is recognized, but not a gain; can’t be taxed on more than what the total gain is; therefore, TP pays tax on $500K gain (All gain up to $700K is taxed in this scenario)

**Taking is involuntary, but re-investing the compensation in another business is voluntary**

§1033(a)(1): conversion of property into similar/service or use
§1033(a)(2): conversion of property into dissimilar use
§1033(b)(1): §1033(a)(1) transactions basis
§1033(b)(2): §1033(a)(2) transactions basis

What is the basis if TP is compensated w/ $1.5 mln, buys $1.2 mln similar use property?
Recognized gain = 1.5mln-1.2mln=300K recognized gain; unrecognized gain = 200K
Basis = cost of replacement property –unrecognized gain = $1 million

- Set 7, #3c: §1033(g)(1): in involuntary conversions of business and investment real estate, the rule is relaxed compared to similar use in rule §1033(a)(1)

- Set 7, #4:
  Amount realized = $400K
  Minus adjusted basis in property sold = $180K
  = $220K realized gain, excluded by operation of §121

§121/§1034: Today’s §121 is not the way it has always been; Congress has given up on taxing residence sales gains; up to $250K single/$500K married, unlimited usage

**Old approach:** When a house was bought, TP gets basis if sold for >basis, TP has taxable gain under §1001(a); houses are personal consumption, so loss deduction is not allowed;
Basis increase for improvements allowed, depreciation not allowed for personal consumption property, only for business uses.

**Old Rule:** If house sold @ gain, it’s realized, but tax is deferred as long as proceeds are re-invested within 2 years (owner occupied only);
Basis in new house = price paid less amount of untaxed gain on sale of old house

Old §1034: allowed rollover of gain into new house

**Problem w/ Old Rule:** Retiring buyer selling expensive house but still has much older house’s basis was screwed under old §121; §121 allowed limited exclusion for TP over 55, 1 time only, could exclude $125K gain not just from one sale but b/c TP had taken advantage of §1034 several times

Under old §121: If no exclusion was granted, elderly stay in a house when they die, then all taxable gain is deferred, results in enormous untaxed gain, housing lock-in; elderly couldn’t afford to sell b/c of taxes; the rollover became a tax-free death benefit; people stayed in houses for sole purpose of saving taxes for kids
§121 can now be used an unlimited # of times. Why? Dubious logic, justified by simplification measure.
Congress doesn’t want to deter the labor force from being mobile; doesn’t want to deter people who are effectively forced to move to new homes; protect what is major investment for most people; what could Congress do besides outright forgiveness?
Original §121: tax forgiveness—normally given at death—thought this benefit should be available to elderly in need of $$ for medical expenses.

Result of new §121: Even if you’re in a house that you want to live in, if you’re tax sensitive, you must move before a house appreciates more than $250K or $500K for a married couple.

  
  IRS argument: No realization, b/c swapping of mortgages is not a substantial change economically; substance over form;
  
  TP argument: disposing of mortgages is giving up ownership of property and receiving of other property; an exchange always involves realization.

  What result under *Bruun*? S&L are immune from further loss to the extent that borrowers can’t pay off their loans; realization has occurred.

  What does “material difference” mean? What authority for S. Ct. definition?

  Material difference standard: S&L1 has traded it risk of losing or gaining on mortgage portfolio #1 and acquired a risk of gain/loss on mortgage portfolio #2.

  Application of *Bruun*: Still realization (loss deduction now).

  Taxpayer wins, but not on its broades argument.

  Hypo: 2 owners of the same stock trade the same number of shares with each other in a year where the price dropped. Can both deduct a loss? No b/c identical stocks are not materially different.

  S.Ct holds that material difference standard applies, but also that similar mortgage portfolios are still different.

  Meaning: “legal entitlements that are different in kind or extent”-doesn’t take much under this standard.

  Authority: prior precedent.

  Why is realization doctrine drawn from precedent when it’s a strictly statutory issue?

  Constitution gives Congress exclusive power to tax.

  §61(a)(3): gains derived from dealings in property.

  §1001(a): gain from “sale or other disposition”.

  Why not provide for “other disposition” while not defining?

  Why won’t Congress be more specific? In *Macomber*, Pitney opinion held Congress could not be more specific; ultimately, courts have to instruct on other realizations; *Macomber* sheds light on stock dividends, but not on all other dispositions; this means courts will ultimately tell us what triggers Congress’s power to tax.

  Another authority is §1031: non-recognition; has no function if properties that are similar cannot be swapped at all: negative implication argument.

  p.257: concept of realization is founded on administrative convenience (liquidity, calculation) this is only dicta, but recurs in other places.

  Supreme Court does not want to be put in the position of *Macomber* again; as a policy concern, it’s better to leave to Congress.

  *Cottage Savings* makes evident the capricious role that realization plays in the tax field; if requirement has a low threshold, then it nearly becomes elective with the taxpayer; possible source of Comm’r’s opposition in *Cottage*; *TP in Cottage* chose to
swap & trigger a realization; exposed Treasury to something of a whipsaw, and awards banks a benefit not intended by Congress

- Problem Set 8, #1a: Sale of stock for cash is realization; if sold at a loss, it’s deductible under §165(a); §267(a) disallows this deduction for sales to family members. This is an internal inconsistency, what is the tie-breaker?
  §261: “In computing taxable income, no deduction shall in any case be allowed in respect of the items specified in this part” (meaning part 9 disallowance section)
  §267(a)(1): After TP’s brother sells for $60/share it is not loss deferral, it is loss disallowance; ($10/share loss deduction allowed, not $40/share)
  What if brother sells for $105/share ($35 share/gain)? Such gain is recognized only to the extent that it exceeds such loss as is properly allocable to property sold/otherwise disposed of by TP: only $5/share recognized gain, not $35/share price difference.
  Loss deduction that is earlier disallowed is eventually “re-allowed” if stock gains value in the form of reduced liability for gain that is realized.
  What if TP’s brother sells for $85/share? Brother realizes gain of $15, but gain is only taxed to the “extent it exceeds loss” under §267(d)(2); because the gain here does not exceed loss, the gain is not taxed.

- Problem Set 8, #1b: What if stock is sold to TP’s brother’s wholly-owned corporation? Disallowance rule is again triggered; if stock is sold to sister-in-law, deduction is allowed (not considered close enough relationship); if corporation is wholly owned by sister-in-law, half may be considered to be owned by the brother, so half is not deductible.

- Problem Set 8, #2: §267(a)(1) disallows “direct or indirect” loss deductions for property exchanges within the family; TP cannot sell thru a broker and have his brother buy thru a broker on the same day and deduct the loss.

- Problem Set 8, #3: Buy 100, sell at 70, repurchase at 74, what is new basis?
  Basis = cost = 74
  Plus disallowed loss = 30
  $104 is new basis; this is only a deferral, not a disallowance.
  §1091: wash sale rule—requires deferral of loss deduction.

Loans and Offsetting Claims

- Proceeds are not income under §61(a).
  Principal payments are not deductible (no disenrichment).
  Income tax is on enrichment—loans are not enrichment, b/c the money is owed back.
  The form of wealth has changed from good credit to cash in hand (no enrichment).
  Bond = loan transaction
  Issuer = debtor
  Initial purchaser = creditor
  Principal is repaid in lump sum at maturity.
  Loan contracts are freely assignable, evidenced by security
  Interest payments are generally deductible, maybe under §162 or §163.

Policy of tax treatment of loans: (1) No enrichment; (2) Administrative convenience; (3) If loan proceeds are treated as income, TP is pushed into a higher bracket, while deductions come at a lower bracket b/c they’re spread out over time;
Kirby Lumber: Issued $12.1 million in bonds; bought back for < $12 mln; Difference = $138K; people purchasing bonds are creditors; Kirby Lumber is a debtor; no principal amortization in bond contract—all is paid @ maturity
Bond trading prices are public information, designed to be freely transferable; What is the effect of trading bond creditor’s rights?

Hypo: I holds 20 year, 10%, $1000 GM bond, w/ 10 years to maturity; how much can I sell it for if newly-issued 10 year bonds of similar security sell for:
(1) 10% interest? Can sell for $1000, I is equally well off keeping or selling for $1K.
(2) 8% interest? $80/yr versus $100/yr? Should sell for >1000 b/c of higher interest pay out; $100/yr discounted @8%, plus $1000 discounted @ 8%= $1134.20 (premium)
(3) 12% interest? Must sell for less than $1000 to induce buyer to forego new 12% bonds, sells for $889.92 (discount)

When federal reserve announces an interest rate change, bond trading prices change at the same time.

What really happened in Kirby lumber? Why could bonds be bought back at discount? B/c interest rates went up

Why does the corporation have income?

Court holding: If bonds are sold at given price, then bought back at lower price, the difference is income; why is this income? It’s income b/c the loan proceeds that become exempted from repayment obligation and were not initially taxed (b/c loan proceeds aren’t taxed), are pure taxable gain

§61(a)(12): Kirby Lumber codified: “Income from discharge of indebtedness”

Kirby found “no shrinkage of assets”; trading cash for bonds of a greater amount has increased TP’s Net Worth; resulting gain was taxable like any other profit derived from speculative activity;

**A taxpayer can (a) exclude the amount borrowed and (b) deduct the outlay of borrowed funds, provided they (c) repay the amount borrowed with after-tax income; if taxpayer is not obliged to repay the full amount of the loan, then to prevent undercounting of taxable income, he should be asked to give up an equivalent portion of the benefit that resulted from combining exclusion & deduction under (a) and (b). If TP contrives to reduce his repayment obligation, he must either include that amount of borrowed funds in his income, or accept a disallowance of his prior tax benefits; the debt cancellation requires a constructive reversal of one benefit or the other—the Kirby court lacked a statutory basis for making refined adjustments, so it did the next best thing by requiring canceled debt to be included in current income.

What if Kirby Lumber has been sabotaged by Enron-like corporate officers? Even if interest rate is unchanges, the bonds have become a high-risk instrument

If a person loaned $ to a high-risk issuer/debtor, they would demand a high interest rate/risk premium

If borrower’s creditworthiness drops, so does the bond price, b/c people face the prospect of receiving no repayment at all

Insolvency Exception: When liabilities > assets before/after repurchase b/c shareholders receive nothing, creditors receive any relative gain; may be no discharge if issuer is insolvent both before and after repurchase of obligations (no income)
This is limited b/c if buyback of bonds creates solvency, discharge is taxable;  
*Liability minus FMV assets = Insolvency static*

Dynamic concern: $$ paid when due

- Two possible interpretations of Kirby (rationale):
  1. Discharge of indebtedness is enrichment, therefore shareholder’s wealth is increased; 
     some of the assets have been freed from claims of creditors; looking to total final status 
     of debtor justifies insolvency exception b/c of continued “nothing for shareholders” 
  2. Recapture rationale: discharge of indebtedness proves that prior loan tax treatment 
     was incorrect to the extent that it was not all repaid

- §108: Exclusion 
  §108(a)(1)(A), (B): Gross income does not include discharge of indebtedness if 
  (A) Title 11 bankruptcy case 
  (B) Taxpayer is insolvent 
  As a practical matter, there are drastic reductions in liability b/c this increases the 
  probability of creditors receiving some payback of debts. 
  Under progressive rates, most release of indebtedness would become a tax liability; by 
  releasing debt, IRS would simply take the place of creditors; this could complicate 
  debtor/creditor agreements. 
  Rationale for §108: if creditors lower their expectations of debtors, IRS shouldn’t 
  intervene, despite there being income in principle 
  **Insolvency exception only applies to extent of insolvency.** 
  §108(b)(1): amount excluded from income in §108(a) is applied in a designated order 
  §108(b)(2)(A): Any net operating loss for taxable year and any net carryover: future 
  profits are not allowed to be canceled out by net operating losses reduced by bankruptcy 
  workout; 
  §108(a)(1) is not forgiveness, simply deferral; defers tax when creditors effectively 
  provide “income” and adds tax later by not allowing as many deductions or depreciations 
  in future tax years 
  §108(b)(3)(A): In general, $1 for $1 replacement discharge (forfeited loss deductions) 
  §108(b)(3)(B): For tax credits, adjusts so that $1 tax credit forfeits $3 future deduction 
  In Kirby a healthy debtor took advantage of a change in interest rates; only if TP is 
  insolvent are they entitled to §108 deferral; §108 does not apply to Kirby.

- Insolvency Exception: 
  1. Enrichment Rationale: Income because some assets are freed from the claims of all 
     creditors; focus on debtor’s total financial situation: Insolvency exception 
  2. Recapture rationale: Income b/c loan proceeds received tax free due to obligations to 
     repay were not in fact repaid; focus on discharged loan only: No insolvency exception 
  §108 implicitly adopts the recapture rationale; 
  No income from discharge of debt if nothing tax free is received in the first place, i.e. 
  making a pledge to a charity and then not paying the whole pledge (CB p.295,1b) 
  p.295 1d: lawyer reduced bill from $1000 to $600; dispute exists over what was owed; if 
  atty/client compromise that lawyer only performed $600 in services, then the $400 is not
really income; only if the $400 is discharge of liability under §108(e)(5) is it income;

**Purchase price reduction for solvent debtors is not considered a discharge of debt**

Purchase price reduction and debt discharge are commonly confused.

p.296 2d: If painter pays a lawyer with a painting instead of cash, §108 does not apply b/c there is no evidence that lawyer gave up on satisfaction of payment.

- **Zarin:** by 1980, TP had borrowed $3.4 million from casino and couldn’t repay; TP had been able to pay 7 figure debts up to 1979;
  1981: TP settles the lawsuit to collect the debt and pays $500K back to the casino IRS says 2.9 million discharge from debt is income under §61(a)(12)
  TP in *Zarin* is not insolvent, so §108 does not apply
  TP argues: (1) “liability” of $3.4 million is not legally enforceable under §108(d)(1); (2) should be treated as a purchase price reduction under §108(e)(5)
  Both TP arguments are rejected: (1) If a person receives $3.4 million w/o obligation to repay, then it is income that is taxable, windfall income under *Glenshaw*; (2) §108(e)(5) does not apply, this is intended for cars that are lemons-the casino chips are not lemons-TP still had $3.4 mln in value from the chips
  3rd Circuit still allowed Zarin to prevail, creating horizontal equity problem
  Hypo: TP1 borrows $3.4 million from bank, loses it all at casino, cannot repay; bank accepts $500K in full satisfaction; this bank loan is legally enforceable; TP1 has $2.9 mln in income, unquestionably b/c of legal enforceability
  Hypo: TP2 gets $3.4 million credit on house, pays it all back
  TP1 has the same economic condition as Zarin
  TP2 has $2.9 less enrichment than Zarin, but has the same tax liability
  §165(d): losses from gambling transactions are allowed only to the extent of gains; court allows Zarin to offset 1980 gamblion loss against 1981 discharge; violation of §165 and §441/*Sanford & Brooks*-ludicrous result
  One possible argument in Zarin’s favor (purchase price adjustment argument): Although there is no dispute about the value received by Zarin, whenever a casino extends credit to a patron, there is a chance the house will lose, but with a compulsive gambler like Zarin, a casino can safely assume there is no possibility they will walk out with casino’s money; the chips may not really be worth $3.4 million to a compulsive gambler b/c there’s no possibility the chips could become winnings

- **North American Oil Co.**
  1916: Oil royalties earned/collected by receiver
  1917: Trial court order, royalties paid to taxpayer
  1922: Court appeal dismissed
  Nobody argues if oil royalties are income, but rather the timing of what year the income is earned; possibly not income until legally certain that royalties will be paid.
  Taxpayer sought to report royalties as 1916 income; if not 1916, then 1922, but no way in 1917 b/c 1917 had HUGE federal income tax hike from 7 to 77 percent
  §446(a): Taxable income shall be computed under method of accounting of which TP regularly computes his income in bookkeeping
  Does TP in *North American Oil* use cash receipts or accrual method under §446(c)?
  Cash method: Year for including is the year of receipt
Accrual method: (1) All events have occurred that fix TP’s right to the income; (2) Amount has to be reasonably estimable
Why not look to cash method in 1916? B/C royalties were not actually or constructively received by TP in 1916.
Constructive receipt: If one can obtain simply by demand, it is constructive receipt, i.e. interest in a savings account
IRS: 1917 is year of receipt; but court decision on royalties is not final b/c it’s still on appeal; why does TP believe they’re not enriched by full amount in 1917? B/c they might not get to keep it; TP argues that 1917 judgment is not a receipt b/c it could lose on appeal; in substance it is a loan, b/c of the obligation to repay contingent upon losing the appeal;
1922: TP won the appeal; for tax purposes, b/c of contingent obligation to repay, it is only a “loan”; in 1922 obligation to repay is lifted, $ becomes income
How does S.Ct. respond to “loan” argument?
The “claim of right” doctrine makes the proceeds 1917 income, regardless of possibility of losing the $ on appeal; mer appeal having been filed is only a contingent obligation to repay; a loan is an unconditional obligation to repay the full amount; too messy to evaluate probability of losing judgment on appeal; clearly there is some enrichment in 1917 b/c of chance of affirming jgmt on appeal; being subject to dispute or other contingencies which extend beyond the taxable year does not create similar basis for exclusion; although it might be fairer to wait until all contingencies are resolved, IRS has an interest in immediate taxation b/c postponing creates risk that TP will become insolvent. In North American, TP could have used the fear of some other collateral attack as grounds for continuing to delay payment of taxes on royalty.
Actual receipt easier to identify than final resolution of a controversy
Cash Flow Tax Treatment
1917: Income on receipt
1922: Deduction for amount repaid
Rationale for not allowing TP’s claim in North American: prevents people from claiming all income as under a conditional obligation to repay unless obligation of repayment is certain; jgmt won by TP must be income; beginning in 1917, TP had no restriction as to use of the royalty $, so the income became taxable that year, even though ultimate ownership continued to be disputed

- Lewis: In 1944, TP receives $22,000 bonus; company realizes the bonus is too high; sues for repayment; TP repays ½ of bonus in 1946
  Court: TP must report full 22K as 1944 income-full cash flow tax treatment and take a deductible loss in 1946.
  TP is bothered b/c 1944 was a very high tax year, after which rates were lowered; then TP can only deduct a loss @ much lower tax rate
  Court’s response: tough shit-taxable income is calculated by TP’s taxable year
  Congress response to Lewis: §1341(a); entitles taxpayer to an alternative; gives option to either (1) take deduction regardless of rate change; or (2) recompute taxes by prior year’s tax excess payment(this is what Lewis wanted to do)

- Claim of right doctrine: conditional repayment obligation ≠ loan for tax purposes
Cash flow tax treatment; theoretical reason; practical reason

Embezzlement Cases

- **James**: re-examines and overrules prior precedent
  Theory: embezzler is not liable for tax b/c they are not enriched; unconditional obligation (legally) to repay; this is a loan made w/o consent of both parties
  This is a practical problem, b/c most embezzlers don’t repay, have no intent to repay or $can’t be repaid; criminal employees consume $ tax free w/o ever paying back
  **James**: embezzled funds are taxable; repayments are deductible
  Practical Reason: focusing on legal obligations is irrelevant; most embezzled funds are never found/repaid
  **James** held that a plausible distinction can be drawn between theft & legitimate borrowing, so stolen money is fully taxable in the year obtained

- **McKinney**: Embezzler reported income; required to repay; rates were lowered; TP entitled to deduction, but at lower rate;
  TP claimed relief under §1341: this is the same inequity Congress had in mind, but embezzling union official does not meet §1341 condition of having an unrestricted right
  TP claims deduction is higher than income in the latter years; claims §172 net operating loss to allow future deductions in later years with income
  §172(d)(4): can only carry back/forward excess deduction if they are from a trade or business, but McKinney argues he is in the business of embezzling!!
  Court holds this was embezzlement for sports, not business

Nonrecourse loans

- Concept of adjusted basis: Current tax-paid investment, gain/loss on sale or disposition
  §1001(a): Amount realized minus adjusted basis = gain or loss
  What is included in adjusted basis?
  Unadjusted basis is cost under §1012—this does not inquire if the source of payment is tax-paid or tax free (i.e. loans/gifts); purchase money loans become part of basis despite not having paid any taxes;
  subsequent loans—do not affect basis if borrowed against property b/c investment in property is not included BUT basis is increased when more $ is invested in property, §1016(a)(1)

- Hypo: TP owns property w/ FMV of $1.2 mln, mortgage principle = $1.0 mln
  TP sells property to buyer
  1. Buyer pays TP $1.2 million, TP uses $1.0 million to pay of mortgage, buyer takes property free & clear of any encumbrances
  2. Buyer pays $200K, TP transfers property to buyer subject to outstanding mortgage, buyer assumes mortgage
     TP received buyer’s promise to pay off mortgage; 3rd party satisfaction of a liability, 2 steps become 1 step under Old Colony rule—TP gets same tax treatment in 1 and 2
  3. What if buyer gives up nothing but offers services as a purchase price?
     Congress did not think of all ways of conferring value on a seller; “§1001 is hideously under-inclusive”
Hypo: TP owns land, 
FMV = 1.2 mln; mortgage principal = 1.0 mln; adjusted basis = 700K
Mortgage principle > adjusted basis b/c FMV went up and TP borrowed against equity
Method 1: Buyer pays $1.2 mln, TP pays off mortgage, transfers free & clear
Method 2: Buyer pays TP $200K, promises to pay mortgage, TP transfers Blackacre subject to mortgage
Method 1 and 2 have same result for TP: $200K, excess of FMV over indebtedness
Method 2: Buyer takes old mortgage instead of using his own, same result as 1
Under Old Colony, buyer’s agreement to pay off mortgage is a taxable release from indebtedness; 200K cash plus 1 million release from debt or 1.2 million cash
Amount realized is the same, tax treatment is the same
Using $700 adjusted basis, gain in Method 1 or 2 = 1.2mln – 700K = 500K in both
What if TP is not liable to bank when buyer assumes loan but does not pay?
Non recourse loans mean no recourse to personal liability of borrower; the only remedy is to foreclose on collateral; no ability to sue for deficiency;
Should Method 1 and 2 have the same tax treatment w/ non recourse loans? Under 2, w/o promise to personally pay off mortgage in a non-recourse loan, is the transferred 1.0 mln a constructive receipt of release from debt? In this case, what is the amount realized?
Functionally: trying to compute gain/loss on sale or disposition of property
Gain = increase in wealth due to increased property value (market appreciation)
Not taxed each year b/c of Macomber realization doctrine, only taxed when sold; ultimately taxed on enhancement of resources
Amount realized: Tax law measure of FMV property on disposition
§1001(b): amount realized = cash + FMV of property
Approach to measuring is not to appraise, but to measure an actual transaction
In addition to cash, gain/loss can include in kind property, in kind services, Old Colony constructive receipt (debt payment)
If trying to come up with FMV, one must include total gross unencumbered FMV; in method 2, all that is paid is equity value
Since goal is to properly measure increase in value, must find accurate way to determine encumbrances
FMV must include release from debt, even if debt is not personally guaranteed: Crane rule

Crane: Amount realized = 200K equity payment plus full principle balance of mortgage debt (1 mln) = 1.2 million minus 700K adjusted basis = 500K gain

Tufts: what if FMV of property has dropped below amount of lien? Bank has waived its right to come after borrower b/c remedy is limited to foreclosing on property;
Rational borrower would choose to default on property where value < nonrecourse debt
TP takes advantage of bank here and “cuts his losses”
FMV collateral < principal balance of mortgage, how is this sale treated for taxes?
Disposition is not ordinary sale, but foreclosure; bank is using property to pay off as much debt as possible; what is really going on, gain or loss?
If foreclosure is viewed as involuntary sale, what are the proceeds?
Cash = 0; Property = 0; Services = 0; Debt release = 0
But does amount realized include any or all of mortgage balance?
900K FMV
-700K adjusted basis
200K gain/enrichment
In addition to gain/enrichment, TP received 1.0 mln loan proceeds and only paid back 900K FMV of property.
2 transactions occur:
1. Property transaction (TP enriched by 200K)
2. Loan transaction (TP borrowed 1.0 mln, only paid back 900K)
   200K sale proceeds +100K debt release = 300K gain
*Tufts* failed to unscramble the two transactions (property and loan);
*Tufts* instead held: on disposition, amount realized = full principle balance of any nonrecourse mortgage or encumbrance
When bank forecloses, gain = 1.0mln discharge minus 700K adjusted basis = 300K gain
Lumps 2 transactions together instead of separating property and loan transactions
**Connor concur: this is a major screw up, b/c if unscrambled, land is a capital asset; 200K from property sale is capital gain w/ favorable tax treatment; 100K discharge is ordinary income under *Kirby Lumber*; by lumping together, all 300K income is treated as capital gain, beneficial to TP, unfair to treasury
Why didn’t treasury interfere? Treasury understood problem w/ not unscrambling, but b/c precedent overlooked this, early 1980’s was a bad time to bring about a major change in expectation; should be done by congress, not solicitor general’s brief to S.Ct.
*Tufts* math:
FMV of collateral = $1.40 mln
Adjusted Basis = $1.46 mln
Principal value of nonrecourse mortgage = $1.85 mln
1. TP loss = $60K capital loss on property investment
2. TP also received $1.85 mln of NR loan proceeds, but only paid back 1.4 mln FMV of collateral = $450K income from discharge of indebtedness
Majority opinion does not unscramble, just treats as a single sale:
1.85 mln amount realized minus 1.46 mln adjusted basis = 390K gain on sale
Correct net amount of 2 transactions, but wrong tax treatment (not fully taxable)
TP gets tax treatment of a long term capital gain on sale of property at a loss!!!
Congress response: §7701(g) clarifies FMV in the case of nonrecourse indebtedness:
FMV should be treated as not less than amount of any nonrecourse indebtedness to which property is subject; effect is to unscramble--**this only applies in nonrecourse debts**
If bank forecloses on a regular mortgage and opts not to go after deficiency, TP is off the hook;
NR loan: lender agrees to only rely on security interest in property; NR loans typically are only made when there is a low risk of FMV falling below principal balance of loan (i.e. real estate, but not cars); banks assume a higher risk in a NR loan by charging higher interest rates
*Tufts* is a case where the lender guessed wrong; factory layoffs led to apartment vacancies and a lower apartment complex value;
• **Parker v. Delaney**: Only included to raise possibility as a policy matter the concept of permitting negative basis; in theory, gain > amount realized, in reality, NEVER the law b/c of Congress aversion to negative numbers; illustration of a path not taken

IV. **The Proper Taxpayer** (Progression Problems)

**Gifts and Kindred Items**
- **Donee**: Is it enrichment? Yes under §61
  - Donor: Is it disenrichment? Yes, tax paid savings
  - Caution: Not all expenditures are disenrichment
  - Economic definition: Income = consumption plus change in wealth
  - Does donor get consumption benefits? If so, gifts should not be deductible
  1. **Material Consumption**: Benefits are not available, allow deduction
     - Why would donor (rationally) give away $ for another’s consumption? Intangible goodwill benefits/emotional gratification/influence over donee’s behavior/strings attached; the fact that donor makes a gift indicates the intangible gratification from giving is greater than utility derived from personal consumption
  2. **Intangible Consumption**: No deduction should be allowed
     - Two plausible tax treatments for donors; for donees, gifts are always enrichment
       - §102(a): gross income does not include value of property acquired by gift, bequest, devise, or inheritance: **this is an express statutory exclusion for donee**
       - §170(a): allows deduction for gifts to charity, BUT ordinary gifts are not deductible
     - Putting 2 provisions together: tax the donor, not the donee
     - Why did Congress make this choice that is at odds w/ material consumption point of view (This policy has been in place since 1913)?
     - There are severe administrative problems with implementing either view
       1. Under **material consumption** view, donee is taxed; progressive tax system is a problem; benefactors tend to be older w/ accumulation of wealth; beneficiaries tend to be younger w/o wealth; when wealthy donor gives a gift and makes a deduction, they deduct at a high bracket; when young donee receives and pays tax at a lower rate, less $ is received by IRS, but still “fair” from tax policy perspective
       - BUT: suppose donors are tax savvy, and give gift, tell donee to buy property that donor gets to use, i.e. parents give child $ to buy a car that parents drive; parents can launder $ through a lower bracket child; **this is very hard to police**; rate reduction is not a problem, but **unjustified rate reduction is a problem**; the invasiveness required for this approach is directly against grain of American revolution; “nuts in Idaho would be shooting government officials” (one advantage to material consumption view is the easiness of donors identifying donees in order to get tax deduction @ higher rates)

   2. Under **intangible consumption** approach: Unfair double taxation ; if donor gets no deduction, donee pays tax; TPs will engage in self help by not reporting gift income; this will result in a “tax on honesty” and deter reporting of gifts; from an economic and theoretical perspective, this is the best, but as a practical matter, it’s hard to enforce and people won’t report

   3. The **actual approach is to tax donor and not donee**

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A. Material consumption view, replace taxation of donee w/ tax on donor to preserve integrity of progressive rate schedule; donor tax serves as proxy for donor tax
B. If Congress prefers intangible consumption view where both are taxed, donees won’t report, Congress is left with donor only tax anyway

- **Irwin v. Gavit:** TP received 15 year partial income interest under testament trust
  - §102(b)(1): no exclusion for income from property acquired by gift
  - §102(a): only excludes value of property acquired by gift
  Hypo: If TP receives stock as a gift, it’s not reported; if stock pays dividend check, it’s included in income b/c it’s income from property
  - §102(b)(2) exclusion for gifts does not apply when gift is income from property
  - TP received interest income as a gift
  - §102(b)(2) is Congress codification of *Gavit*

  When TP’s daughter reaches the age of majority and receives property, she gets exclusion under §102(a) as principal beneficiary of trust (remainderman, corpus, etc)
  Without 102(b)(2), everyone would give gifts in the form of tax exempt income from property; this would be grossly unfair b/c the only income tax allowed would be on labor income
  Hypo: Gavit sells income interest to buyer for $30K; how should buyer be taxed? Income interest is a payout, but there was a basis in $30K paid for income interest; buyer should only be taxed on payout minus cost basis; buyer is entitled to depreciation deduction for income interest.

  Assume Gavit sells 15-yr income interest to buyer for $30K, avg annual income = $3K
  How does Buyer report?
  - Basis/cost §1012 = $30K
  - Gross Income §61(a)(15) = $45K total
  - ROC via 15 yr straight line amortization = 30K/15 yrs = $2K/yr depreciation
  - Can Gavit claim amortization? No, §102(b)(2), §273
  - How does Gavit report sale to buyer? Always compute gain or loss:
    - 30K amount realized minus 0 adjusted basis = 0
    - §1001(e)(1): No basis allowed when property rec’d by gift/inheritance/devise is sold
    - The donee/devisee/ life tenant is taxed on every penny they receive
    - Principal beneficiary will take underlying property in 15 yrs
    - Upon death of testator, value of principal = $100K
    - Principal beneficiary sells to B2 for $70K
    - Proceeds of sale = $70K
    - adjusted basis §1015 (donee takes donor’s basis); §1014 (basis =FMV@death)=$100K = -$30K deductible loss
    - If principal beneficiary waits to sell for 15 yrs, proceeds =100K-100K basis=no gain/loss
    - Income beneficiary/life tenant (30K)-basis
    - Principal beneficiary/remainderman (70K)-basis
    - Over time, remainderman’s basis increases
    - §1001(e)(3) exception: §1001(e)(1) does not apply to sale that is part of transaction in which entire interest in property is transferred to person/persons; recipient/donee of
income interest will pay tax on everything received UNLESS entire principal and interest are sold together

- *Early:* 2 separate transactions: (1) property acquired by gift; (2) purchase of income interest in trust
- IRS: all one transaction = settlement of disputed ownership claim; inter vivos gifts of stock, §273
- TP made this investment to settle a dispute, not a prior valid gift
- Dispute over whether gift ever occurred

**Settlements are taxable**
- Appellee taxpayers acquired interest in stock from decedent as a gift. Due to a will contest, **appellees agreed to return the stock to the estate in exchange for a life estate in a portion of the income.** Appellees sought to amortize the value of the life estate in subsequent tax returns, which appellant Commissioner of Internal Revenue disallowed. However, the tax court reversed and allowed the amortization, finding that 26 U.S.C.S. §273 did not govern because the life estate was not a gift, but an exchange for consideration. On review, the court disagreed and reversed the tax court's decision, holding that because the original stock exchange from decedent was a gift, the subsequent settlement for the life estate was a gift, as well.
- The court reversed the decision of the tax court, finding that because the life estate was acquired as a gift or bequest, that appellee taxpayers could not amortize the value of a life estate.

- *Taft v. Bowers:* Donor’s adjusted basis = $1K; FMV = $2K
- Donee is niece receiving gift of stock
- Under §102(a), how much does niece exclude? $2K FMV @ time of gift
- Donor cannot use realized gain for consumption; cannot be consumption when property is given away (not under material consumption premise)
- What could donor have done?
- Under *Bruun,* there is realization from intangible benefit of “giving” (intangible consumption premise)
- Should doctrine of realization by gift or bequest be adopted?
- 2 alternatives: (1) Sell something for gain, pay tax on gain; (2) give something away that has increased in value since purchase; “intangible gift”, realized gain not taxed;
- If TP’s are forced to sell property to pay taxes, they’ll be pissed; should back away from liquidity constraint
- Policy argument to tax donor @ time of giving: Congress has never imposed a general rule of taxing realized gain from giving
- §1015 Donor’s basis
- **Donee inherits donor’s basis when selling stock received as gift; must pay tax on gain earned while in possession of both donor and donee**

- Hypo:
  - T1: X makes donative transfer of stock to Y, FMV = $2K, adj basis = $1K
  - T2: Y sells stock to B, FMV = $4K, adj basis = $1K, Y has $3K realized gain
  - §1015: Donee takes donor’s basis
§7701(a)(43); “transferred basis” or “carryover basis”

X: No income on transfer (no realization by gift/bequest = material consumption)
Y: No income on receipt, §102(a) FMV exclusion
No deduction for gifts given: §102(e) exclusion (ordinary non-charitable gifts of money)
§170(a)-charity exclusion

Gifts in kind are more complicated
1. Tax donor: adjusted basis
2. Tax donee (later): appreciation in value of property at time of gift
3. Tax neither at time of gift

- Problem 1, p.154: A purchased shares of stock for 10K;
  1986 gift to B, value = $16K
  B sells for $15K in 1998
  Donor A has no income when they make the gift, but is not taxed; A also does not get a deduction; B pays no tax at time of gift, §102(a)
  @ time of B’s sale in 1998: gain/loss = amount realized (15K) minus adjusted basis (10K, under §1015(a)) = $5K of gain realized
- Problem 2, p.154:C buys stock for $1000;
  1995: C gives stock to D when FMV = $600; no loss or deduction or tax allowed

2a. D sells for $1400;
   amount realized = 1400
   -adjusted basis = 1000**
   D’s realized gain = $400
   **§1015(a): If “such basis” (transferred basis) is greater than FMV of property at time of gift (1000>600), basis = FMV

2b. D sells for $500
   amount realized = 500
   -adjusted basis = 600
   D’s realized loss=100

2c. D sells for $900
   D gains, but under transfer basis of $1000, it’s a loss;
   Under §1015(a) it’s a gain (basis of 600);
   What if it’s sold between those 2 numbers? Circularity problem, no gain or loss

If transfer basis >FMV at date of gift, use FMV basis for determining loss; this 400 is an ultimate disallowance; better to sell for cash, deduct a loss and give a cash gift

Gifts of depreciated property do not result in deductible losses
Why does Congress prohibit shifting of loss deductions through gift? B/c it doesn’t tax realized gain to donors on appreciated gifts; Congress sacrifices revenue by not taxing appreciated gifts; Congress stops even lower receipts by not allowing loss deduction on
depreciated gifts; by giving appreciated property to lower rate donee, massive rate reduction results

Bequests
§1014: If value of property increases during donor’s life, tax on gain is forgiven; Donee’s basis is FMV at time of donor’s death
What if FMV declined during decedent’s lifetime? The loss cannot be deducted
Tax advisor should tell elderly clients to sell stocks that have decreased in FMV and deduct the loss; when rich, well advised person dies, they should only have property that has increased in value
**Liquidity concerns**: If taxes are imposed on gifts in kind at time of donor’s death, donor’s estate or donee may have to sell property to pay tax; this will piss off taxpayers despite enrichment;
Main appreciable properties: Real estate, equity ownership in businesses; don’t want to force people to “sell the farm”
** **Capital Lock-In Problems**: B/c payment of taxes can be avoided by not selling property, continuous tax deferral is allowed; the more realized gain is in an investment, the more deterrence from selling; investors stay in lower paying investments b/c of the tax burden of switching investments

How to solve capital lock in? Repeal §1014 and allow realization @ death
**If taxed on death, people would sell property to pay for retirement
**The lure of death tax forgiveness under §1014 is what causes capital lock-in in large part
If liquidity concern is addressed, capital lock-in problem is exacerbated; if capital lock-in problem is addressed it causes liquidity problems
Solution: Make death realization taxes payable in 15-yr installments
$37 bln/yr cost of non-taxable realization at death-GOP wants to keep this rule in place
Biggest problem in tax code w/o tax or social policy benefits

§1014 & Estate Tax Repeal
See §1022(a): Property acquired from decedents dying after 12/31/2009 treated as gift and basis of donee = adjusted basis of decedent; or FMV of property @ date of decedent’s death; this is also seen in §1015
Carryover basis causes capital lock-in problems, §1014 loophole
Death time carryover is a better solution, addresses liquidity problems
§1022(b)(2)(B): In the case of any estate, aggregate basis increase in $1.3 million
In substance, death time carryover basis only applies to wealthiest 0.5% of Americans
§1022(c): allows add’l $3.0 mln transfer to spouse; rule only applies to people w/ more than $4.3 mln in unrealized appreciation at death

Prizes or Awards
• Tax status under general principles? Gift under §102 or compensation under §61(a)(1)?
• Pauline Washburn: TP wins $900 prize from Tums; did nothing to earn or win the prize; cannot be viewed as compensation; prizes are excluded under §102, but this is not a normal gift out of sympathy or gratitude b/c donee did not know donor
This could also be a windfall (overlooked alternative); then it would be taxable under 
_Glenshaw Glass_, but this case predates _Glenshaw_; presumably could be a windfall after 
_Glenshaw_.

§74(a): Prizes and awards are included in GI, this is an express inclusion

§74(b): Scientific/literary/artistic achievement awards get excluded under certain 
conditions

§117: express statutory exclusion for fellowships and scholarships; i.e. graduate student 
receiving tuition remission plus living stipend-tuition excluded/stipend is not excluded

**Mixed Motive Transfers**

- _Duberstein_: TP gives valuable customer referral; receives Cadillac as a “gift” is this 
really a gift or compensation? Donor’s corporation bought the car and deducted as a 
business expense.

Issue: how to handle a scrambled transaction

This referral paid off; by giving a “gift”, maybe this will lead to future referrals

IRS argument: no such thing as a business gift

Why does S.Ct. reject IRS argument? Congress did not give scope of gift exclusion in 
§102; w/o guidance from Congress, court assumes common usage-must admit there are 
gifts w/ business connotations i.e., gifts to/from co-workers

Supreme Court test:

Primary purpose test: What is primary or dominant motive of transferor?
1. Detached and disinterested generosity
2. Moral/legal obligation or anticipation of future benefits

_Duberstein_ and _Berman_ (donor) had never met and were not really “friends”

Reason for test: Gifts can be given for multiple motives; this is a scrambled transaction; it 
should be unscrambled for objective tax treatment; as a practical/administrative matter, it 
cannot be determined

_Congress Response_

1964: §274(b), No such thing as a deductible gift

1986: §102(c), No such thing as an employer/employee gift

**Marriage and Divorce**

- _Davis_ (divorce case): property settlement was incident to divorce

Husband gave wife 1000 shares of DuPont stock; under _Macomber_, no realization until 
sale; 500 shares cost = 75K, FMV = 82K, 7K of untaxed appreciation

_Under Macomber_, did transfer of stock trigger taxation? Gain or loss happens on sale or 
other disposition

Other disposition is not defined; Congress did not define b/c it did not think it had the 
power; Supreme Court stepped in:

Has husband gained benefit? Yes
1. Release of wife’s claims from the rest of husband’s property
2. Release from risk of stock losing value

Despite losing property, husband gets benefit of increased value

_TP_ argument: Non-taxable division of property between co-owners, thinking about 
common law co-ownership (TIC, JT, etc) that is split by non-taxable partition
IRS: If husband did not have to give stock, he would have to sell, pay taxes, then give wife the cash (*Old Colony* applied)
In a common law state, wife’s property ownership is not co-ownership; division of property is taxable; in community property state, divorcing husband & wife can divide any way they want tax-free
Amount realized minus adjusted basis

= value of wife’s release minus adjusted basis of property

value of wife’s release = FMV (can be assumed by law not fact)

Divorcing husband and wife hate each other’s guts, assumed to be strangers operating at arm’s length.

What is the tax treatment of Mrs. Davis?

1. Taxed on receipt? No tax under prevailing practice
2. What is her adjusted basis in the stock? FMV?

Amount realized = $82K

Adjusted basis = value of marital rights? 0, b/c no out-of-pocket cost of marital rights

Is current administrative practice wrong?

Why does the state law give wife rights in husband’s property? B/c marriage is breaking up, claim arises b/c of breakup of marriage; if H&W had not agreed, judge would have awarded damages; what is the tax treatment of damages? *Raytheon*

*Davis* only addressed tax consequences of transferor:

Husband has realized gain. What about tax treatment of recipient? Problem is that:

1. Cannot “sell” marital rights;
2. Not a market transaction

Divorce settlement damages: use *Raytheon* to determine in lieu of what were damages received. Possibilities:

1. In kind support, food, shelter, clothing, etc.;
2. Intangible support, loss of consortium, love, help @ home w/children;
3. Share of spouse’s property at death-inheritance of elective share rights

Under *Raytheon*, how should benefits received as damages be taxed?

1. In kind support, §102 exclusion as a gift
2. Intangible support, imputed income not within §61 (tax free)
3. Share of spouse’s property at death/ Tax free under §102 and §1014

What is appropriate basis of divorce settlement in kind?

- *Farid-Es-Sultaneh*: Ex-wife sells for $19/share stock received under premarital agreement. Gain?

  Adjusted Basis

IRS: $0.15/share, S.Kresge’s basis (cost) as founder of enormously successful business

Taxpayer: $10/share, FMV on receipt

IRS: Stock was a gift, so donee gets donor’s basis under §1015

IRS loses, TP wins, takes FMV on rcpt. as basis; this is not a gift under gift tax, but not for income tax purposes; the stock is advance negotiated liquidated damages in the event of divorce.

Under *Raytheon*, damages are for tax-free benefits, so they’re not taxable and TP gets basis = FMV at time of transfer

Kresge should have paid tax; if buying a release from marital claims w/ appreciated property, buyer should pay tax on realized gain.
Congress response to Davis: §1041
No gain/loss shall be realized on a transfer of property from an individual to a spouse/former spouse
Non-recognition of gain realized on marital transfers; “former” spouse applies to any transfer within (c)(1) 1 year or (c)(2) related to cessation of marriage
§1041(b)(1): Property shall be treated as acquired by transferee by gift
§1041(b)(2): Basis of transferee in property shall be adjusted basis of transferor
§1041 does not follow Sultaneh b/c it gives transferee a carryover basis
Why did Congress “stick it” to ex-wives in this manner?
This is not a matter of tax deferral, but tax reduction; §1041 gives separating spouses the power to shift appreciated property to the lower bracket spouse; b/c wives are often @ lower brackets, they have less liability under §1041 than Sultaneh; this also gives divorcing couples more $ to split up b/c donor no longer pays taxes.
Also, the rule of Davis was counter-intuitive to taxpayers; although substantively using proceeds to buy release, intuitively it feels like having $ taken away; people did not recognize payment of divorce settlements as gains in reality and pay taxes; IRS never got anything under Davis rule.
Treasury begged congress to adopt §1041, b/c collecting from spouse @ lower rate is better than collecting nothing; after Davis, people lobbied for community property statutes

Support and Maintenance to Former Spouse
- Pre-1942: Tax-free to recipient; not deductible by payor
  1942: §71, “Alimony” is gross income to payee
    §215, Alimony is deductible by payor
Explanation for flipping liability around? Major change in income tax in 1942; began to reach mass % of population (formerly only 5% of population had income tax, now 60% had income tax)
After mass tax imposition, ex-husbands were liable for alimony tied to pre-tax earnings; once suddenly subject to income tax obligation, crushing burden was imposed
Hypo: 30% income tax, 40% alimony left only 30% after both payments
This led to allowing deductibility for alimony payments; that way both husband and wife are taxed on the resources that they can actually consume or save.
1984: Congress changes definition in §71 of alimony
IRS cannot determine nature of all spousal support, b/c impossible to administer
1984 definition of alimony: formalism/simplicity
5 requirements: §71(b)(1) for alimony definition
  1. Cash payment
  2. Divorce/separation instrument
  3. Not allowable as deduction under §215
  4. Not members of same household
  5. No liability to pay after death
If parties say nothing, alimony rules apply, payee includes, payor deducts; parties are free to choose otherwise; parties can agree to have party in the lower tax bracket include the alimony; if payor is lower bracket, payee can exclude
This allows parties to minimize liability by negotiation
§71(f) recapture limits: If divorce settlement calls for lump sum payment and payor doesn’t have $ to pay, payor must pay in installments, receives different tax treatment than alimony. If there is a massive drop off in payments, §71(f) recapture rule is triggered. Will lead to reversal of tax treatment in following years.

Parties can switch tax treatment from continuing support to property transfer.

§215: Payor deducts
- §71(a): Payee includes

Definition of alimony has nothing to do with purpose, it’s **formalism**. Property settlement typically results in no deduction for payor and no inclusion by payee, but only carryover basis; should advise client that if they want deductible property settlements called “alimony” for tax purposes, they should pay in equal installments over 3 yrs.

- **Bernatschke**: question of alimony versus annuity

### Child Support
- No deduction for payor, no inclusion for payee; deductible child support? Allowable if “alimony” criteria are satisfied
  - §71(c)(2): Congress concern about deductible child support
  - If there is a clear association of change in “alimony” intended for child support, it becomes non-deductible

### Costs of Producing Income (Deductions)

#### Business and Investment Expenses
- **Welch v. Helvering**: Corporation fails, owner voluntarily pays off discharged debts from bankrupt corporation; wants to deduct as ordinary/necessary business expense, claims deduction.
  - §162(a): IRS claims deductions are not authorized under express wording of §162
  - “Necessary” means? According to Cardozo, “appropriate and helpful”
  - What persuaded court to avoid common usage? By using “essential” standard, courts are entitled to second guess every business expense; contrary to free market principles, courts should not meddle in business world so much
  - “Ordinary” means? Common or typical; Welch considers “common business world” not common to the specific taxpayer
  - Hypo: During 1st month in business, are start up expenses non-deductible b/c they’ve never been spent before?
  - But common or typical could also include non-business related expenses that are commonly spent by taxpayer
  - Cardozo concedes that under relaxed standars, pay off of discharged debt was “necessary” but not “ordinary” or deductible

**Why not ordinary? Possibilities**

1. Payments were to maintain good business reputation, but TP failed to prove §162(a)
2. Payments were to **acquire** or **improve** a good business reputation; §263 disallows deductions for permanent improvements/betterments to improve reputation
3. Payments were to maintain, acquire or improve **good personal reputation**
§262: Considered consumption, personal, living or family expense; maybe he was trying to buy his way back into high society

§263: Not consumption, so deduction is eventually allowed, just not at the present time Deductible later by depreciation (167-68), loss(165), sale/adjusted basis(1001(a))

In retrospect, Cardozo’s opinion reads nicely, but it’s unclear; Welch has been reinterpreted by Supreme and lower courts.

If expense creates future income, present deduction is not allowable: §263 disallows under timing rule

Problem raised: cost of law school books/education; when it comes to education costs there are 3 problems raised:

1. Skills maintenance: CLE costs are a requirement to maintain skills and are deductible under §162(a)
2. Qualifies TP for new trade or business: Law degree gives lifetime benefit under §263, maybe it should be deductible over course of legal career; why not allow depreciation; presumably appropriate tax treatment under §167
3. Recreational/Entertainment: Not deductible under §262

If cost recovery is allowed for investment in legal education and it cannot be sold thru adjusted basis, why not tax thru depreciation? Why not treated this way? B/c an education is not property and cannot have a basis. W/o basis, cannot have depreciation.

**Public Policy Disallowance**

- **Tellier**: Criminal securities fraud/mail fraud charges incurred $23K in legal fees §162(a): Necessary expense? Under relaxed standard, staying out of jail is useful and helpful. Ordinary Expense? Common in the business world to hire a lawyer when charged with a crime

Supreme Court finds legal fees to be ordinary/necessary under Welch v. Helvering standard.

§262 could intervene to disallow b/c staying out of jail is a personal expense

What was source of criminal charges? These crimes grew out of TP’s work/business as securities broker; Gilmore origin of claim test

Origin: Judicially created exception to business expense allowance of §162

After Tellier, Congress asserted its authority to determine what is deductible. Tellier is a narrow judge-made rule; cost of defending criminal charges arising from business activities are legit business expenses within §162

Common to defend from criminal charges; tendency to undercut enforcement of criminal laws.

Congress can allow/disallow deductions as it chooses

If Congress is silent, normally courts allow in limited circumstances

Only if disallowance would frustrate policy proscribing conduct has Supreme Court upheld disallowance.

Tellier: Deductions are not allowed for payment of fines and penalties b/c this would reduce the intended effect of a penalty

§162(c) thru (g) various deductions disallowances

§162(g) settlement of antitrust strike is deductible b/c there has not been a violation as a matter of law; only when criminal

§280: Drug dealer’s distribution expenses are not deductible
Congress message of §162: Wants the courts to get off Congress’s turf; wants to end the judicially created disallowance; all business expenses are deductible unless Congress says they’re not.

Mazzei: Counterfeiting scheme: people in the counterfeit scheme had money stolen from them; tried to deduct as a loss under §165; loss incurred in profit making
IRS: this sharply undercuts policy, no deduction; this case is after Congress intervened; Possibly §162(c)(2): But Mazzei is claiming deduction under §165, claims that it doesn’t fall under statutory disallowance keyed to §162(a)
Court says: Where Congress intervened in §162, wanted to second guess business expense deduction, but judge made exceptions are blocked by §162, survive outside of §162; maybe Congress should have cross-referenced more than §162(a)

Capital Expenditures & Depreciation, §263

- *Mt. Morris Drive-In*: Ordinary repair §162 versus improvement §263 is difficult to discern

  Tax Court arguments:
  1. Initial part of Drive-In Construction if paid initially
  2. Drainage system can be seen as separate piece of property, long-lived

  Tax Court Dissent: Same drive-in, same physical life, same capacity, repair only; doesn’t expand physical life or capacity

  CA6 Appeal
  Majority: Doesn’t expand capacity/life of property; tax court dissent is concerned with capacity/life is misplaced; should be concerned with extending economic life of property. Neighbor was suing for an injunction, so economic life was extended.
  *Mt. Morris* hypo: Getting a faster computer processor may not expand physical life, but it does expand economic life of computer

  CA6 Dissent
  Wrong b/c if TP pays settlement for past, present & future damages, the payment of future damages is the purchase of an easement which is a capital expenditure

- *Idaho Power*: Current §167(a) dedn for depreciation versus improvement under §263

  Pickup Trucks & Vans: If a truck is used for capital expenditure, that will create future income for 30-40 years, despite wearing out, the truck is a cost of producing income for 30-40 years; different from using a truck to read meters (ordinary/necessary expense)
  Suppose TP contracted w/ construction co to build facility, cost of trucks figured into capital cost, not presently deductible, using one’s own equipment to build capital should be treated the same way; neutrality between self versus hired construction;
  Policy of §263: proper matching of costs of producing income w/ the income it is producing
  §161: Deductions allowed in Part IV (itemized deductions)
  Subject to exception in §261 and following (ergo Idaho power loses)

- Capital expenditure cost recovery
  §263: No deduction now
Basis: (1) §1012 cost; (2) §1016(a)(1): improvement of existing piece of property; cost of improvement added to adjusted basis
1. Property wears out through use or over time, then entitled to depreciation/amortization deduction, §167(a), §1016(a)(2)
2. Basis offset on sale, computing gain/loss on sale §1001(a)
3. §165 loss deduction; §165(a),(c)
   Trucks used to build new plant are not deducted but added to the adj basis under §1016
   §167(a): There should be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (incl reasonable allowance for obsolescence)
   §1016(a)(2): Proper adjustment made for exhaustion, wear & tear, obsolescence (matches §167)
   When depreciable property is later sold, §167, 1016, 1001, and 165 all work in conjunction
   §165(c): Deduction limited to loss incurred in business; transactions for profit; loss arising from fire, shipwreck, etc.
   §165,167: If property is used for consumption, loss is not deductible

VI. Expenses Not Productive of Income

Distinguishing Consumption
- Income = Consumption (§262) + Savings (§263);
  Capital expenditures are an accumulation in savings and are taxable income
  Accelerated depreciation: designed in 1962 as a tax reduction and deferral bribe to get businesses to invest in more capital

Child Care
- Henry Smith: §262 overrides b/c childcare is an inherently personal expense
  What other conditions are implicit in the language?
  Accrual: when have events occurred to fix obligation
  Incurred: when cash arrives
  §162(a): Child care decution prevented b/c costs are not incurred in actually “carrying on” the cost of advancing business; despite being business related, childcare is an adjustment in personal life that doesn’t advance one’s job.
  Does this make sense as a matter of tax policy?
  What if the mother was forced to work out of necessity rather than a career woman making a choice to have children?
  Cannot make case by case determination that is reliable; need an all or nothing objective rule that minimizes unfairness; Henry Smith found child care an inherently personal decision, deductible for nobody
  Today that rule is probably fair, given the number of working women and better birth control options; back then fewer worked and had children by choice.

Clothing
- Pevsner: Clothing costs are personal; even if used for business under §162, still overridden by §262
  TP argues: modest means, middle age, devoted to family, don’t wear fancy clothes off the job, not a personal expense, but exclusively necessitated by business
Again hard to analyze on case by case basis; elect to use conventional/generalized standards of what constitutes personalized consumption.
Costs of uniforms not usable off the job b/c extra expense is exclusive to the job
Nice clothes only used for work; could be used off the job; non-deductible b/c of administrabilily concern

- Problem Set 9, #1: Is commute to work deductible? No b/c not carrying out business interests, requirement not met; the definitive term is “in” carrying on not “while” carrying on; cell phone call while stuck in traffic is deductible, but driving cost is not deductible; also TP could have lived across the street; problem b/c this assumes that work location is fixed but residences are variable; what about poor blacks who can only live in N. St. Louis but who can take jobs in many places (but not N. St. Louis b/c there’s no jobs there)? Presumably cannot achieve complete justice on a wide scale; can’t analyze case by case; must make a choice that minimizes unfairness; assume work location is fixed.
- Set 9, #2: Traveling expenses for out of town business are deductible incl meals & lodging under §162(a); why is this/should this be deductible? B/c this housing expense duplicates already existing housing expense at home; what about meals on the road? On principle, meal costs should be deductible to the extent they exceed cost of eating at home; this was the traditional rule; difficulty w/ theoretically correct rule led treasury to beg Congress to deduct everything; §274(n)(1): amount allowable as deduction for food & beverage shall not exceed 50% of the amount for such expense; 50% disallowance is a compromise; easier to assume there is some add’l expense w/ business travel but also some clearly personal consumption component of eating on a business trip.
- Set 9, #3: Meals on a day trip are not deductible b/c it’s not an overnight trip; different interpretation for transportation b/c there is no arguable personal consumption component in out of town travel on a day trip; don’t need §162(a)(2) or (3) to allow transportation deduction b/c it’s covered under §162(a) in general intro clause.
  *Old Colony* analysis: transport btw one business location and another is exclusively needed to earn $$.
- Set 9, #4: What about 8 months of hotels/meals on out of town business? Isn’t there some inherent consumption component? Yes, but TP still needs to pay for home. How long can a trip become and still be deductible?
  At some point, an extended stay would stop becoming a business trip and become a permanent relocation; 1 yr became the cutoff; if anticipated duration of new job site was 1+ years, none deductible; but if expected time at new job location is less than 1 yr, still deductible? §162(a)(3), Congress does away w/ prediction and just made an actual 1 year requirement
- Set 9, #5: If TP moves to live halfway btw work place and client, the cost of daily travel is not deductible for either city
  How to advise as client: Let her have an office w/ clients in middle location, then she gets travel deduction for both cities
- Set 9, #6: Is a Concorde flight lavish under circumstances? If TP needs to get to Europe ASAP, maybe deductible; IF TP doesn’t need to be there for 2 more days, maybe not
Concorde is transportation, not meals & lodging under §162(a)(2), so lavish & extravagant limitation only applies to meals & lodging; transport not covered by this limitation.

§274(k)(1)(A): lavish/extravagant limit on all business meals

Litigation Expenses

- *Gilmore* is the other side of *Raytheon*

  Hypo: car accident damages payment; if done for sport or in home to work commute, not deductible, but if from one meeting to another, deductible

  *Gilmore* hubby had to defend against wife’s divorce claims to protect his stock shares

  §212: expenses for production of income from investments; Gilmore TP claims deduction for production of income under §212; divorce expenses still an adjustment in personal life, not a cost of *carrying on* income producing activity

  Supreme Court reads in §162 “carry on” requirement into §212, wants parity btw business and investment related expenses.

  **Deductibility of legal fees depends upon the origin of the litigated claim rather than upon the potential consequences of success or failure to the taxpayer’s income status. When origin is TP’s marital problems, no deduction allowed.** (but, but/for financial interest to protect, legal fees would be much lower)