

FEDERAL INCOME TAX OUTLINE

Norms of Tax Policy

1. **ECONOMIC NEUTRALITY**- tax law should interfere as little as possible with economic decision making (should still maintain same work vs. leisure, spend vs. save, consume vs. invest regardless of tax)
2. **FAIRNESS**-vertical equity-persons in different circumstances should be treated differently (Regression, proportionality, progression)

-for economic neutrality-if there was a head tax (flat dollar amount for everyone; for example, everyone pays \$20,000 a year), this would completely satisfy

problem-unacceptable societal, unfair (violates vertical equity)

-standard for vertical equity-progressive system (proportion paid in taxes increases as tax increases) (flat rate tax-same proportion, regressive-reverse what we have done, tax rate decreases as income increases)

-debate typically between progressive and flat rate

-why is progressive chosen?

1. benefit based taxation (income > benefit)

problem: is income really showing how much benefit you get?

2. Low income people more affected by tax system, it takes away from their essentials
problem: could address this in other ways, by allowing a liberal exemption, such as the amount necessary to stay above poverty line

3. Make up for unfairness of other elements of the tax system (sales tax, SS tax, etc.)

4. Ability to Contribute to the System/Pay

This could also be addressed by flat rate with exemption among

But at higher rate, less burdensome for B. Gates than for people to pay less

Point at which extra income is less valuable (decreasing utility) (is this really true with money though?)

5. Norm of equal sacrifice?

Problem Set #1

1(a)→ § 1(c)- “unmarried individuals-there is hereby imposed on the taxable income of every individual...”

-no statutory definition of individual-Congress is silent-what to infer from this

-every individual-any human being, Keisha fits this definition, so 1c applies

-How do we know if this is what Congress meant?

Congress could have defined the word but didn't

First Principle of Statutory Construction: Absence of a statutory definition implies that it should be interpreted according to common usage/ordinary understanding of the words

Congress probably intended it to apply to an infant

-but this has practical difficulties (can't write check, etc.)

-§ 6012(b)-filing returns on behalf of incapacitated persons, etc., therefore Congress intended *everyone*, even incapacitated people, to pay taxes

Assumptions: 1. Keisha is an individual; 2. Interest on government bonds is “taxable income”; (compare § 61(a)4 with §103(a)-interest of state and local bonds excluded from GI); 3. “of” every individual-connotes ownership

1(b)→ Why does it matter if Keisha or her parents pay the tax?

They have \$50K other income + 3500 bond interest= \$53500 taxable, so their tax for that is 5535 + 28% of the excess over \$36,900 (so they'd be paying a 28% IR on the 3500, which is \$980) vs. Keisha-only 15% on \$3000 under 63(b), (c)(5), and 151(d)(2), so she'd only have to pay \$450

1(c)→Tax reduction strategy for middle and upper income taxpayers-spread money around to lower tax brackets is the message sent, but this is limited by 1(g), in that minors under age 14 are taxed as if parents income.

Net unearned income=2500 (500 deduction)=300-2500=500*.15=75 dollars

Allocable parental tax= 50000+2500=52500

.28(2500)=\$700

-this is still less than parents would have paid, but more than Keisha

-purpose of 1(g), kiddie tax-if you shift income to children, you avoid the tax, so Congress is suspicious (this doesn't apply to earned income)

-this only alters the rates/Keisha is still the one liable to pay the tax

-what if mom, dad, and keisha all buy jointly and file on Keisha's return-Congress meant ownership as defined by benefit, align tax to those who benefit from it; Even though Keisha's name is on the account, does she really benefit?

-ownership=benefit/control

-2 limits on abilities of parents to shift income:

1. 1(g)-kiddie tax

2. beneficial ownership

2. Working overtime-"can't afford to be pushed into a higher tax bracket"
makes 36,900 dollars and overtime he'd make \$2000

a. $36,900 \cdot .15 = \$5535 \rightarrow$ net income = $36,900 - 5535 = \$31,365$

b. $38,900 = 5535 + .28 \cdot 2000 = \$6095 \rightarrow$ net income = $38,900 - 6095 = \$32,805$

-only excess income (over what tax would have been in lower tax bracket) is subject to the higher rate, so you can never be harmed by earning more money

3.(a) § 11-tax imposed on every corporation→is a municipality a corporation?

- § 7701(a)(3)(c)→"the term corporation includes associations, joint stock companies, and insurance companies." **The language "includes" is not exclusive/doesn't exclude**

3(b)-Gross income does not include income derived from public utility or exercise of any essential governmental function of state/political subdivision or income accruing to any possession of the US. Probably no tax because it is not considered gross income

(c)-not an essential government function/possession of the political subdivision?

-U City doesn't pay under § 11 b/c not an individual

Issue: §11-corporation? Is U-City a corporation?

No definition in §11, look to § 7701

§ 7701-corporation "includes"-list not exclusive

-gives three examples but even ordinary business is not included, so this means others can be

-means vs. includes-means-closed set; complete vs. includes-open set, not complete
why? Common usage

-what about a municipality ("incorporated"-same structure, fictional legal entities

-does this mean Congress intended to catch municipalities?

-§ 115 says “gross income doesn’t include” for municipalities, which leads to the necessary assumption that because there are two types of income not subject to the tax, then others are (if Congress took the time to exclude types of income, they would otherwise have been taxed

-Therefore, municipalities are considered corporations because that is the only way they would be taxed (not individuals)-negative implication of § 115

-Does U-city pay tax on interest income?

-no definition of public utility or essential governmental function

-obviously not public utility under common usage

-essential government function-is money management of tax excess funds necessary? Didn't have to invest them

-therefore, it is questionable whether they would be subject to the tax

-what is meant by essential? Absolutely necessary? Really important?

-RESOLVE BY CASE LAW

-IRS said early on that it is not taxed (Congress didn't want to interfere with traditional government functions)

Look to statutory definition, if none→common meaning

What if U-City appropriates a bank?

Essential governmental function? Common usage-history/tradition-running a bank is not a governmental function

Ambiguity is ultimately resolved by courts

What would courts look to? Precedent, legislative history, purpose/policy of statute

§ 115-no legislative history

-inferences of purposes of § 115-don't want federal tax collector to interfere with essential state and local functions→intergovernmental tax immunity/federalism

Hypo: College town, government raised revenue without taxing citizens by expropriating restaurants, bards, etc. and tax transients, not residents

-This is a corporation subject to tax (probably not an essential governmental function)

-competition would have to pay tax, city could lower prices, competitive advantage; violates **economic neutrality** and distorts the market

4. TP paid \$5000 in dividends on GM stock. Tax if:

a. US citizen and resident and dividends on US stock

-“on taxable income of every individual”

-§ 61-gross income includes all income from whatever source derived including dividends

-yes

b. US citizen and resident, paid by French corporation-yes

-“from whatever source derived” (source of income is irrelevant)

c. US citizen living in England and paid by French –yes

d. If only looking at § 1, yes, because any individual but 2(d)-only applies in 871 or 877

“resident alien” in 4d implies that residents aliens are taxed (implies that general rule applies)

US Citizens and/or residents pay tax on worldwide income

“individual”=every living human being everywhere is potentially subject to US income tax

e. Non-resident alien-2(d)-taxable only under § 871 or § 877

§ 871(a)-30% from sources within us, certain, not effectively connected with conduct of US trade or business types of income (periodical income)-expressly include dividends

-§ 871(b)-if engaged in trade or business within US, 1 or 55 rate schedule

-what is not taxed? Income not connected with US trade or business AND either not from US or not specified type → not subject to US income tax

§864(c)(1)b-not engaged not “effectively connected” so § 871 b doesn’t apply

1. is stock from sources within US? 2. periodical (dividends), 3 is satisfied

SO, THE FOLLOWING ARE SUBJECT TO TAX: citizens, residents, US income

(US and other countries have signed treaties to avoid double taxation) and usually give full credit to taxes you pay to foreign government

Problem Set #2

Role and Value of Deduction-subtracted from gross income or adjusted gross income (credit reduces tax dollar for dollar)-people have incentives not to get taxed on money

non-itemized deductions vs. itemized deductions-non-itemized listed in §62(a)

(standard deductions vs. itemized)-itemized are all those above the standard deductions, so they only matter to the extent they exceed the amount of the standardized deductions

(standard deduction is a flat allowance for personal deductions)

3. Deduction vs. Exclusion-exclusions-don’t even include in gross income

4. Deduction vs. Credit-credit-absolute dollar amount taken out of taxes (deduction is an amount that lowers taxable income)

-Lower income taxpayer would prefer credit, and higher would prefer deductions

-Value of deductions are higher the greater the income tax rate

-value of a credit is fixed (if refundable)

-Taxpayer support for some type of concession

TP’s attitudes differ depending on bracket

IRS doesn’t care because cost is about same

Recipients for charities depends on who is donating (wash u vs. small church)

-Currently charitable contribution system (credit, not deduction)

Religious organizations and United Way support this

CHAPTER 2: INCOME IN KIND

A. Non-cash Receipts in General

Old Colony Trust Company

Company agreed to pay TP income tax, paid IRS, IRS claims that those taxes were additional income to be taxed separately

ISSUE: Does an employer’s payment of income taxes constitute additional taxable income of an employee? Is a taxpayer obligated to pay taxes when a third party pays his obligation?

YES

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

-this case was in early years of income tax, around WWI, taxed as high as 70%

-no authority for this is cited (tax is not CL or executive, it is the power of Congress)

-tax must be statutorily based

-gross income has expressly included “compensation for services” (§61a)-normally you receive compensation, and he didn’t here, argues not GI because never got anything

-definition of gross income is circular

-fall back to common usage-Does income have common meaning?

Income usually connotes “in”/something being received, and he didn’t

-court: even though no check in hand, he received some benefit, and it was equivalent as if he received it and then paid IRS

-one step transaction is equivalent to the two step transactions and economically equivalent transactions must be taxed the same. (economic neutrality)

-are the two transactions really equivalent? TP may argue that he would have had control over it and done something different with it, but paying taxes are not voluntary; thus this does not hold true, he would have had to pay or had something repossessed

If someone pays off your legal obligations, it is equivalent to getting it and then paying it (only applies to *legally enforceable obligations*)

-legally enforceable debt

-direct payment to creditors is no less valuable than payment to A, A pays creditor

-tax inequities if opposite

-violates economic neutrality because it sends message to employees to have employers directly pay the IRS and tax system would be interfering with decision making and behavior

-violates horizontal equity-most employees are not in a position to rearrange their compensation so some employees would get an advantage (individuals in similar circumstances should be treated the same)

-because this goes against common usage (nothing came "in"), it shows that if common usage conflicts with legislative purpose, we reject common usage. And there are so many indications that Congress didn't intend to create an unfair tax system

Second Principle of Statutory Construction: If common usage leads to a result contrary to the purpose of the statute, purpose prevails over common usage.

-could argue it was a gift but SC says even though it was voluntary, it was still likely to be compensation, CL notion of a gift means not obligated to give it, TP could argue that Er not obligated to do this, but SC says don't import CL property law to tax

-compensation for services is not a gift

-also can argue infinite loop (Er pays tax on a tax on a tax...) but SC sidesteps this argument (should have said that it would end at some point, not an infinite tax because tax rate is less than 100% and that everyone pays a tax on a tax because money used to pay the tax is included in gross income, so everyone pays it-

§ 275a1c2-no deduction allowed for withholdings (compare to § 164 (a)(3)-state, local, foreign taxes deductible

why? Does money you pay in taxes create additional enrichment/value? No doesn't create increase in ability to pay taxes (involuntary disenrichment is the value behind § 164)

-why doesn't this apply to § 275? Inter tax payer fairness is actual policy behind §164 and different state taxes vary widely, so people with the same income have different resources to pay and ability

-federal tax, however, is not a matter of fairness because tax payers are uniform throughout US

-why not allow both? Tax rates that would apply in order to get same amount would be so much higher, even over 200%, which would lead to same result but taxpayers wouldn't be happy

Arthur Benaglia

-manager in charge of hotels, "for performance of duties and convenience of employer," he lived in hotel rooms and got meals from them and his wife, salary was fixed without reference to meals and lodging, commissioner added the FMV of the rooms and meals to gross income
-ISSUE: is the value of hotel managers room and food income to the employee?

NO

-only reason he stayed there was to perform required services, always on duty, couldn't perform otherwise, implicit that he had to do it to do his job, no accounting in hotel's books for his room, meals, etc., advantage is merely incident to performing his duty

-distinguishing factor-need/convenience for Er

-court says on call 24 hours a day, so essential to his duties, **business necessity**

-Majority assumes that the value was de minimis because it was incidental

-Dissent says wrong legal standard, and ought to focus on benefit to employee, look at expenses avoided (he may have not have chosen the hotel and food, so include lesser amount) because better off because he didn't have to buy groceries, rent home, etc. and dissent also looked at original contract which included it so he probably intended it to be part of compensation (bargained for benefit-shows it is valuable), majority's factual premise is wrong because its not really necessary (because he managed other resorts and didn't live there)

Which valuation?

Retail price-7800

Ee subjective value-4600

Cost of other arrangements (expenses avoided)-3600

Employer Cost-doesn't work because want to know individual enrichment

Zero-convenience of Er/Benaglia majority

Horizontal equity-this results in under taxation of Benaglia, compared who makes same amount of money and uses it to pay rent, etc.

Example: TP1 gets \$10,000 TP2 gets 13,600 but doesn't include meals and lodging, Benaglia is more like TP2 even if his "salary" is \$10,000

-also compared to similar compensation, all taxable vs. some taxable (distorts choices)

Economic Neutrality-demand for jobs increases and salaries would decrease, hotels can lower costs

Reginald Turner

-TP won radio show contest, received prizes, including tickets for a cruise, reported 520 dollars, commissioner increased to 2200 (retail price)

-court says 1400 dollars (split difference btn two)-no

-says value not equal to retail cost because he would not have bought them ordinarily, tickets are not transferable or salable, could refuse and avoid the tax, so they had some value

-if transferable, a better value might be FMV, what he could have gotten had he sold them, because if he doesn't sell them, it shows the value to him was more than it would have been

-in kind goods or services

if transferable-minimum enrichment-net resale value

if nontransferable then?????

-why doesn't Benaglia apply and make there no tax? Benaglia standard was convenience to the Ee as a matter of necessity and this is not Er/Ee relationship

but can same rationale apply?

Incidental benefit, objective of radio station was to make money

-why not value equal to expenses avoided (living expenses, some food, pleasure of the trip)

Benaglia dissent says expenses avoided is correct legal standard)...this is basically what the court adopts here

RULE: In-kind

Er/Ee context-convenience of the Er, then not taxable

Other contexts-minimum enrichment of Er/how much better off is he

Haverly

-principal of school, publishers sent him sample books with the value of 400 dollars, he donated them to charity and included in a deduction for the value of the books but didn't include as income when he received them

-ISSUE: Is the receipt of books by publisher considered income?

YES

-Congress can tax *all* gains except specific exemptions

-§ 61(a)-all accessions to wealth...

-receipt of textbooks increased his wealth, intent to accept property as his was shown by his deduction (complete dominion)

-when a tax deduction is taken for donation of unsolicited samples, they must be included in gross income (otherwise he'd get a double tax benefit)

-Did he have GI from books?

-books were transferable, he took them

-value=net resale value, but this is probably minimal

-why does court say \$400 when he is not likely to get it?

-this is how much he claimed as a deduction (over valuation)

-ignore samples because even though there is enrichment it is so small that it doesn't matter (but because he tried to deduct, he is in trouble)

-taxable income is trying to measure enrichment

-correct reporting-include in GI→net resale value and charitable contribution deduction should have wiped out the inclusion

B. Meals and Lodging

Commissioner v. Kowalski

-police officers get cash meal allowance in addition to their salary

-ISSUE: Are the meal allowances included in gross income?

Yes-the police officers have complete control, increased wealth, which is clearly gross income and § 119 doesn't apply, no judge made exceptions anymore

-enrichment-getting cash, don't have to show amount spent on lunch

-undeniable accession to wealth, increases, clearly realized, and had complete dominion § 119-statutory exclusion (vs. Benaglia-CL exclusion)

-statutory exclusion-meals and lodging furnished to him

-but the meals are not "furnished" by the Er or provided in kind, they are given cash

-when Congress enacted §119 it replaced the judge made exceptions, such as Benaglia, so if it is not in §119, you can't exclude it

-“except as otherwise provided in the subtitle”→ shows Congress is the only one who can provide exemptions and deductions

-Even if Congress hadn't replaced this, he would have to show it was necessary for his business

-SC announces in Kowalski that it will follow convenience with the judicial meaning (necessity)

-Congress responded to Kowalski by adding § 119 (b)-don't like distinction between cash and in kind

Sibla v. Commissioner

-LA firemen, 24 hour shifts, not permitted to leave on duty, had to eat at firehouse, common mess system, provided cooking facilities, etc., typically the fire fighter would do cooking, pay out of won pocket, didn't want to pay tax on what they give to grocery cost because they argue it is business expense or excludable under § 119

-deduction and exclusion lead to same result (functionally equivalent)

§ 119→only applies to meals, lodging "in kind" (cash vs. kind distinction)

-lower court said not in kind so taxable under Kowalski

§ 119-IRS interprets convenience of Er as convenient or helpful, not business necessity

-congress wasn't redundant, clearly intended to be more restrictive with lodging

-why did court not address § 119 b(3) in this case? Not a fixed charge for meals (dependent upon what firemen wanted to eat), meals furnished by the employees

Policy: If Er pays A 10,000 in salary and A gives back 9,000 right away, all taxable, but if employer pays A 9,000 up front and provides meals, they are in the same economic position but pay less tax. Congress has always said that economic position must be the same

Does chancellor have to pay taxes? On call 24 hours/day but not necessary that he be physically present

What about George Busch-could argue no because you don't have to be physically present but sometimes having an official residence is necessary (persuasion, etc.)

-Benaglia standard very dependent on specific facts of the case

Problem Set 3

A. Meals and Lodging

1. Benaglia-in kind benefits provided for the convenience of the Er are not income to the employee. Convenience of the Er→business necessity

2. IRS and courts move to limit this exclusion and say if facts indicate it is intended as compensation, it must be included in Ees gross income even if business necessity, only apply Benaglia test in doubtful cases to determine what was intended

3. § 119 enacted to codify treatment of Er provided meals and lodging. §119(b)(1) negates the limiting interpretation ("intended as compensation" approach)

4. Treasury Regulation §1.119-1 interprets section 119 requirements for exclusion: meals must be furnished for a substantial non compensatory business reason of the Er, and must be required to accept lodging as condition of the employment (necessary for lodging, convenience for meals)

**5. SC reinterprets the convenience of employer test in Kowlaksi
Convenience of Er-business necessity**

6. Congress responds to Kowalski by adding § 119(b)(2) and (3)

4. § 107-express statutory exclusion for minister for rental value of a home as compensation or if allowance given, as long as it doesn't exceed the fair rental value of the home.

Why this deduction? Entanglement concern. This was enacted before § 119 and Benaglia

Should Congress amend § 107 to make it consistent with § 119?

-longstanding tax concession available to religious personnel and if you take this away, they may complain to who they preach to

What about a rabbi-free housing? No statutory definition of minister → common usage doesn't help and Congress' intent had to be to include because if only applied to ministers, it would be unconstitutional, so it is applied without regard to religion

§ 107-no distinction for cash or in kind

5. Laugh Church →

6. a. Based on Benaglia, which said that in kind benefits that are produced by Er, business necessity, not taxable because they are for business necessity, could argue income for the other family members, but under § 132(h)(2) it says that spouse and dependent child usage is treated as if used by Ee)

Different values → Retail Value (IRS would argue this)

Expense Avoided (value if he would have had to provide it)

§ 61(a)(1) includes fringe benefits but not including the following

GET NOTES FOR THESE PROBLEMS

8. 5% discount for Ees multiplied by the number or years worked, but not exceeding 60%

§ 132 → purchasing goods

§ 132 (c) → qualified employee discount

-gross profit percentage=gross markup (average markup %)

-hardware store=5% per year, gross profit=15% if between one and three years, you can get the Ee discount tax free, but 4+ years=only get discount tax free of 15%, pay tax on the extra
§ 132(j)-must be substantially same term to a group of employees in order to apply to highly compensated employees. The group of Ees must be reasonable classification that doesn't discriminate in favor of highly compensated employees

-probably no problem with definition of a group, but issue is same terms? Could argue yes because everyone under the same terms with the arrangement or no because the highly compensated employee has more years of service

-is the nondiscrimination requirement formal or do we look to operation of it?

-it applies to both the formal/organizational and the operational/practical

-so president would pay taxes on the entire discount

8b. issue becomes number 2 (does everyone qualify-no; have to have four or more years)

this group is probably not "neutral" and doesn't apply to all

-is this reasonable classification that doesn't discriminate?

-all nondiscrimination issues usually examine: amount of benefit (ex: same terms) and coverage/eligibility of program (certain group defined)

-look at proportions of highly compensated compared to not and usually if greater than 70%, then it is discriminatory

-policy-highly compensated employees are the ones that establish the terms of the program and this may be a way to shift compensation

-vertical equity-higher not paying proportionately (instead paying less) than lower paid workers

-perception of fairness, need it from the masses the most

B. Fringe Benefits

- statutory rules for exclusions for certain fringe benefits
- may employees receive goods and services at discount or free which Er sells and this has long been treated as not taxable even though they receive an economic benefit, employers have reasons other than compensation to encourage employees to avail themselves (clothes stores, etc.) that are not merely to replace cash compensation
- also want clear guidelines in the law
- without any limits on compensation tax free, there is a huge loss in tax money and shift tax burden on those who receive only cash (economic neutrality, horizontal equity)
- nondiscrimination rule-most fringe benefits may be made tax free to officers, owners, highly compensated Ees only if they are substantially on equal terms to other Ees.
- fringe benefits excluded from gross income: no additional cost service, qualified Ee discount, working condition fringe, de minimis fringe, qualified tuition reduction
- any fringe benefit that does not qualify for exclusion and not excluded under any other express part in code is includible

C. Imputed Income

- results from investment of capital or performance of services for personal or family use
- no effort to tax generally

1. Owner Occupied Housing-Invests funds, rents to someone else→ taxable income in rent
When TP lives in house herself, it is omitted from taxable income (imputed rent) (even though in same situation as she would have been in each case)
2. Other Consumer Durables-investment in cars, appliances, boats, jewelry, paintings, etc.
-impracticable to tax all of these things
3. Household Services-care of home, meals, children-substantial component in total income and deduction but commonly considered that difficulties of valuation would be too hard
4. Leisure- (time not working)
5. Borderlines-if two homemakers to laundry and cooking, no taxable income, if one does one and one does the other, each compensated and taxable on value

D. Alternative Formulations

Another formulation starts from observation that you can't include everything and taxable income should be thought of as money income plus any income in kind that is necessary to avoid distortion→doesn't embrace production within the home and consumption within the job

E. Deductions

- deductions-would result in same if uses fees to pay cash to trip and same as if someone else paid tax free, so exclusion of fringe benefits and deduction of business expenses lead to the same thing

F. Microeconomic Effects-Omission of non-cash items in computation of taxable income is unfair because it imposes a smaller burden on same taxpayers that may be in similar situations

G. Taxing Employers in Lieu of Employees

1. Withholding-if non-cash items is wages subject to withholding, the government can proceed against an Er on basis of Ers duty to withhold and pay over to government-is this the most practical way to deal with fringe benefits?

2. Other Possibilities

-tax employer in lieu of employee? Deny an employer deductions for fringe benefits not reported as income to the employee

-excise at a specified rate based on value of fringe benefit not reported as income

Problem Set #4

1. Each have 200,000 in savings, each in 30% tax bracket

-TP invests in house which she uses as her residence and will sell for 200K in 20 years

TP2 invests in corporate bonds that pay 10% interest and principal repayment in 20 years, invests the 20,000 in a house

a. TP1-not taxed on anything-imputed income, TP2-taxed on interest and no deduction for rent

b. How to equalize-don't tax either or tax both (allow rent deduction or make TP2 pay for rental value of the house)

-to tax both, problem with enforceability and administer

-to tax neither would will create a loss of money, incentive for investing in housing in general rather than food, clothing, etc. (more wealth→violates economic neutrality)

-message to TPs-tax based preference for owner occupied housing

-two step versus one step (old colony) and violates economic neutrality and horizontal equity

2. TP3-married, same job, two children TP4-married, same job, two children

TP3's spouse stays at home, TP4 works, 30,000 salary but would cost 18,000 for childcare

-TP3-say income each 50,000, taxed 25,000, after tax-25K. TP4-80,000 salary, 40,000 tax, 40,000 after tax-18,000=22,000 after tax. In order to work, she'd have to make over 36,000 because the tax on that money would be the cost of childcare

-cost of childcare is not deductible (§ 262)

-could: credit childcare costs/deduction or tax both

-tax both-how to administer? Hard to determine value of parents work

-makes sense to take job at time your income is greater than the value of your service at home

-Congress has tried to do this (§ 21-partial credit)

-value of deduction depends on TP overall income, credit independent→

Congress wanted to do this because wanted lower income to benefit more

3. Services are paid for services- FMV of them

-when TP cuts his own lawn-imputed income, when he cuts his neighbors-no income

-when neighbor cuts his law-payment for earlier services so taxable (not imputed)

-GI includes payment for services with services-

-gross income=500 dollars (half is imputed, half getting paid)

-Where do we draw the line between imputed income and gross income?

-once there is payment for services the line is crossed

-what if TP's daughter mows lawn? Members of household performing services is imputed income

-message-if you want something done tax free, do it yourself (or have family do it)

-debatable place to draw the line→identical services (such as carpools)-IRS announced as a matter of prosecutorial discretion, they would not tax carpools (and IRS only tends to enforce services for services when large scale abuse)

COMPENSATION FOR LOSSES AND RETURN OF CAPITAL

- income-central characteristic is gain (sale proceeds taxed only to the extent that they exceed prior investment)
- amount realized, adjusted basis, FMV, cost

Clark

- TP had a deficiency because improper deduction on loss of sale of capital assets for more than two years, upon doing so realized that tax attorney messed up by having them file jointly; attorney compensated him for a loss from giving him erroneous advice (settlement) and issue as to whether damages are taxable
- commissioner said this was taxes paid by a third party and so it was income by Old Colony Trust rule, but TP says they were compensation for damages
- Court→taxes not paid by anyone else, he paid legal obligation, payments for settlements of breach of promise to marry, injury to reputation, libel, etc. are not income because it is not “derived from capital, labor, or both combined.”
 - Distinguish from Old Colony Trust-source of liability was income tax whereas in Clark the source of the liability is the action of the lawyer.
- third party payment of something caused by the third party is not gain or enrichment**
 - focus of income→ gain or enrichment
- what if TP2 filed but didn't have a lawyer-he would be liable himself, couldn't sue for malpractice
 - same liability/same resources
 - violation of vertical equity

Raytheon

- is an amount received by TP for damages under antitrust laws taxable as income?
- RCA-claim against Raytheon for failure to pay royalties,
- Raytheon-claim against RCA for antitrust
- 410K-60Kpatents→350K compensation for antitrust injuries
- issue→how to tax 350K?
 - no money changed hands but Raytheon still has to pay 350K in tax never received
 - why taxing/no money?
 - Old Colony Trust-as if Raytheon received damages and turned around and paid out to RCA (2 step vs. one step process)
- TP said-realization from a chose in action (damages from a legal claim so not taxable under Clark)
- IRS says too broad to say damages are all tax free

Court: Antitrust suit, RCA paying for profits lost, if they would have used the profits, they would have had to pay taxes on those

- but for RCA's illegal conduct, they would have paid taxes
- Raytheon says they are damages for lost goodwill
 - intangible, goodwill is association with customer lists, TM, trade name, location
- What would have happened had Raytheon sold out to RCA? Profit would have been taxable
 - § 61(a)(3)→ “gains” derived from dealings of property (not proceeds), only to amount of increase in resources
 - § 1001(1)(a)→ on sale or other disposition of property, how to compute gains/loss

**amount realized-adjusted basis of property sold/gain
(total sales proceeds)=amount realized
(cost/amount invested)=adjusted basis
-only tax gain/enrichment**

- so if RC bought the whole business, it would pay some amount for goodwill
 - RCA stole the business, if ordered court to pay for it, (involuntary sale of business)
- Raytheon is essentially getting money for sale of business, even though it was involuntary
- How to tax proceeds of involuntary sale? Old Colony-must be taxed same as voluntary sale therefore, goodwill would be taxed, but not all should be tax, could subtract cost
- but court taxed all 350K
 - recognizes that if compensation for destruction of goodwill, only gain should be taxable but the cost is zero because no evidence of basis, Raytheon started the business so unable to show cost

**Raytheon Replacement Test: IN lieu of what were the damages awarded?
Old Colony Trust-two economically equivalent transactions must treat same**

Glenshaw Glass

- Glenshaw Glass Company, litigation with HE company, machine Mfg, claims-fraud, injury to business by antitrust violation, settlement→800K (324K punitive)
Commissioner-all is taxable (Glenshaw didn't report punitive)
- court says punitive damages are taxable as income (Congress intended to exert full measure of taxing power)
 - punitive damages→ windfalls would result of culpable conducts of third parties "from any source whatever"
 - undeniable accessions to wealth
 - liberal construction
 - undeniable accessions to wealth, clearly realized, TP has complete dominion (look at perspective of TP)
- § 22-reenacted a case saying not taxable but court said the commissioner has consistently held taxable, it is a simple definition not an exception

Problem Set 5

1. Breach of Employment-in lieu of his salary/would have been taxed→yes
2. Wrongful destruction of property→ forced sale—would have made 100K so that is taxable
3. Malpractice damages-no, not taxable, replacing taxable income already
4. breach of promise to marry→dower, etc.→ not taxable?
5. Damages for lost of arm
 - a. medical expenses→ not taxable (replacing health)
 - b. pain and suffering→ not taxable (replacing state of mind)
 - c. lost earning capacity→ yes taxable (replacing salary)
 - d. punitive damages-→ Glenshaw Glass windfall

Rules for damages:

- 1. compensatory-Raytheon Replacement Test-in lieu of what were the damages received?**
- 2. non-compensatory-Glenshaw Glass-windfall-gain/enrichment→ taxable**

-in order to carry this into affect, have to be able to sort out factually and find out what the money is in fact compensation for

§104(a)(2)-gross income does not include any damages, other than punitive, received on account of injuries or physical illness

-don't ask Raytheon-all is tax free BUT punitive damages

-compensatory-tax free even if would have been taxed

-rationale-difficult to determine allocation of damages

Structured Settlements

-“whether by suit or agreement and whether as lump sums or periodic payments” (§ 104(a)(2))

Nonphysical Injuries and Non-physical Sickness-§ 104 only applies to physical

a) libel, slander, alienation of affections, loss of child custody

-exemptions in § 104 don't include alienation but issue is whether or not considered income, same with defamation of character (but different with business libel)

-without gain, no income is realized

b)employment discrimination→usually backpay, under statute, confined to backpay and injunctions, not a tort like personal injury so taxable

IRS-exempted Title VII sex discrimination, ADA, etc.

Revenue Ruling 74-77

Loss and alienation of affects for loss of child custody is not income

Punitive Damages

-not received “on account of” personal or physical injuries

Compensation by Insurance

§ 104(a)(3)-no deduction for premiums paid by an insured under disability income policy

Compensation by Employers-payment of benefits when employer pays premiums used to not be taxable but now, self insurance equivalent to company insurance, GI does not include coverage under accident or health plan, but if employer provided plan, benefits from it would be taxed (but § 105 take a good deal of that away, leaving mostly only the income replacement to be taxed)

-Raytheon Replacement Rule vs. § 104(a)2 exclusion→ which controls?

-even if no Raytheon replacement, may be an exception under §104

-Policy of § 104

1. judgments unallocated/general verdicts

-too hard to determine which portions for what

-no rules requiring states to make allocations (this would make states mad)

-would have to have second round of fact finding (inefficient)

-so we should allow some gain/enrichment to go tax free

-why not tax all damages?

-fairness (unfair to tax reimbursement which was already after tax income)

-would create disrespect for tax system/loss of political support

2. lump sum vs. payments

-tax rate goes up with lump sum so average rate of tax would be vastly higher (income bunching)

-unfairness/violates horizontal equity

-but you could find tax on 1/30 and average income over 30 years

- Scope of § 104(a)(2)-personal physical injuries or physical sickness; other than punitive damages (in order to justify punitive damages, the jury usually has to state what amount is punitive so it doesn't undercut rationale)
 - for property damages, etc. → Raytheon applies
- Example: *TP, pedestrian, witnesses her four year old run over by drunk driver, suffers psychological injuries, pain and suffering, lost wages, etc.*
 - car didn't touch, so § 104 doesn't apply; Raytheon does → lost wages and lost earning capacity are taxable (we still apply Raytheon)

PREVIOUSLY DEDUCTED LOSSES

1. Annual Accounting

Burnet v. Sanford & Brooks

- "net operating losses"-contract fees were less than cost of doing the work, lost over 175K dollars, included it in NOL
- S&B sued for breach of warranty of the character of material to be dredged (fraud), appealed, finally SC issue final order, got 175K, IRS wants to include as gross income
- Different types of loss: 1. net operating loss (negative profit), costs over revenues, 2. loss of sale on property (negative gain) § 1001(a); 3. casualty losses (damage or destruction) (negative windfall) § 165(c)(3)
- government says they get the money in 1920, paid no salary, no costs, etc., so no deductions to offset
- TP-says look at entire transaction and it just puts them at even, no increase in resources
 - court of appeals-not gross income if they amend the previous returns in which they deducted the losses (will allow them to deduct this year)
 - in those years, had no taxable income anyway so the deduction won't save them anything
 - ability to pay didn't increase at all
- SC-taxed because don't look at entire transaction, period is covered return is one year
 - calculate enrichment on annual basis (not transactional)
 - § 441(a) → taxable income computed on basis of TP taxable year
- TP argues that even if the statute says this, it's unfair, unconstitutional because its not income, no enrichment
 - SC-16A intended to provide practical reliable revenue source and practicality requires the certain periods of taxing
 - But isn't whole point of income tax fairness of burden?
- Congress' response → § 172(a)-take NOL into next year to offset something
- this was a payment of damages, which is normally governed by Raytheon-in lieu of what were the damages received? Higher K price they would have negotiated if full disclosure, which would be taxable gross income

2. Tax Benefit Limitations

Dobson

- loss on sale of property (fraud in buying stock)
- loss=amount realized-adjusted basis of property sold
- Raytheon → money is partial refund of purchase price because paid too much and was defrauded; previously taxed income would have been used, so NOT Taxable
- settlement proceeds attributable to 200 shares sold in 1930 and 1931

- loss on sale (deductible § 165)
- Real issue → was entitled to loss deduction in those years (he claimed them but had not income to offset)
- if he did get to deduct and benefited, then when he gets his money, we need to tax because he wasn't really worse off and not a lower ability to pay
- inclusionary side of tax benefit rule-error correction device
- but is there enrichment in this case → no b/c didn't save any money with deductions
 - yes, the deduction was erroneous but the error was harmless, didn't save any \$
- exclusionary side of tax benefit rule (limits inclusionary side)
- tax benefit rule (b/c earlier deductions produced not tax benefit, don't have to pay tax)
 - § 172(a) doesn't help because negative gain (not negative profit)
 - § 172(d) → carryover provision only for excess business expense (negative profit)

§ 111-codifies tax benefit rule (sort of) → if you recover amount of a deduction but the deduction did not equal a benefit, then you do not include it as gross income

tax benefit rule-if all or any portion of the prior bad-debt deduction did not result in a tax benefit to TP then you may exclude a portion of recovery to the extent the previous bad debt deduction failed to effect a tax benefit

Deducting Extraordinary Medical Expenses

- if no compensation by insurance or otherwise, deduction is allowed
- OCHS v. Commissioner
- wife had cancer, sent 2 kids to boarding school and deducted cost of it under § 213, wife unable to speak, highly nervous, throat cancer, dr said irritation caused by caring for children, should be separate from kids, in boarding school for five years and when she recovered, they took the kids back home. Tax court → not deductible
- Nondeductible family expense under § 262
- Replacing what? Loss of wives service-H and W got benefit, expenditures also while wife was working
- dissent-if mother was sent away, would be deductible, mitigation of damages, guided by physicians bona fide advice, should look at motive/purpose of TP, advice of dr, relation between illness and treatment and proximity in time
- § 105(a) unlimited and (b) medical care
- if proceeds of group coverage is going to medical care, they are tax free under § 105(b)
- if not, then under § 105(a)
- § 213(d) → Congress' definition of medical care-broad definition
 - consequence-Er provided medical care is tax free, tax based incentive for Er to provide group health care
 - Congress wanted incentive
- Proposal-take away exemption (tie tax free to a dollar amount) to motivate people to lower medical costs and reduce second opinions, etc.)
- § 105(b) doesn't apply to health care coverage other than medical care so proceeds are included in gross income and taxable unless you provide it on your own
- breadth of § 213(d) definition of medical care
- § 213 vs. § 262
- How to handle dual purpose expenditures?
 - a. direct vs. indirect test (no → Old colony Trust)
 - b. Doctors orders (OCHS dissent)(problem-doctor shopping)

- c. But for causation (TP purpose?)(OCHS dissent)
- d. Custom/convention (majority OCHS)
- e. Sort out relative benefits/expectations → allocated expenses
(Ex: cost of boarding vs. tuition)

-single expenditures produce multiple benefits

F. ANNUITY CONTRACTS

-life annuity contract-periodic payments for the life of an annuitant

-problem in taxing: income to recipient but only to the extent they are gain over the cost of the annuity, which may not be known until death

- a. used to be untaxed until the annuitant had gotten back what they invested; then taxed in full
- b. 3% rule-taxable income to the extent of 3% of investment, anything over 3% was taxed on return of capital
- c. exclusion ratio rule-§ 72 (a), (b)(1), and (c)

-gross income includes annuities

-doesn't include any amount that bears the same ratio to such amount as the investment in the contract bears to expected return

-investment in contract-total amount paid for contract-amount received to that point that was excluded from GI

-employee annuities- § 72 (d)(f) → may not be includible in GI of Ee if qualified retirement plan

-depreciation-machine and equipment → declining useful life, allows deduction for depreciation § 167

-Deferred Annuities-partial surrenders or cash withdrawals before annuity starting date are income to the extent that the cash value of the contract exceeds the investment in the contract; dividends are considered cash withdrawals

**See handout for tax treatment of health care costs

-TP gets 1000/year for five years

-cost 3790

5000-3790=1210 → increase in resources/enrichment

Problem: how to allocate receipts between income and return of invested capital

1. traditional → tax free until you get your money back (ROC first)

2. ROC last → tax on gain (1210) and after that its tax free (this isn't practical because you don't know when last is)

3. each payment ins in part return of capital and in part income (pro rata ROC) so that 3790/5000 → 75.8% of each is tax free, so 758 tax free, 242 taxable

4. Back Load ROC-like a loan to insurance company

5. Front load ROC-how much will you charge me today for five thousand dollar payments of next five years? Same is if lump sym payment in one year

-Congress uses pro rata return of capital with the exclusion ratio under §72

1. Exclusion Ratio= investment/expected return

investment=50,000, expected return=16*5000=80,000

50/80=.625

exclusion ratio*each annuity payment= amount tax free

.625*5000=3125 tax free

2. investment=900*25=22500

expected return=80,000

22500/80000=28.125%

Why different results?

- he gets so much less tax free because he paid for so much less
- taxed on enrichment (less invested)
- insurance company had use of his money for much longer when he gives it sooner
- What if you invest the money in your savings account, pay annually on interest you earn even if you don't withdrawal vs. annuity-tax deferral and not fully taxable
 - economic neutrality problem
- if you withdrawal before the annuity start date, treated as ROC last (tax on everything first) (§72(e)(3)(a))

G. PROCEEDS OF LIFE INSURANCE CONTRACTS

1.pure insurance component (term insurance)

-fixed premium for coverage per year

2. savings/investment component

example: whole life insurance-get the amount even if you outlive at maturity, pay face amount

Tax treatment of life insurance

-pure insurance vs. savings

pure/term insurance-proceeds are taxable (old colony and Raytheon)

-reasons to buy insurance-proceeds being used to replace income for families and if they go to replace wages, salary, proceeds should be taxable'

-premiums-return of capital? If purpose is to provide protection, it is a cost of earning income (tax is business expense under § 162(a))

-people also buy insurance on homemakers to protected against loss of caring, so imputed income, should be tax free

§ 101 (a)→ blanket exclusion for insurance proceeds payable by reasons of death

§ 72(e)1→for survivors who outlive the policy term and receive face amount must include as income the excess of the total premiums

CAPITAL APPRECIATION

A. Unrealized Gains

Eisner v. Macomber

-Possibilities for profits:

1. retain, invest to expand business
2. retain, invest and issue stock dividend
3. issue optional stock or cash dividend
4. distribute as cash dividend

-Can Congress tax a stock dividend as income?

-Macomber says its not income

-Stock dividends cannot be taxed as income within the meaning of the 16th Amendment (Brandies says it is a two step process in effect with: 1. cash distribution and 2. purchase of additional shares of stock through subscription rights)

-What is the meaning of income as used in the 16 Amendment?

- majority says gain derived from labor or capital or both
- is this gain derived from capital?

- stockholder doesn't really get anything (same equity investment, so no income)
- Brandeis dissent-reason by analogy. Congress recognized that the board had a number of options and drew the line between taxable and non taxable between two and three above (1 is not taxable, 3 and 4 are taxable, 2 and 3 are too similar to tax one and not the other)
 - might be a difference→rearrangement of ownership portion of equity
- Majority says that difference between one and two are even smaller, more analogous
 - only change in the paper record, no change in ownership
 - substance over form
- Brandeis says Congress could even tax one if it wanted to and when differences are so slight, defer to legislative branch (power to tax income is the power to define income)
- READ THIS IN CHIRELSTEIN
- tax deferral or tax forgiveness?-tax free when received but if he sells for a gain, then it is taxed, *so it is only a timing issue*
- Congress lacks power to tax mere increases in appreciation
- Business Income Taxation Alternatives
 - tax profits of corporation when earned and taxes stockholders on dividends
 - partnerships, LLCs are not taxed but taxed owners on profits as earned, no tax when cash is distributed
- small corporation will likely never pay dividends (will make payments that increase salary which is deductible, or land, or pay rent to LL, etc)
 - mass problem of characterizing payments to SH when they are likely Ees, LL, and lenders to the company
- Tax Policy
 - a)for realization requirement-even though you are enriched and can take advantage of it (can borrow against it, use loan, etc.), there is still a risk that the increase in market value may disappear and income=FMV of property, would have to have appraised yearly, FMV is disputable (practicality, administerability)
 - but with principal assets (stocks), it is easy to find value
 - liquidity problem-how will TP pay tax that he didn't have money for (if no realization requirement and annual tax, may force sales, people would be mad→ this is politically infeasible)
 - b)against realization requirements-if taxing year by year for increase in property, if value you goes down, you can deduct and many states already appraise property and assign values
 - inequality in timing (horizontal), if both same amount of stock in corporation and A distributes as dividend, B retains and invests in business, both have the same "income" but only A is taxed
 - message: invest in low dividends companies that don't pay money in dividend but have greater retained earnings
 - this benefits wealthier people because they can afford to buy stock and focus on LT growth.
- Congressional Response- § 61(a)(3)-"gains *derived from* dealings in property"→income means gains derived from, which indicates there must be a realization
 - key: what is gain (§ 1001(a))-timing rule

B. TIME VALUE OF MONEY

- deferral may turn into exemption if TP never sells or realizes gain on sale
- present value of money payable at some future date is less than a dollar due today (time value of money)

1. interest-can defer, value of deferral depends on how soon tax will be paid and how TP employs funds (but interest earned may itself be subject to income tax, which depends on the rate of tax)
2. present discounted value-discount is just a way of describing interest
3. After tax returns
4. Effective tax rate-after tax rate of return on investment
5. tax deferral as a course of capital
6. fruits and trees-
7. equivalence between tax deferral and yield exemptions

C. INTEREST AND BOND DISCOUNT

- put money in bank account, let interest pile up→taxable (constructive receipt)
- zero coupon bonds discount-interest will diminish with time as value rises. Taxed?
 - measured in terms of cash and then converted into equivalent rate of interest
- bonds-allocated interest based on compound interest because income should be less in earlier years because TP has less
- why difference in interest and dividends?
 - creditors entitle to money, shareholders only get what corporation decides, interest deductible by payor

D. REALIZATION

Macomber- need realization of gain as precondition to taxation (limited view of realization)
 Subsequent cases-may be found in events less indicative of profits than stock dividends
 (Helvering)

Helvering v. Bruun

- TP-lease lot of land and building for 99 years, lessee could give bond and remove or tear any building. Lessee to surrender land and all buildings at end of term; tenant demolished building and erected a new one in 1929
 - 1933 lease cancelled for default
 - building newly built, FMV-64,245 dollars
 - old building FMV 12, 811.43, so value added is 51, 434 dollars
 - says net gain of this
 - ISSUE: Was income realized in 1933 when the lessor regained control of the land?
 YES
 - Income upon termination of the lease
 - definition of GI in §22(a)-gain may occur as a result of exchange in property, payment of debt, release of liability, etc. (doesn't have to be cash from sale of asset); don't have to be able to sever/same as exchange of property
 - amount realized(total sale proceeds)-adjusted basis
 - If we tax in 1933, increase its basis by 50,000
 - whenever you include property value in income, the adjusted basis goes up**
 - GI-rent § 61(a)(5)
 - Taxable income=GI-deductions (cost of producing income)
 - Lease→ GI=Rent, but building value will decline and TP can subtract depreciation
 - If you don't tax in 1933, no tax paid investment so no adjustment to basis and no depreciation on the building (DIFFERENCE IS ONLY IN TIMING, not tax forgiveness)
- § 1019

Congress Response to Bruun: §109→gross income does not include income derived on termination of a lease representing the value of property due to improvements or buildings erected (pay tax on gain because basis in building stays the same)

- Congress is saying, yes there is realization, yes we have power to tax, but we decline
- why? Probably TP would have cash at time of sale but not at termination of lease

Basis-Like Kind exchanges

-requirements for tax deferral:

1. exchange
2. Trade or business investment
3. solely
4. like kind
5. trade or business investment

-Basis of the Property Received=Basis of property given up-cash received + recognized gain-recognized loss

-Recognition vs. Realization→ very different tax consequences

-general rule→ § 1001(c)

exception→ §1031

Why did Congress enact this policy?

- liquidity (you can sell stocks to make money to pay taxes and a few shares, but this is harder with land)
- also if wealthy investors don't have to pay taxes on stocks and can keep switching
- and not easy to compare stocks (not like kind)

Policy behind § 1031→

1. administrative convenience (valuation concerns)
2. TP compliance (liquidity concern)
3. Horizontal Equity (compare continued ownership of property with exchange for very similar property)
4. Economic Neutrality-capital lock in problem (to switch, realized gain goes down, TP won't switch because has less to invest)

Exceptions with § 1031-inventory (no problem with valuation, liquidity, capital lock in, objective not to hold for LT) and stocks

Realized Gain/Loss=amount realized (\$ rec'd +FMV of property)-adjusted basis of property sold

-issue of like kind→ RE for RE is always like kind, RE for property is probably never like kind, personalty for personalty→factual evaluation of nature and risk of investment

-gain, if any, shall be recognized not in excess of FMV of other property (§ 1031b)

tax-gain but not to exceed the boot

-grant tax deferral because you kept it in and when you withdrawal (with the boot), only tax gain.

-To figure out adjusted basis of new property when boot is included, add up total adjusted basis (basis of property given up –money received + recognized gain – recognized loss

§ 1031(d)→ if more than one property or item, boot gets a FMV basis

-§ 1031-nonrecognition of losses because TP could respond by deferring realization of gains and accelerating realizing losses, so if boot is involved, tax boot if gain but don't deduct for loss (if you want your deduction, sell for cash and don't exchange)

-message: if property has declined in value, don't do an exchanged

E. NONRECOGNITION EXCHANGES

Like Kind

Alderson v. Commissioner

- A and O enter into an agreement, sell BP to A for 172,000, 17,205 in escrow; later found farm land they wanted in exchange for EP; Amended escrow saying land could be exchanged for BP in lieu of original agreement and if not effective by 9/11, original agreement would go forward.
- provided a payment of 190K to property, remaining would be deposited with Orange, Salinas title could decree to Alloy to record deed
- Alloy letter to petitioners→agreements summarize for exchange of property, Alloy would deposit money for EP with Salinas, all transferred to each through Salinas title
- Petitioners-10,000 real estate commissions, 471,80 fees
- Alloy-106.38 escrow charges
- commissioner says this is a sale, LT capital gain, tax court upheld
- ISSUE: Is the transactions whereby TP transferred on parcel of realty and another a sale whereby the gain is recognizable under § 1001 (c) or a nontaxable exchange under § 1031?
 - NONTAXABLE
- No intent of petitioners to purchase property except to exchange money; money deposited by Alloy was his property in his behalf
- no obligation of Alloy to pay cash for property; liability to pay cash never matured
- agreement for money never came into being; what actually took place was exchange of deeds

Revenue Ruling 79-143

- TP bought \$20 gold coins and they appreciated
- she exchanged for African gold coins=FMV
- gain was realized
- “like kind”-nature/character of property; not characteristics
- one kind or class cannot be exchanged for another (ex: different sex of livestock/different types of investment)
- coins are different types of investment (SA→bullion type-only based on metal content v. American→numismatic-type-value based on age, number, history, art, condition, metal content)

John Marsh Co. v. Commissioner

- TP gave two parcels in Boston with Department Store in exchange for 2.3 million in cash (FMV) and received back lease for 30 years, option to renew, not connected to vendor
- TP Claimed sale, adjusted basis-cash deduction
- commissioner said disallowed and under § 1031, it was exchange of like kind property
 - exchange of fee interest (lease for thirty years)
 - Congress' intent→ TP have paper gain still tied to an investment (shouldn't equal losses either if mere change in form of ownership)
- HOLDING: IT can be deducted because: more than change in form of ownership but rather change in quantum; it was a sale (RE had to be liquidated) Finally closed out a losing venture; ordinary usage of the term exchange doesn't fit (this as cash for property/the sale and lease were separate)

2. Non-recognition on Dispositions for Cash

a. involuntary conversions

-example: condemnation

§1033→ similar or related in service or use/property qualified for reinvestment

§ 1033→ allows reinvestment if property is compulsorily or involuntarily converted into similar property with no gain recognized

-if it is converted into money or not similar property, gain recognized

unless the money is used to replace the property similar or related in service or use or buys stock in corporation owning other property, then can recognize gain only to the extent that the amount realized exceeds the cost of the other property

b. principal residences

Until 1997→ § 1034-if you buy a new principal residence within two years of the sale of the old residence, nonrecognized gain.

-problem with this: left tax on people selling and then buying a less expensive replacement home/older people, etc.

-Congress provided limited exception to TP selling home after 55 (§ 121) that could be taken once in a lifetime up to \$125,000

-1997→ § 121 was expanded, §1034 was repealed

§ 121-doubles dollar limits on amount excludable, eliminated 55 age requirement and made it available once every two years (calculating capital gain from the sale of principal residence is complex and excluding gains below a high threshold would eliminate this for most people)

§ 121→"gross income shall not include gain from the sale or exchange of property if, during the five year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer's principal residence for periods aggregating two years or more" (subject to certain limitations)

-up to 250K, 500K for joint returns

-only to one sale every two years

-this also applies if the reason is for change of employment, health, regulations, unforeseen circumstances, then it does apply

§ 1033 vs. § 1031→ § 1033-"similar in service or use" whereas § 1031-"like kind" (always RE for RE)—functional equivalent??

Mortgage Participation Exchanges

Cottage Savings v. Commissioner

-Cottage Savings-S&L association, held many long term low interest mortgages, declined in value when IR went up

-regulated by FHLBB, would have benefited by selling mortgages to realize loss but accounting regulations required them to record losses on books which would have placed risk of closure

-FHLBB in response said you don't have to report losses with mortgages exchanged for substantially identical mortgages held by other lenders

-traded 252 90% participation interests in 252 mortgages to four S and Ls and purchased 305 mortgages, all single family homes, most in Cincinnati

FMV=4 million each

Face value=6.9 million

-deducted 2.4 million on return (face value sold-FMV rec'd), commissioner disallowed, tax court reversed, ct of appeals reversed and said losses realized but not actually sustained during that year

ISSUE: was the exchange of mortgages entitled to a loss deduction?

YES

-§ 1001-real property must be realized

-gain or loss=amt realized-adjusted basis (administrative convenience)

- Commissioner says no sale; exchange was not disposition of property because the items were not materially different

-Cottage savings: any exchange of property is other disposition and interests were materially different

-Congress property intended this language

-issue: what constitutes a material difference?

-commissioner-economic substance

-court-less demanding test

Eisner v. Macomber-exchangeable value/different rights and powers

-material different if the possessors enjoy legal entitlements different in kind or extent (ex: different stocks in different corporations)

-here, different legal entitlements

-IRS: Substance over form

TP: exchange=sale and purchase

-Bruun-realization

-realization if property taken is materially different than property given up

-SC-material difference standard-legal entitlements different in kind or extent

-authority for this→ precedent and § 1031 (nonrecognition provision)

-why is this drawn from precedent when dealing solely with statute?

-gains derived from dealings in property

-gains=sale or other disposition

-what is taxable other disposition? No definition

-why? Eisner v. Macomber, realization doctrine

-Congress doesn't have power to say what is other disposition

-case law on realization and because Congress had no authority, because constitutional issues are for the court to decide

-Congress didn't have to enact § 1031 if it didn't have power to tax anyway so it would be surplusage (if commissioner's test was adopted, you wouldn't need § 1031)

-reaffirms Bruun but with one imposition

-realization is founded on administrative convenience (SC basically saying that they wouldn't insist on realization for the constitution)

-Brandeis dissent in Eisner?

-§ 267 (a)(1)-no deduction allowed from loss in property when sold to family member

§ 267-loss disallowance

-message of § 267(a)(1) and § 267(d)→ if property continues to decline in value, loss is disallowed and gone forever but if value goes up, you can claim the loss if the property recovers its value

- if you are in between and your loss is 30 dollars a share, brother gains 15 dollars a share, no gain or loss
- if you sell and then buy 2 days later, (within thirty days)→ loss disallowance (§ 1091)
- So wash sale disallowance is really only deferral and not just disallowance, because your basis increases so when you sell, you'll recognize less gain

Receipts Subject to Offsetting Liabilities

- borrowing funds=not income but no deduction for repayment of loan either
- borrowing proceeds are offset by liability to pay so no net gain results but what if liability is altered or terminated?

A. Cancellation of Indebtedness

United States v. Kirby Lumber

- Kirby lumber issued its own bonds worth 12K
- purchased in open market bonds at less than par, worth 137K total
- ISSUE: IS the difference taxable gain or income of Kirby Lumber for the year?
(gross income-gains or profits and income derived from any source whatever)
- If corporation purchases and retires bonds at price less than issuing price or face value, it is gain (12K indebtedness, don't pay tax at time they issue bonds, but when they buy back and don't have to pay full value, then they have to recognize the difference as income)
- no shrinkage of assets, clear gain, new money previously offset by obligation of bonds, but no longer had the obligation
 - exceptions to the rule: bankruptcy etc.
- bankruptcy→ preserve the debtor's fresh start, no income is recognized from debt discharge in bankruptcy so that a debtor coming out of bankruptcy is not burdened with an immediate tax liability
- debt discharge amount is excluded from income and applied to reduce NOL unless he elects to apply it to reduce basis in depreciable assets or inventory
- Congressional intent of deferring but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge
- insolvency exception→ enrichment rationale→income because some assets are freed from claims of all creditors (focus on debtors total financial situation→insolvency exception)
- recapture rationale→income because loan proceeds received tax free due to obligation to repay were not in fact repaid (focus on discharged loan only)
 - Congress response→codifies result in Kirby Lumber § 108(a)(1)→ not tax on discharge of indebtedness if TP is insolvent or bankrupt
- as a practical matter, the reductions in repayments usually occur when insolvent or near bankruptcy
 - under Kirby, creditors voluntary reduction generates income taxed so it doesn't help much, Treasury should back off in this case
- § 108(a) exclusion→ typically this is all tax free
- § 108(b)-reduce tax attributes (reduce amount of NOL), reduce capital loss, basis in property (decrease depreciation deduction) or higher gain on disposition in future
 - only tax deferral not tax forgiveness
- also reduces credits
- result: Congress is saying no judge made exceptions to broad scope of gross income
- But § 108 doesn't apply to Kirby Lumber because no bankruptcy/financial hardship
 - § 61 still governs

PROBLEMS: Discharge of liability only when it is first tax free, then later found we made a mistake (did TP get something tax free)

1.a. son never received anything tax free

b. when a promise is charitable → legally enforceable but B never received anything tax free
c.

d. Dispute over how much he owed → did he really get 1000 dollars of legal services? No
e.

2. scrambled way of repayment

all of these problems → no reduction or discharge of creditors claims, but rather scrambled way of repayment, satisfy discharge

David Zarin

-professional engineer, began developing casinos, occasionally stayed at resorts, hotel with construction

-line of credit increased to 200 K

-no further credit checks, comps rooms, meals, etc.

-received chips in exchange for markers, held for maximum period and redeemed with personal check

-2.5MM debt, paid in full

-compulsively gambling

-again increased credit limit without check

3.4 million markers and checks-insufficient funds

-resort filed suit, settled for 500K

-tax commissioner claims the difference between 3 mill and 500K is income because it is forgiveness of indebtedness

-not all discharges are for indebtedness

-gain → freeing assets that otherwise would be used to pay

-TP → no gain because only chips, gave oppty to gamble, temporarily received it, destined to lose, overall loss

-holding: gain at time he incurred his debt and promised to repay value prevented taxing at that time

-§ 61 (a)(12) applies (obligation forgiven)

-legal enforceability of obligation to pay is not determinative of whether the money is taxable

-all events test-don't need legal liability

§ 165(d)-losses from gambling only allowed to extent of gains, no definition of gains

-losses in 1980/gains occurred in 1981, so separate and a party from losses

-TP says purchase price adjustment (chips not negotiable property, can't use outside casino)

-commissioner-received case in return for debt

§ 108(e)(5)-inapplicable because of a purchaser of property to the seller which arose out of purchase of such property, TP solvent, no bankruptcy, would otherwise be discharged of indebtedness income

-only intended to apply if reduction results from an agreement, no transfer of debt by seller to third party, no transfer of purchase property

-not the type of property intended (oppty to gamble is not property)

DISSENT → on benefit that would go untaxed, debt unenforceable under JN law, chips realized income to value of chips and loss in 1980 exceeded amount of income, § 108(e)(5) applies to this case

Zarin v. Commissioner-

§ 108 and § 61(a)(12) inapplicable, because debt is unenforceable, it is not a debt “for which TP is liable” (applicable, because debt is unenforceable, it is not a debt “for which TP is liable” (§ 108)

- therefore no legally enforceable obligation to pay
- so not cancelled debt, but rather a disputed debt, contested liability
- settlement should equal amount debt cognizable for tax purposes
- Dissent: skipped step of giving cash, paying chips, Old Colony, assets freed in 1981 but impracticable to tax him them because no value, income should be recognized when debtor releases obligation to pay

- IRS claimed he owed 2.9MM from discharge of indebtedness under §61(a)(12)
 - don't argue § 108 because he is not insolvent
- TP argues that liability was unenforceable, so no discharge of debt that wasn't really a debt “for which TP was liable”
 - problem with this argument-would be a windfall (Glenshaw Glass)
- purchase price reduction-§ 108 (e)(5)-not really a 3.4 MM liability in the first place, 500K is actual amount of liability
 - problem with this argument-got 3.4 million worth of chips, didn't really get full value-not clear what chips are worth (This section only for bona fide disputes about value)
- problem with fairness: compare to TP1 who borrows 3.4MM from bank, pays for chips, bank later accepts 500K
 - no question about enforceability of liability with debt
 - the discharge is taxable now (same economic conditions, taxed differently)
- compare with TP2 who gets 3.4M credit on house, pays it all back (not same because less resources than Zarin/should he pay tax on 2.9MM because more enriching??)
- §165(d)→wagering losses only deducted to extent of gains from such transactions

B. Claim of Right

North American Consolidate v. Burnet

- oil land belonging to US operated by NA Oil by appointment of receiver to operate property, hold net income paid money in 1917, earned in 1916
- income earned in 1916 entered into books as income but not included in taxes, included amount in return in 1918
- other problems, deficiencies, commissioner said that income should also be taxed under amount received in 1917
- court of appeals-profits taxable as of 1917
- company should have been reported by receiver for income in 1916, if not returnable, should had been returned by company in 1916 (income accrued) and if not then in 1922
- income by receiver in 1916 not taxable→not complete control, only had part of company's property
- net profits not taxable to company as of 1916 (might never get that amount), uncertain who got money, not entitled to money until 1917
- not income in 1922→ income in 1917, entitled to it and received it (would have gotten a deduction in 1922 if income not theirs after appeal)

- enables tax payers and revenue officials to settle tax liabilities without reference to questions about whether a claim has been settled or abandoned
- spirit consistent with cash receipts and disbursements accounting (report income when received, deduct expenses when paid)

U.S. v. Lewis

- Lewis claimed over payment of 1944 tax (reported 22K as bonus but found improperly computed, should have only been 11K in 1946)
- gov't→don't recompute 1944 tax, deduct 11K loss in 1946
- court of claims-excess bonus under mistake of fact not income in 1944
- NA Oil→if TP gets money under claim of right, it is income even if later there may be a claim that he is not entitled to it
 - no exception because mistaken validity of his claim
- taxes must be paid on income received during annual accounting period
- conditional repayment of an obligation is not a loan for tax purposes
 - cash flow tax treatment (theoretical and practical reasons)

C. Embezzled Funds

James v. US

- Union official, embezzled 738K, didn't report, convicted for tax evasions, 3 years imprisonment
- Wilcox-embezzled money not taxable income under year of embezzlement under § 22(a)
- Rutkin- extorted money is taxable income under year rec'd
- Wilcox-taxable gain→1. claim of right 2. absence of definite obligation to pay; embezzlement-no claim of right, duty to repay, etc.
- Before cases→all gains, lawful and unlawful are gross income (lawful was omitted in 1916)
- examples: gains from illegal liquor, ransom, black market, etc.
- Test: actual command over property taxed (actual benefit)
- Wilcox wrongfully decided
- willfulness can't be proven for failing to include embezzled funds in gross income so conviction may not stand

McKinney v. US

- embezzled 91K in 1956, reported as miscellaneous income in 1966
- convicted in 1969, repaid,
 1. wanted a deduction under §172, net operating loss carry back, claimed he was in the trade/business of investment
- court says that as a matter of the law, embezzlement is not a trade or business (policy reasons/don't want to encourage this action)
- 2. or wanted claim of right→§ 1341
- court says issue is whether he had a claim of right
- Jones holds that embezzled money must be included in gross income whether or not he held under a claim of right
- but it is clear that an embezzler's funds are not held under a claim of right

F. Nonrecourse Borrowing

- effect of loans on TP property basis
- adjusted basis=current tax paid investment

1. gain/loss § 1001(a) → amount realized-adjusted basis
 2. other deductions
 - depreciation, loss deductions
- to make sure only taxing income (and not something already taxed)
 - adjusted basis-basis=cost (doesn't matter where the money came from, purchase money loan proceeds are included in basis)
 - subsequent loans no effect on cost unless you spend that money to make improvements
- TP-FMV of property 1.2MM, 1 MM mortgage, B wants to buy property
1. B pays 1.2M, TP pays off mortgage with 1MM
 2. B pays 200K, and assumes mortgage
- nonrecourse mortgage-lender provides money, takes security interest in property (collateral) but no personal promise, so no need for buyer to promise to pay if seller has no personal liability
- Amount realized really equals-cash+FMV of property rec'd+services+debt payment (Old Colony)
 -

Crane v. Commissioner

- husband died, owned apartment and lot subject to mortgage (255 K and interest of 7K)
- appraised at value equal to this. Agreement with mortgagee reserving money in taxes, remit net rentals to mortgagee (7 years)
- gross rentals-income, deductions for expenses paid, interest, depreciation, interest increased
- sold to third party for 3K subject to mortgage, 500 expenses
- reported taxable gain of 1250 (only property equal excess in value of building over mortgage)
- commissioner says 23K (property-physical property)
- ISSUE: how to tax a TP who acquires depreciable property subject to an unassumed mortgage, holds for a period, then sells it
- gain-excess of amount realized over adjusted basis, amount realized=sum of \$\$ +FMV of property rec'd
- adjusted basis if acquired by devise=FMV at time of disposition
- if property = equity, then the basis of her property was zero, but if it means the land and building themselves disregarding the mortgage, the basis was 262K.
- words of statute should be given ordinary meaning
 - “property”-physical thing or owners rights to that thing (not equity)
- § 113(a)(5) → value of property from devise is FMV at time of death (doesn't include liens, mortgage, etc.)
- property and equity are two different things and ideas and if Congress intends equity, it uses it expressly
- § 23-deductions for depreciation/wear and tear
 - expressly precludes equity basis, against tax depreciation, administrative difficulties
- proper basis=value of property undiminished by mortgages
- adjustments-exhaustion, wear and tear, depreciations
- amount realized=sum of \$+FMV over land mortgage and boot
- 257K

Parker v. Delaney

-TP-got property by agreement subject to defaulted mortgage, depreciation-45K, payments on mortgage-14K, TP reconveyed to mortgagee for nothing
TP said not like Crane because no boot, court rejected

Types of Debt:

1. General unsecured obligations-judgment can be levied on debtors property generally
2. secured obligations-mortgage (lender may demand security interest that enables creditor to foreclose)
3. nonrecourse obligations-secured obligation but debtors obligation personally has been avoided or eliminated
ex: inheritance, or obligation from beginning

1. Inadequately Secured Nonrecourse Debt

Commissioner v. Tufts

-TP who sold property encumbered by a nonrecourse mortgage must include the unpaid balance of the mortgage in the computation of the amount the TP realized on the sale (Crane)
ISSUE: Does the same rule apply when the unpaid amount of the nonrecourse mortgage exceeds the FMV of the property sold?

-general partnership to construct apartment building, mortgage loan agreement nonrecourse basis, later admitted other general partners

-Later sold partnership interest to unrelated third party and assumed nonrecourse mortgage
-(adjusted basis was 1.455 mill and sold for 1.4mill, each partner reported his share of loss)
-commissioner said on audit that they realized the full amount of nonrecourse obligation (gain of 400K)

§ 752-liabilities incurred in sale or exchange of a partnership interest are to be treated in the same manner as liabilities in connection with the sale or exchange of other property

§ 1001-gains and losses on sale or other disposition → amount realized-adjusted basis

amount realized-sum of any money rec'd plus FMV of property received

-what about property encumbered by nonrecourse mortgage in excess of FMV of property

-same rule applies as did with Crane

-nonrecourse mortgage is same as a true loan (nonrecourse liability is to be included in both the basis and the amount realized)

-When TP receives loan, has obligation to repay at future date, so not income, but when he fulfills the obligation, the repayment does not effect his taxes either

-able to include loan proceeds in the basis of the property, so loan is party of his cost

-no difference between recourse and nonrecourse loan because the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay

-mortgagor originally received the proceeds of the nonrecourse loan tax free on the same assumption

-value of property decreased(in which case owner would stop paying)

-would foreclose

-two step process:

1. 900 FMV-700 Adj Basis → 200K gain appreciation

2. 1M loan proceeds-900 paid back to bank → 100K income from discharge of indebtedness

- SC failed to separate these two into these parts
 - on disposition of collateral, amount realized=sales proceeds and full principal of mtg
- Congress Response to Tufts→ § 7701(g)→FMV of nonrecourse-for all income tax purposes, to determine gain/loss with respect to property→FMV cannot be less than amount of any nonrecourse indebtedness (always include the amount of nonrecourse indebtedness in amount realized)→CODIFIES Tufts

GIFTS AND KINDRED ITEMS

A. Income Interests

Irwin v. Gavit

- Brady left residue
- part in trust-Gavit gets income interest for 15 years until daughter reaches 21 and gets it and principal
- ISSUE: are the sums received by Gavit income or a gift?
- HOLDING: income, taxable, Congress intended full use and power of income
- NI=gains, profits, etc., including value of property by gift
- the provision of the act assumes a bequest is only with the corpus and not the income arising from it
- SC-exception for principal beneficiary (daughter gets benefit of § 102(a))
- buyer tax treatment→he takes basis of 30K if Gavit sells him his interest for that much and then he is only taxed on whatever payments are in excess of that
- Gavit on the other hand→ gets not basis (§1001e1)
 - tax of donee of income interest on ALL received
- daughter-take basis of FMV at time of death (100K), divide between income and principal beneficiary, if he sold for 30K, her basis is 70K

Commissioner v. Early

- TP-husband and wife, joint returns, friends of VW
- stock powers in favor of TP and wife, not shown in her federal gift tax return
- will-trust, income to physician and wife for life, remainder to donees will not about stock
- TP-owned share (intended to make gift)
- heirs challenged (undue influence, etc)
- settlement-part of stock over, destruction of stock powers, joint life interest in 32% income from trust-4K for each of first four years, 20K legal fees
- FMV-2.288 M, included in federal estate
- income from trust was as not a gift because they had the right beforehand

B. APPRECIATED PROPERTY

1. -Inter vivo gifts-§ 1015

Taft v. Bowers

- A→100 sh stock/11K
- FMV→2K, gave to B, sold for 5K
- US-B taxable on 4000 realized profits
- B→3000 (only on appreciation during her ownership)
- Entire amount of appreciation is taxable
- § 1015→purpose of Congress
- gain is not gain accruing to capital or growth but rather something of exchangeable value
- if sold first time, would have been taxed
- seen as single investment by donor

-succeeding owner takes place of predecessor

2. Property Acquired from Decedents → § 1014 and 691

-no carryover basis rule when death time transfer, §1014→basis is FMV at date of death except if the property is income in respect of a decedent (uncollected fees, wages, pension rights, interests due on a bond, stock dividends, rent due, etc.)

Gifts and Income Tax Policy

-Donee: is enriched (§ 61)

-Donor-disenriched-tax paid savings

-disenrichment or consumption or savings?

Consumption? Not material consumption but donor could have spent it before it was given away, gets certain intangible benefits

-the fact that she made the gift means she gets greater benefits from the gift

-so no disenrichment→**intangible consumption**

§ 102-gross income does not include gifts (for donee)

§ 170(a)→deduction allowed for charitable gifts (gifts to charities) and because Congress granted an express deduction for charity and not regular gifts→no deduction

Ordinary gifts not taxable by donor:

Policy points:

1. tax donee and not donor (material consumption)

2. tax both (gratification)

-Congress→ who do we tax?

-we tax the donor and not the donee

why? Practicality and administrability

Problems with 1 and 2→

1. shift from high to low tax bracket (gifts usually from elder to younger generation) and disguised consumption (they give you money, you buy a car, they drive it)

2. intangible consumption –to collect from donee, you'd have to allow deduction to donor, but don't so there is no way to tell if gift has been given, public would see as double taxation, taxes honesty, won't report

3. tax donor not donee-administrable, preserves integrity of progressive system, donor tax is proxy for donee tax

-§ 1015 donor takes donees basis (LT transfers)

NO gain or loss if you sell at any point between FMV at time of sale and cost because if you use basis for gain, you have a loss, and if you use basis for loss, you have a gain

-Why exception in §1015(a)? Disallowance for loss

-when you make a transfer, the loss is not available to anyone

-message: if you have property that has declined in value, don't give it away. Instead, sell it and give cash proceeds

-can't shift loss deductions to donee. Why? Can shift taxes on gains to lower tax bracket but can't shift taxes on loss to higher tax bracket

-appreciation is lost at time of death (takes FMV basis)

-message→wealthy people should get rid of those that have declined in value (and take loss deduction) and hold on to those that have appreciated

Why § 1014? Liquidity concerns (if taxed at time of death, may have to sell property)

-why not just grant carryover basis? Capital lock in

solution-realization at death, then older people won't hold on until death, they'd sell it

§ 1014 exacerbates capital lock in problem

C. Gratuitous Transfers Outside the Family

-1954→prizes, awards, scholarships, fellowships-statutory exclusion

§ 102 applies to transfers to employees and family

1. Prizes and Awards

Pauline C. Washburn

-phone call from radio company saying she won, sent 900 dollars, man called, asked her to be on commercial, she said no, 900 outright gift, not income

-Congress response: § 74-Gross income includes prizes and awards

Paul v. Hornung

-Sport magazine gives away Corvette to Super bowl MVP, purpose to promote magazine, issue of how to be taxed

-Petitioner says a gift, so no income under § 102, nontaxable prize/award under §74
no because not detached/disinterested generosity and § 74 eliminates awards

-It is an award under § 74, not education, artistic, scientific, civic achievement

Maurice M. Wills

-award for athlete of year (Hickcock Belt)

-claims §74(b) exemption→ trophy

Court says not different from Hornung/but trophy-not able to use, but STILL not excludable

2. Scholarship and Fellowship Grants

-Before 1954-not under § 102

1954-enacted §117→limited to tuition and related expenses

3. Commercial Compensatory Gifts

Commissioner v. Duberstein

-gift of Cadillac given from business person whose companies worked together, gave info for customers, already had two cars, donee corporation deducted as a business expense, he said it was a gift, not included in gross income

-commissioner/tax court→intended by payor to be for services rendered

Kaiser

-union strike assistance in the form of rent and food vouchers to be a gift

4. Marital Property Transfers

-Davis-property settlement with his wife

-voluntary agreement, support to wife and minor child in addition to transfer of real property in full settlement of rights to dower, etc.; half of his stock was delivered in 1955 an balance after (cost basis=75K, FMV=82K)

Issue: was the transaction taxable? If so, how much?

-economic growth of tax should be taxed but when? To TP or to wife?

-It is taxable event

-measure of taxable gain by TP

§ 1001(a), (b)

-judged marital rights to be value for which they were exchanged and the values of the two properties exchanged at arms length are presumed to be equal

-therefore, taxable to husband and market value of assets at time is her tax basis

-Transfer of appreciated property to a spouse or former spouse in exchange for the release of marital claims results in the recognition of gain to the transferor

- but these were differences between community property and separate property states because the rules didn't apply in community property states
- Congress believes inappropriate to tax transfers between spouses, so the act provides that the transfer of property to a spouse incident to a divorce is treated the same as a gift
 - gain is not recognized to transferor and transferee takes transferor's basis

Farid Es Sultaneh v. Commissioner

A transfer of corporate stock to taxpayer pursuant to an antenuptial contract upon taxpayer relinquishing her inchoate interest in property of her affianced husband, which interest greatly exceeded value of stock transferred to her, was based on sufficient consideration, and hence stock was not acquired by "gift", so as to require taxpayer to take husband's cost basis in determining taxable gain made by her on a subsequent sale of the stock.

ALIMONY

- seen as damages for failure to provide support according to marital contract
- no income on support you get from family, so this should not be taxed
- no income on support you get from family, so this should not be taxed
- it wasn't until § 71 was enacted that was a companion to §215
- § 71-GI includes amounts rec'd as alimony

Bernatschke v. US

- suit for tax refund for money paid by □ from 1956-1959
- Issue: is the money under § 72 or § 71(a)(1)
- received annuity payments of 25K a year under annuity contracts paid by her former husband, Crane, pursuant to a divorce agreement
- in general, annuities are taxable under § 72, which provides portions of amounts rec'd under an annuity to be excluded as return of capital (investment in the contract)
- these rules are not applicable to payments under an annuity contract which is includible in income of wife under §71
- § 72 says doesn't include annuity interest as includible in wife's gross income under §71
- § 71 says if wife divorced, GI includes periodic payments in discharge of a legal obligation that the husband is under incident to divorce or separation
 - purpose: allow deductions to husband, taxed to wife
- so the issue is whether the annuities were paid by virtue of an obligation to support □
- depends on substance of the transaction and true intent of the parties
- standard of living changed dramatically, no mention of alimony, he just wanted to give her part of his money
- money intended to be □ share in his estate/dower right without reference to any obligation to pay support or alimony (not based on marital obligation to support)
- annuity payments were to continue for lifetime of □ without regard to remarriage or death of ex shows not intended as alimony or discharge of obligation
- not related to husband's income and didn't change if change in income, couldn't live in same style as when she was his wife, fixed sum
- so the money was not to discharge marital obligation and is therefore not alimony under §71, so plaintiffs get deduction for the years when they applied § 71 and should have applied § 72.

Business and Investment Expenses

A. Ordinary and Necessary

Welch v. Helvering

- involuntary bankrupt, contract with Kellogg Co. to purchase grain, in order to reestablish customer relations and solidify his credit and standing, he decided to pay the debts of his old business so far as he was able over five years, commissioner said these payments were not deductible as ordinary and necessary expenses, but were rather in the nature of capital expenditures an outlay for developing good will
- § 162 allows deductions for all ordinary and necessary business expenses paid or incurred in carrying on any trade or business
- necessary (appropriate and helpful)
- ordinary means that we know from experience that payments for such a purpose are common and accepted means
- men do not ordinarily pay debts of others without legal obligation even though result might be to increase their reputation

B. Education and Training

- education of educational costs as business expenses has been dealt with by Reg. §1.162-5
- nondeductible expenditures are personal or inseparable aggregate of personal and capital
- deny deductions incurred prior to commencement

C. Public Policy Limitations

Commissioner v. Tellier

- are expenses incurred by TP in unsuccessful defense of criminal prosecution deductible under §162 which allows deduction for ordinary and necessary business expenses?
- yes
- rationale: they are business expenses and we can't make public policy exception to §162 (sources of his claims arose as a result of his ordinary business)

Raymond Mazzei

- fake money scheme, was never actually money, took theft loss
- issue can he take a theft loss? No, his acts violate public policy and just because he was victimized doesn't make it any better
- wants to allow under theft loss of § 165©(3) but for public policy considerations it is not allowed

Public Policy Disallowance→ Tellier-narrow judge made rule

Congressional response→§ 162 ©;(e);(f);(g); §289e

C. CAPITAL EXPENDITURES

§ 263 disallows new buildings, improvements, etc.

Mt. Morris Drive in Theater

- TP bought farm land to build drive in, natural draining to N land removed vegetation, increased grade, increased water flow, N filed suit, settled agreement to construct drainage system, split cost, deducted depreciation of drainage system after paid
- Commissioner disallowed depreciation deductions, saying drainage system is a permanent improvement/capital expenditure

-ISSUE: was the transaction a capital expenditure? YES
-should have done it from beginning and if he did it would have been a capital expenditure
-not an ordinary and necessary business expense b/c test is character of transaction which gives rise to the payment
6th Cir. Affirmed TC decision, added to value of petitioner's land for the use to which it was put (dissent said not permanent improvement, only did because suit and if he had damages, money would not build drain, should treat same as damages)

Commissioner v. Idaho Power

-TP-public utility/energy, used its own machine for improvements and additions, radio devices, automotive transportations, equipment, etc.
-if used in construction, TP depreciated equipment and costs to capital assets constructed but in federal income tax, deduction from GI all the years depreciation on such equipment commissioner says its nondeductible expenditure under §263(a)
-ISSUE: was the depreciation of construction equipment a nondeductible capital expenditure? YES
-when assets used to further TP's day to day business-periods of benefit=production of income (vs. when consumption of asset takes place in construction of other assets that will produce income in the future)
 -no correlation with current income, cost allocated as part of cost of acquiring
-other construction related expenses are treated as part of cost of acquisition
-compare with wages of workers, §263 excludes any amount paid for construction of permanent improvements
-§ 167 vs. §263
-if pickup truck driving around to read meters it is depreciable this year, but if it is used to make another facility lot, it is depreciable as cost on that property over many years
§ 263→ no deduction now but basis-capital expenditures increases basis in property under §1016(a)(10)

§ 167 (a)→depreciation deduction of property used in trade or business or held for production of income

 -cost of machinery, building, etc.
 -§ 1016 (a)(2)→ basis=cost of assets, adjusted downward for allowed depreciation, so issues usually of timing
-no depreciation is allowed for assets whose useful life is indefinite or unlimited (land), buildings, other improvements, tangible business equipment, etc. depreciable but for intangibles only if limited useful life that can be ascertained with reasonable certainty.
§ 197

Amortization of goodwill and other certain intangibles→allows amortization deduction with certain intangible property in connection with conduct of trade or business or production of income, by determining adjusted basis of intangible over a 15 year period, no other depreciation or amortization deduction is allowed

Rates and Methods

Straight line method-adjusted basis-salvage value spread in equal increments over useful life
Declining balance-most common-faster initial rate and applies that rate each year to remaining uncovered cost

Useful lives-

Recapture or Conversion of Depreciable Property-adjusted basis-cost-depreciation

§ 1245 the amount of this gain will be treated as ordinary income and taxed as such (gain is commonly called depreciation recapture) (but this doesn't apply to buildings and improvements)

§1250→more limited form of recapture (only recaptures additional depreciation)

Personal, Living, or Family Expenses

A. Childcare

Henry C. Smith

TP deducted childcare expenses, commissioner says not

TP says but for her leaving kids, she wouldn't work, no income to tax

Court says this is slippery slope and would lead to many different exceptions

-§ 262→childcare is a personal expense and denied under this section

-no income for wife who stays home (this shows the personal nature of it)

-common acceptance and universal experience

(ordinary→directly accompany business pursuits) vs. indirect

-“carrying on” seems to indicate advancing business, making better, etc.

-which was starting point? Kids or work?

-no Congress allows limited deduction for child care (§ 21)-30% credit for 100K or less

income and 20% for higher income, no greater than 2400 for one, 1499 for more than one

§ 129-Ees can exclude from income amounts paid by Er for dependent care assistance (see notes p. 514-515)

B. Clothing

Pevsner v. Commissioner

-manager of boutique, expected to wear those clothes, very expensive, spend 1381 to buy, 240 to maintain

-wants to deduct as ordinary business expense

court says no

§ 162 vs. §262

some expenses such as commuting and meals are essential or helpful and still disallowed under §262

-clothing is only deductible as business expense if: 1. specifically required and 2. not adaptable to general usage and 3. not worn for general usage (uniforms)

-no “carrying on problem” but § 262 applies because clothing is inherently personal, objective bright line rule because of administrative concerns

Problem Set 9

D. Travel and Entertainment

Sanitary Farms Dairy, Inc.

-dairy-deducted trip to Africa as ordinary and necessary business expense, couldn't have obtained same amount of advertising for same money in normal manner, enjoyment of work doesn't make it personal

John D. Moss

- law firm, lunches, last minute planning, meet everyday to discuss business matters, sometimes ate, law firm paid for meals
- most convenient and practical time
- deducted under § 162
- court says no, can't deduct because must show it is different or in excess of what TP would normally spend in order for a personal living expense under § 162, daily meals are inherently personal expense, compare to atty who spends all day at work and gives up in noon hour, doesn't make meal deductible
- compares to commuting and even though it contributes to success, still personal and not deductible
- not educational

Moss v. Commissioner

- partner deducted his share
- result of disallowing would excessively tax people who spend more
- won't pay for meal if not business
- should pay tax on fair value to him (theoretically) but this isn't worth the cost
- TP can deduct whole price if different or excess but must show real business necessity
 - such as outside client or customer/different when all coworkers
- if large firm, monthly lunch to socialize
- but here only 8, don't need
- all a matter of degree circumstance and timing
- meal is not an organic part of the meeting

Today: § 274 → entertainment not disallowed but subject to limitations that are directly related to and not just associated with the conduct of business

G. Marital Litigation

US v. Gilmore

Are the husband's legal expenses incurred in divorce proceedings deductible since he successfully defended her claim?

§ 212-expenses incurred for the conservation of property held for the production of income
 -§ 262 limits § 212 and holds that the only kind of expenses deductible under § 212 are those that relate to a business (profit seeking purpose)

-is the litigation costs business or personal? → what does the claim arise in connection with?
 Wife's claims in stocks were not a business expense and are therefore nondeductible

Flip side of Raytheon

-if lose and pay damages (Raytheon)

-test for payor of damages-origin of claim (personal/business/investment)

Patrick

-wife sued for divorce, alleged adultery, settlement neither admitted or denied, owned a property, he gave her high securities worth her value of the stock which she transferred to him
 -no distinction here with Gilmore

Ruth K. Wild

-deductions for attorneys fees disallowed because § 212(1)→deduct expenses paid or incurred for the production or collection of income, and claims that she paid fees to seek custody, support, and property (Gilmore was claiming under § 212(2))