

## Problem Sets

### I. NON CASH RECEIPTS

#### A. In General

- Real Income is real goods and services consumed, or accumulated rights to such goods and services, whether they are purchased w/ money or received in kind.

#### 1. Old Colony Trust

- Does the payment of an employee's income taxes, by the employer constitute additional income to the employee.
- HELD: The payment of the tax by the employer was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor.
- The discharge by a third person of an obligation to his is equivalent to receipt by the person taxed
- 61.a.1: Gross Income: Expressly included compensation for services, Gain from whatever sources received
- Economic Neutrality: Equivalent economic payments must be taxed the same.
- Receipt of a benefit is an indirect receipt of income
- Horizontal Equity: Individuals in similar circumstances should be treated the same.
- Purpose of the statute prevails over common usage
- 

#### Policy Implications:

- Policy Implications: If result had been reversed, only the wealthy would have benefitted, resulted in higher tax burden for low income people. Employee could reduce their tax bracket and burden.
- 275 v. 164: Contradictory Rules
- According to OCT, an employers payment of an employees state income taxes would be included in federal taxable income to the employee.

#### 2. Benaglia

- Rooms and meals furnished by the employer (Hawaiian Hotel)
- Should rooms and meals be considered as income and be subject to tax?
- Or, were the rooms and meals supplied as a convenience to the employer?
- HELD: Rooms were not compensation, necessary for employee to perform his job as hotel manager.

- 'Convenience of the employer' means: Not just helpful, but absolutely necessary, business necessity.
- The value of meals and lodging is not income to the employee, even though it may relieve him of an expense which he would otherwise bear.
- The advantage to the employee was merely an incident of the performance of his duty
- Must be careful of taxing employee on value of rooms to someone else - may not value them the same.
- DISSENT: Argues this constitutes compensation in exchange for services.
- Living quarters and meals are expenses he would otherwise have had to pay for himself.
- Should focus on benefit to employee, not just employer's standard
- This creates a tax advantage for hotels - provide at lower prices b/c they 'pay' employees less

### 3. Turner

- P won cruise tickets and exchanged them for boat tickets
- IRS claims tax of retail value, TP claims value to him
- Ct averages the two.
- What would be the right amount? If TP could sell them, what would be their FMV?
- Ct adopts Benaglia dissent, what is the value to him

### 4. Haverly

- P received books, donated them to charity, and took a deduction
- Held: When a tax deduction is taken for the donation of unsolicited samples the value of the samples received must be included in the TP' Gross Income.
- SEE 170: Value at time of contribution
- Receipt of books was an accession to wealth, TP recognized the value when he donated them and took a deduction
- TP doesn't have to claim the income, but if he takes a deduction, he must have income he's deducting from
- Otherwise, TP would have double tax benefits
- Section 61: GI encompasses all accessions to wealth, clearly realized

## B. Specific Statutes

### 1. Meals and Lodging

- 119: Codifies the rule in Benaglia

- 2. Kowalski (61, 119, 120)
  - Q: Whether cash payments to police, as a meal allowance, are included in GI under 61.a or are excludable under 119?
  - HELD: The payments are GI b/c they are accessions to wealth, clearly realized, that TP has complete dominion.
  - 119 is only for meals, not for cash: see language: "meals furnished"
  - Only non taxable if employee was REQUIRED to accept meals as a condition of employment (Benaglia)
  - Disregard convenience of employer doctrine
  - Convenience of employer is only for necessity
  - Convenience of employer test should only be applied in cases in which the compensatory character of benefits is not otherwise determinable.
  - In the absence of a specific exemption, TP's meal payments are income w/in meaning of 61, b/c like the pmt in Glenshaw Glass, they are accessions to wealth, clearly realized, and over which the TP has complete control
  
- 3. Sibla (162, 119)
  - Firemen - required to pay \$ and eat at work
  - TP deducted these payments from GI, claimed as an ordinary and necessary business expense under 162.a
  - Concurrence would have allowed the deduction under 119, NOT 162
  - These payments are excludable under both
  - That which may be a personal expense, when required by the employer, becomes a business expense
  - Held excludable under 119 if 4 conditions exist:
    1. Meals are furnished by the employer.
    2. There is a charge for the meal which must be paid irrespective of how much he eats
    3. The meals are furnished for the convenience of employer
    4. The charge equals the value of the meals
  - Distinguishable from Kowalski: employee does not have complete dominion.

## C. Fringe Benefits

### 1. Statutes

- §132, 117.d
- Excluded fringe benefits are those that fall into one of five categories:
  1. A no additional cost service

- 2. A qualified employee discount
- 3. A working condition fringe
- 4. A de minimis fringe
- 5. A qualified tuition reduction
- Exclusion applies only if benefits are provided to all employees, not just high paid execs

#### D. Imputed Income

1. Owner-Occupied Housing
  - If owner moves into house, previously rented out, the imputed rental value is not included in taxable income
2. Household Services
  - Performance of services w/ in the home: care of the home, preparation of meals, care of the children
  - Difficulties in valuation would interpose an insuperable obstacle to any direct inclusion of such items in taxable income
3. Leisure
  - Non taxable, obviously
4. Borderlines
  - What if I do my neighbors laundry and she cooks my food?
  - Technically, each has performed compensated services for the other, and is taxable on the value of what is received in kind.
  - Benefits derived from organized barter clubs are taxable
  - What if the benefits are performed in different years?
5. Taxing Employers in Lieu of Employees
  - Should the question of what constitutes wages subject to withholding be any different from what constitutes income to the employee?

## II. COMPENSATION FOR LOSSES AND RETURN OF CAPITAL

### A. Damage Payments

1. Clark (1211.b, 6013.b)
  - TP advised by a tax preparer - received bad advice
  - Preparer screwed up and failed to save TP money
  - Settled w/ TP and paid TP the difference of what he should have saved

- IRS claims this is taxable based on OCT
- TP claims not taxable b/c it is compensation for damage or loss, not income
- 3<sup>rd</sup> party payment of liability is enrichment unless it's the 3<sup>rd</sup> party's fault.
- Tax council CAUSED the tax liability, TP is not enriched, just put back where he should have been.

## 2. Raytheon

- Q: Whether an amount received in compromise settlement of a suit for damages is taxable?
- Damages which represent reimbursement for lost profits are income
- IN LIEU OF WHAT WERE THE DAMAGES RECEIVED?
- Compensation for the loss of good will in excess of its cost is income
- Ct claims the cost of the good will was 0, so anything received above that is taxable.
- In the absence of the basis of the business and good will, the amount of any nontaxable capital recovery cannot be ascertained. There is no cost, so all is gain
- Burden: 7491: TP has burden of production, but if TP introduces credible evidence, then the burden of proof shifts to the commissioner

## 3. Glenshaw Glass (61)

- When Congress enacted statute (61) it intended to use the full measure of their taxing power.
- Can punitive damages be taxed?
- Undeniable accession to wealth
- Windfall, MANNA FROM HEAVEN
- Gain ... from whatever source derived

## B. Previously Deducted Losses

### 1. Sanford & Brooks (441, 172,

- TP had business losses for 3 years and took deductions as net operating loss
- TP sued b/c of a bad deal and received \$ settlement, (arguable the price he should have been paid for the contract)
- TP was taxed on this settlement
- Ct App held that it wouldn't be taxable if he re-filed his old returns w/out taking the deductions.

- However SC held that the full amount was taxable.
- We must look at the amount received in the accounting period, not by the transaction.
- TP had to pay tax on a break even transaction - Congress meant to screw you.
- 441.a: Taxable income shall be computed on TP's taxable year, not on the basis of contract or transaction
- In this context 441 is unconstitutional.
- Under Raytheon, these damages were substitute income and would be fully taxable.
- 172 would now solve: Allow TP to carry forward the loss deductions to a year where he has income to offset.

2. Dobson (1001.a, 1016.a.1, 165.a,c,

- Tax Benefit Rule
- Inclusionary side of the Tax Benefit Rule:
  - › You took deduction b/c you qualified
  - › Subsequent events show you weren't dis-enriched
  - › Instead of going back, we fix it now
  - › Inclusion of income to offset and solve prior erroneous deduction - error correction device.
- 

C. Personal Injuries or Sickness

1. Settlements (104.a.2

2. Nonphysical Injuries and Nonphysical Sickness

- 104.a.2 only applies to physical injuries or sickness
- 

3. Rev Ruling 74-77

4. Punitive Damages

5. Compensation by Insurance

6. Compensation by Employers

D. Deducting Extraordinary Medical Expenses (213

- TP allowed deduction for medical expenses if there is no compensation

1. Ochs (213, 262

5 Ways of viewing this:

- 1. Direct v. Indirect Test
  - Are we treating it directly? No, here treating indirectly by sending

off the kids.

However, Old Colony Trust says that one step transaction must be treated the same as two step transaction. This is just a form-al distinction. Doesn't really examine issue.

- 2. Necessity
  - Is this under doctor's orders? Ochs dissent. However, if coverage depends on doctor's orders, = shopping around for a compliant doctor. 213(d)(1)(c): Long term care services
- 3. "But For" Causation
  - Would never have done it under ordinary circumstances. Only did it b/c they need it.
  - But/for the medical condition they would never have done this. (Ochs Dissent)
- 4. Custom or Convention
  - Boarding school is almost always a personal consumption cost and this is what Congress was considering under 262 and b/c it's conventionally a personal cost, for consistency, always treat it that way. (Majority) It's personal consumption in generality
- 5. Sort out Relative costs related to necessity v. personal consumption.
  - Sort out relative benefits/effects. Allocation of expense. How much is really related to attempt to mitigate/cure condition. If they're already out of the house for 6 hrs/day, what does it cost for the rest of the day. The education is for benefits for kids, only food and shelter (boarding) is for benefit of mom.
- HELD: Expenses were a non deductible family expense w/in the meaning of 262, rather than medical expenses. Money was only spent indirectly on medical expenses.
- DISSENT: Havey Test: Test for 213 Applicability
  1. Motive
  2. Doctor's Advice
  3. Relation between illness and treatment
  4. Proximity in time of treatment to illness
- 
- 2. Employee Health and Medical Plan (104, 105, 106, 213
  - When employer provides hc/ins, you're better off/enriched by the fact that employer pays this.
  - If employer hadn't paid, you would have to pay ==>Old Colony
  - Employer pays \$ directly to the insurance co, instead of paying you more and you paying insurance.
  - Economic neutrality requires that one step transaction be treated the same as the financial equivalent two step transaction.
  - 106: Yes, its enrichment, but Congress has declined to tax it.

- If employer provided group plan: Premiums are tax free under 106, Proceeds are tax free under 105.b,
- 104.a.3: Exclusion for proceeds if you pay for it yourself.
- 213.a: Only get to deduct medical costs to the extent they don't exceed 7.5% of GI
- Wage Replacement, other coverage by employer, taxable under 105.a
- For sick pay, proceeds taxed under 105.a, premiums are tax free
- 

## E. Annuity Contracts

### 1. Annuity Payments

#### Possibilities:

- Return of Capital Treatment
  - In place until 1934
  - Annuity payments weren't taxed until total payments received equaled what had been paid, and then any further pmts were taxed in full.
  - Return of Capital First:
    - Don't tax until all of investment has been recovered
  - Return of Capital Last:
    - Tax on gain first, The first check is taxable in full
- 3% Rule
  - Annuity pmts treated as taxable income to the extent of 3% of the investment, Any excess over 3% was treated as a return of capital
  - Made the taxable portion proportional to investment in the contract
- Exclusion ratio rule
  - 72.a, b.1, c, Reg1.72-9
- Mortality Gains and Losses
  - Profit if the annuitant lives long, loss if he dies early
  - 72.b.2, 3, 4: Increase in income taxes
- Employee annuities
  - When pmts made by employer, may not be taxable b/c of exclusion in 403 for qualified retirement plans
- Depreciation

### 2. Deferred Annuities

- Other payments were treated as reductions in investment if received prior to the starting date, and were fully taxable thereafter.

- Only taxable after all of investment had been recovered
- This was changed.

#### F. Proceeds of Life Insurance (101.a.1, 7702)

- Ideally, Tax treatment should be governed by what the \$ replaces.
- Losing source of support (spouse): should be taxable as wages
- Household service substitute: Imputed income, proceeds tax free
- However, this is impossible to implement
- 101.a: GI does not include insurance proceeds - tax nothing
- Imposes burden on payor

### III. CAPITAL APPRECIATION

#### A. Unrealized Gains

##### 1. Eisner v. Macomber (305, 307)

- HELD: must have realization of a gain as a precondition to taxation
- After a stock split, are new shares income?
- IRS argues that statute expressly includes stock dividends
- TP claims that it just dilutes the value of the shares - no enrichment
- Pitney Syllogism: Income means gain derived from capital
- Pitney: SH derives nothing from corporation via stock dividend.
- Must look to substance over form.
- SH derived nothing from spit, If he derives nothing, TP receives no income.
- Stock Dividend is Not income
- A Cash dividend would be taxable b/c its realized there and separate from the risk of the underlying stock investment

#### B. The Value of Money

##### 1. Interest

- The value of deferral is a matter of interest
- Interest earned on deferred taxes may itself be subject to income tax

##### 2. Present Discounted Value

- Rule of 72: Money invested at x percent compound interest will double in  $72/x$  years

3. After Tax Returns
4. Effective Tax Rates
5. Tax Deferral as a Source of Capital
6. Fruits and Trees

#### C. Interest and Bond Discount

1. Constructive Receipt and Original Issue Discount
2. Market Discount
3. Bonds Issued for Property

#### D. Realization

1. Bruun - Leasehold Improvements
  - T improves land, defaults on lease, transfer back to LL
  - Are the improvements taxable to LL upon default?
  - Held: Improvement is taxable upon transfer. Gain is realized when LL retains possession of the land.
  - Realization of gain need not be in cash derived from the sale of an asset.
  - The fact that the gain is a portion of the value of property received by the TP in the transaction does not negative its realization
  - Severability is not necessary to recognition of taxable gain
  - If LL isn't taxed, won't be able to depreciate bldg. His basis won't go up and every penny of rent received will be taxable b/c no offsetting depreciation.

#### E. Non-recognition Exchanges

##### i. Like Kind Exchanges

1. Alderson (1001.c vs. 1031)
  - Whether the transactions whereby TP transferred one parcel of realty and acquired another constituted a sale, the gain from which is recognizable under 1001.c or a nontaxable exchangeable w/in the meaning of 1031.
  - Held that all acts of P were w/ the intention of an exchange, held to be like kind exchange

- Note: Gain on a like kind exchange is realized in an amount equal to the excess of the value of property received over the basis of the property transferred (1001.a,b) 1031 only provides that the gain shall not be recognized.

2. Rev Ruling 79-143

3. Jordan Marsh Co

ii. Non-recognition on Dispositions for Cash

- Page 278

F. Mortgage Participation Exchanges

1. Cottage Savings

- Mortgage co's swapped bad mortgages and reflected a loss
- An exchange of property gives rise to a realization event under 1001.a only if the properties exchanged are "materially different"
- Define materially different as respective possessors enjoy legal entitlements that are different in kind or extent.
- 1001.c: Gain shall be recognized unless a non-recognition provision applies.
- 1031.a.1: Like Kind exception, doesn't apply. If Congress had intended that it be exempt, it wouldn't have enacted non-recognition provisions.
- Held: The mortgages are materially different b/c they embody legally distinct entitlements (different owners, loaners, etc.)
- Thus, this is a realization event, and a loss deduction is allowed

#### IV. RECEIPTS SUBJECT TO OFFSETTING LIABILITIES

A. Cancellation of Indebtedness

1. Kirby Lumber

- Discharge from Indebtedness.
- Loan proceeds are not taxable, but if you pay off the loan, bond, etc at a lower price, the difference is gain to you and thus taxable
- Result is codified in 61.a.12
- Insolvency Exception: If debtor (issuer) is insolvent both before and after the repurchase, there is no income
- Enrichment rationale: You have income from discharge b/ you have enrichment.
- Recapture Rationale: To the extent you don't repay, you don't get

the exception and must be taxed. Prior loan tax treatment was therefore incorrect to the extent. NO insolvency exception under this rationale

- 108a.1: GI doesn't include indebtedness discharged if insolvent
- However, if you're insolvent before, and not afterward, only taxable to extent you are rendered solvent. (Lakeland Grocery)

## 2. Bankruptcy Tax Act of 1980

### 3. Zarin (108.d, e, 165.d

- Gambler - held to be discharge
- TP argues that the reduction of the debt was a purchase price adjustment under 108.e.5, however, there are 3 conditions:
  1. Debt must be that of a purchaser of property to the seller which arose out of the purchase of such property
  2. TP must be solvent and not in bankruptcy when the debt reduction occurs.
  3. Debt reduction would otherwise have resulted in discharge of indebtedness.

•

## B. Claim of Right

### 1. North American Oil Consolidated v. Burnet (446, 451

- If a TP receives earnings under a claim of right and w/out restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed and he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.
- The fact that there is a possibility you could lose, does not defer income. There is no reciprocal obligation to repay at time of receipt.
- Only contingent obligation to repay
- If you have to pay it back, take a deduction then, no deferral now

### 2. US v. Lewis

- Claim of right Doctrine
- TP is paid a bonus, but paid too much and forced to repay part
- Problem: When TP repaid and took the deduction, the interest rates had decrease, and amount of tax paid is much greater than deduction now given.
- Congress solved - 1341.a: Tax paid will be lower amount

## C. Embezzled Funds

### 1. James v. US

- Does an embezzler have an unconditional obligation to repay the full amount of embezzled funds?
- Held: Embezzled funds are not treated as a loan and are taxable
- Problem: No likelihood of repayment if lender doesn't know about the loan
- Problem: It's enrichment and should be taxed, not fair to let criminal enrichment be tax free.
- If caught and paid back, they'll receive a deduction under claim of right doctrine

### 2. McKinney v. US (1341, 172

- TP embezzles but pays taxes, caught and repaid and claims a deduction
- However, rate change and deduction doesn't fully offset taxes paid.
- TP claims relief under 1341, however, under this, TP must have unrestricted right to the item.
- TP's income isn't enough for deductions to offset
- TP looks to 172 for net operating loss so he can take the excess deduction and offset prior years.
- However, under 172, TP must prove he was in the trade or business of embezzling.

### D. Non-Recourse Borrowing (1016,

- Purchase money loans factored into basis, subsequent borrowing against property doesn't effect the basis.
- If buyer assumes a mortgage, there is value obtained. Economically equivalent transactions must be taxed the same.
- OCT: Indirectly received principal balance

### 1. Crane

- How does a TP, who acquires depreciable property subject to an unassumed mortgage, holds it and then sells it still encumbered, compute the taxable gain?
- The proper basis (113.a.5) is the value of the property, undiminished by the mortgage.
- Where the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage.
- Buyer will become responsible for the mortgage on the property as part of the purchase transaction. When the seller transfers the property to the buyer, the latter either expressly assumes the debt

or takes the property subject to the debt. The buyer will pay the seller the "equity" in the property -> the difference between the property's fmV and the debt.

- When the amount of the mortgage is less than the fmV of the property, the seller's amount realized includes the debt assumed, regardless of the nature of the mortgage as recourse or nonrecourse.
- The Seller's amount realized will be the amount of money received, the fmV of any property received, and the debt assumed by the buyer.
- Buyer will assume in basis the amount of debt assumed plus the amount of money and the fmV of property paid to seller

## 2. Parker v. Delaney

### i. Inadequately secured Non-Recourse Debt

#### 1. Tufts (7701.g)

- When non recourse mortgage exceeds fmV of property
- B/c the lender bears the risk of a fall in value of property for a nonrecourse mortgage, a buyer might well purchase a property subject to a nonrecourse mortgage w/ a face amount greater than the fmV of the property
- TP (seller) must include in his amount realized the debt assumed. Realized gain on sale = difference between debt and adjusted basis
- TP's tax free receipt of the loan proceeds and the inclusion of those proceeds in the basis of the mortgaged property requires consistent treatment upon sale of the property.
- Congress's response to Tufts: 7701.g: clarification of fmV in case of non recourse indebtedness: fmV shall be treated as not less than the amount of any nonrecourse indebtedness.

#### 2. Rev Ruling 91-31

## V. GIFTS AND KINDRED ITEMS

-congress has always taxed the donor, not the donee, preserve integrity of progressive tax

### A. Income Interests

#### 1. Irwin v. Gavitt (102)

- Whether the sums received thru inheritance were income and taxable
- The money was income in the hands of the trustees and we know of nothing in the law that prevented its being paid and received as

- income by the donee.
- Codified in 102.b.2
- Eisner & Macomber; Income is gain from whatever source derived

## 2. Early

- 273: Pay tax on all income received per an income interest
- Amortization and deductions only allowed if life interest is bought, not received by gift.
- If a dispute of a will is resolved in settlement, and is to resolve an underlying and disputed claim based upon a gift ... what is received in settlement must be characterized, for tax purposes, by the nature of the underlying and disputed claim resolved.

## B. Appreciated Property

### i. Inter Vivos Gifts: s1015

- If A's property appreciates and then gives it to B, A is not taxed on gain b/c A does not realize anything on the transfer (1001.b)
- B is not taxed b/c of 102

#### 1. Taft v. Bowers

- Gift of stock that has increased in value during period of donor's ownership, hasn't been taxed b/c of Eisner & Macomber - hasn't been realized.
- At time of gift, donee can claim an exclusion per 102.a
- Under Bruun: has there been a disposition of property that separated risk from investment? However, not all dispositions are taxable - must have control of the appreciation for your use and benefit.
- 1015: Donee takes donor's basis when gift received
- Then, when gain is realized, you realize the entire amount, not just donee's amount. - Tax deferral
- If basis is greater than fmv basis shall be fmv to calculate loss
- If no info available, basis shall be fmv

### ii. Property Acquired from Decedents: 1014 & 691

- Property acquired by bequest, inheritance or devise covered by 1014: Basis = fmv at date of death
- Exception to 1014: If property in question is income in respect of a decedent - uncollected amounts due to decedent.
- If capital asset is sold and pmt is not received until after death, income will be a capital gain. 691: These will be taxed when collected or dispose of

## C. Gratuitous Transfers Outside the Family

### i. Prizes and Awards

#### 1. Pauline Washburn

- TP won \$ in contest she did not sign up for.
- P had not further contact w/ payor and had no obligations.
- Held: Money was a gift and not income
- Congress reacted by passing 74: GI includes cash prizes and awards
- How would Glenshaw Glass have affected Washburn w/out 74?
- NOTE: This decision is before Glenshaw Glass

#### 2. Paul v. Hornung

- Prizes and awards are GI and taxable, exception provided in 74.b
- What constitutes as an educational, artistic, or civic achievement w/in meaning of 74.b?
- Held that football award was GI and taxable
- Taxable upon receipt - considered compensation
- What about trophies? Valuable trophies? FMV is includable in GI b/c TP could sell it if he wanted to.

### ii. Scholarships and Fellowship Grants (117)

- GI does not include any amount received as a qualified scholarship

### iii. Commercial and Compensatory Gifts

#### 1. Duberstein

- A voluntarily executed transfer of his property by one to another, w/out any consideration or compensation therefor, though a common law gift, is NOT necessarily a "gift" w/in the meaning of the statute
- Mere absence of obligation to make a pmt does not establish it is a gift. (OCT)
- What controls is the intention the pmt was made, regardless of how voluntary
- There can be no 'gift' made by a corporation, and thus no deduction
- 274: No deduction for the cost of business gifts in excess of 25\$/recipient / year

#### 2. Stanton

- Payment held excludable under SC's motivation test

- Would be overruled today by 102:
- 102 now provides that no exclusion shall be allowed for amounts paid by an employer to an employee.
- 102 supports OCT
- 

### 3. Kaiser

- Union strike assistance in the form of room rent and food was a gift
- Assistance was not confined to members
- Pmt must be made w/ intent that nothing of value be received

### 4. Rev Ruling 61-136

- Strike benefits will be regarded as gifts and will be exempt from income tax
- 

## D. Marital Property Transfers

### 1. Davis

- Property settlement incident to divorce
- H gives W stock, which has appreciated in value - 7K untaxed appreciation, b/c not yet realized
- Does this conveyance make W realize the gain at transfer?
- Must answer 2 questions:
  1. Was the transaction a taxable event?

In a common law state, yes, not in a community property state.

2. If so, how much taxable gain came from the transfer?
- Bruun: Other taxable dispositions, Has the owner separated his risk from the investment?
  - See also: Cottage savings: other taxable disposition
  - HELD: There is realization:
  - H no longer bears risk, transfer of stock is value of the release of W's claims against him - he has derived benefit.
  - He is effectively getting the value of release of the claim
  - If she didn't want the stock, he would have sold it to pay her - A two part transaction must be treated the same as an economically equivalent transaction
  - W does not pay tax on receipt
  - The release of marital rights in exchange for property or other consideration is not considered a taxable event as to wife.
  - W's adjusted basis will be FMV

## 2. Transfers Between Spouses or Incident to Divorce

### E. Marital Settlements

#### 1. Faird-Es-Sultaneh

- Ex wife sells stock she received under premarital agreement.
- What is the gain?
- Basis is fmV of stock at date of receipt ( as opposed to H's basis at time of transfer)
- Held: This is prepayment of liquidated damages (Davis)
- This is substitution of (advanced compensation) liquidated damages upon divorce.
- Should be governed by Raytheon
  
- 1041: Non recognition rule
- If we don't tax Davis or Kresgee on the appreciation of stock at time of transfer, then recipients basis must be carry over - tax deferral - NOT forgiveness
- 1014.b.2: In every case you get a transfer or carry over basis even if value has dropped below the original basis. NO exceptions for losses

### F. Alimony (71, 215)

- Damages for the failure to provide support according to the primary obligations of the marital contract

#### 1. Bernatschke

- Whether 71 governs the taxability of money received under annuity contracts for which consideration was paid pursuant to an agreement for divorce.

#### Periodic support payments

- Alimony is defined for tax purposes as GI of payee
- IRS can't determine whether all these payments made under the millions of decrees, was made to release an obligation. - - Unadministrable
- 71.b: Objective easily applicable bright line rules:
  - Form over Substance
  - Substance is unadministrable
  - Need objective criteria w/out reference to intent
  - Simplicity means formalism
  
- 5 Criteria for Alimony\*\*\*: Doesn't matter what you call it as long as it

meets these criteria, its alimony and deductible

## VI. BUSINESS AND INVESTMENT EXPENSES

### A. Ordinary and Necessary

#### 1. Welch v. Helvering

- Exec voluntarily repays large amounts of the discharged debts of his employer
- He had no legal obligation to do so, he claims 162 business expense
- Is this ordinary and necessary in context of 162?
- Was it essential?
- Must be ordinary: Commonness or typicality standard

### B. Public Policy Limitations

#### 1. Tellier

- Stock broker charged w/ fraud and accrues atty fees
- Is this a deductible business expense?
- Origin and character of the claim is the proper test, not the consequences to TP
- Held disallowed b/c of public policy???
- See Gilmore: The origin and character of the claim w/ respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the TP, is the controlling basic test of whether the expense was "business" or "personal" for 162.a

#### 2. Raymond Mazzei

- Although TP was defrauded and suffered a loss, the deductibility is precluded by Richey, which held that when the loss is suffered in the commission of an illegal act, it is not deductible.
- The fact that TP was victimized in the conspiracy does not make his participation any less criminal or violative of public policy
- 165 allows deduction for losses incurred in trade or business or 'any transaction entered into for profit'
- 162 has a theft loss deduction, or loss of property used in the production of a profit

### Judicial Disallowance:

Where Congress is silent as to the deductibility of an expense, only in extremely limited

circumstances will the court make exceptions. Only where the allowance of a deduction would frustrate sharply defined national or state policies, would the courts uphold disallowance.

### C. Education and Training

#### 1. Reg 1.162-5

### D. Capital Expenditures

#### 1. Mt. Morris Drive in Theater (822, 263)

- Ordinary repair (162) vs Improvement (263)
- Ordinary repairs are deductible - ordinary and necessary costs of carrying on the business
- Improvement or betterment: Expressly disallowed despite business connection.
- The drainage system was a permanent improvement and the cost was a capital expenditure
- If TP had included the expenditure in its original plans, it would have been an expense.
- The facts that payments were made in compromise of a lawsuit is not determinative of whether such payments were ordinary and necessary business expenses or capital expenses.
- The decisive test is still the character of the transaction which gives rise to the payment. The character of the expenditure is not changed simply b/c it is made at a subsequent time.
- Section 263: Disallows any deduction for capital expenditures, generally defined as "permanent improvements made to increase the value of land"
- IF an expenditure constitutes a capital expenditure, the amount expended is capitalized and is added to (or constitutes) the basis of the asset.

#### 2. Idaho Power (167, 263)

- Depreciation and other expenses associated w/ equipment used to build an asset are capital expenditures.
- 263 is a capital expenditure
- Must include it in the cost of the property constructed:
  1. Economic Neutrality: Old Colony Trust  
If Idaho paid someone else to build it, cost would include the fact that the other company's trucks are becoming less valuable. Part of the price would

include the cost of their trucks. You pay it now not deductible now. Cost of using up the machinery/equipment is an indirect cost of the assets.

2. Statutory:

Competition between express statutory deduction of 167 and an arguable express disallowance provision 263. When conflicting allowance: see 161 and 261

E. Capital Cost Recovery

i. Section 197

1. Amortization of Goodwill and Certain other Intangibles

- TP is allowed depreciation deductions for the cost of other basis of intangible property that is used in a trade or business or held for the production of income if the property has a limited useful life that may be determined w/ reasonable accuracy.
- A TP able to prove that a particular asset can be valued, and that the asset has a limited useful life which can be ascertained w/ reasonable accuracy, may depreciate the value over the useful life regardless of how much the asset appears to reflect the expectancy of continued patronage.

ii. Depreciation

1. The Straight Line Method
2. Declining Balance Methods
3. Useful Lives
4. Optional Expensing
5. Purposes
6. Acceleration
7. Economic Depreciation
8. The Investment Credit

VII. PERSONAL, LIVING OR FAMILY EXPENSES

## A. ChildCare

### 1. Henry Smith

- TP argued that childcare is a necessary 'business' expense - necessary to carry on her business under 162.a
- however, this is a personal consumption expense and non deductible under 262.

## B. Clothing

### 2. Pevsner

- Held that clothing, even if required for the job, is not a deductible expense b/c it is inherently personal under 262.
- Only allowance is for a uniform

## C. Travel and Entertainment

### 1. Sanitary Farms Dairy

### 2. John Moss

### 3. Cohan

### 4. 1962 Legislation

## D. Marital Litigation

### 1. Gilmore

- other side of Raytheon: What's the appropriate taxation of damages
- Was the origin of the claim personal or business capacity?
- 

### 2. Patrick

### 3. Hunter

### 4. Ruth Wild